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December 6, 1996

To: Members of the Executive Board

From: The Secretary

Subject: **Philippines - Staff Report for the 1996 Article IV Consultation
and Review Under the Extended Arrangement**

Attached for consideration by the Executive Directors is the staff report for the 1996 Article IV consultation with the Philippines and the review under the extended arrangement, which is proposed to be brought to the agenda for discussion on Friday, December 20, 1996. A draft decision appears on page 26.

Mr. Hicklin (ext. 37137) or Mr. Weerasinghe (ext. 38413) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Unless the Documents Preparation Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the Asian Development Bank (AsDB), the European Investment Bank (EIB), and the WTO Secretariat, following its consideration by the Executive Board.

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INTERNATIONAL MONETARY FUND

PHILIPPINES

**Staff Report for the 1996 Article IV Consultation and
Review Under the Extended Arrangement**

Prepared by the Southeast Asia and Pacific Department

(In consultation with other departments)

Approved by Kunio Saito and Joaquin Ferran

December 5, 1996

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I. Introduction and Summary

1. The Philippines' main economic challenge is to ensure that the economy remains on a path of rapid, and sustainable, growth. At the 1995 consultations, Directors noted that a significant fiscal adjustment—involving tax reform, oil deregulation and civil service reform—was a necessary condition to achieve medium-term sustainability. They also agreed it would be preferable to err on the side of caution in the conduct of monetary policy in order to reduce inflation. The progress of the economy was last discussed by Directors at the second review under the extended arrangement (7/15/96), by which time the recovery was more firmly based and inflation was on track to decline sharply in 1996.
2. Against this background, the 1996 Article IV consultation discussions focused on the authorities' plans for strengthening the macroeconomic fundamentals for sustained growth and reducing vulnerability and, in particular, on: how best to increase the savings rate, especially through a stronger revenue effort; how to reduce the vulnerability to external shocks, given the widening trade deficit; and how to maintain financial stability, including by strengthening the banking system. As the main components of the Administration's present reform agenda are nearing completion, the discussions also began to explore further structural reforms, including importantly those that would support poverty reduction.
3. The staff team¹—in meetings during September 13-26 with the Governor of Bangko Sentral ng Pilipinas, the Secretary of Finance, the Secretary of Planning and other senior officials, as well as with leaders of Congress and the private sector—supported the authorities' efforts to significantly strengthen fiscal policy, and to reduce other vulnerabilities to sustained economic recovery. Key steps to secure a tax reform package are being taken, and the authorities are maintaining a policy stance that should help maintain confidence in the ongoing expansion. The Fund-supported 1996 program² remains largely on track, although there have been delays in implementing some structural reforms. The Oil Price Stabilization Fund (OPSF) performance criterion for September was not met, and in a letter of intent, the authorities request a waiver for end-September and a modification for end-December. Based on the authorities' actions and commitments, the staff supports their request, and the report includes a proposed decision for the conclusion of the third review, due by end-December 1996.
4. The Philippines has accepted the obligations of Article VIII (Annex I) and subscribed to the Special Data Dissemination Standards (SDDS). Statistics are provided to the Fund on a generally timely basis, although difficulties in measuring the external current and financial accounts hinder analysis (Annex II); further technical assistance is planned.

¹ The team comprised Messrs. Hicklin (Head), Felman and Weerasinghe, Ms. Lim, Mr. Lall (all SEA), and Mr. Gerson (FAD), and was assisted by Mr. Nellor (Resident Representative). Mr. Singh (SEA) attended some of the meetings.

² The extended arrangement for SDR 474.5 million (75 percent of quota) was approved in June 1994. After the first purchase of SDR 36.5 million, at the request of the authorities the arrangement has been precautionary: they do not anticipate making further purchases.

II. Economic Setting

5. The Philippine economy has undergone a marked transformation in the 1990s, and sustained growth with low inflation—after two decades of economic problems—finally appears within reach. The decade did not begin in auspicious fashion. Economic growth came to a halt in 1991; the revival of growth in the late 1980s, in the aftermath of the 1983 debt crisis, proved a false start (Charts 1 and 2). In addition to political uncertainty, the unfavorable structure of the economy—predominantly protectionist—remained essentially unchanged, and excess demand pressures emerged. Swings in financial policies, together with external shocks, added to inflationary pressures.

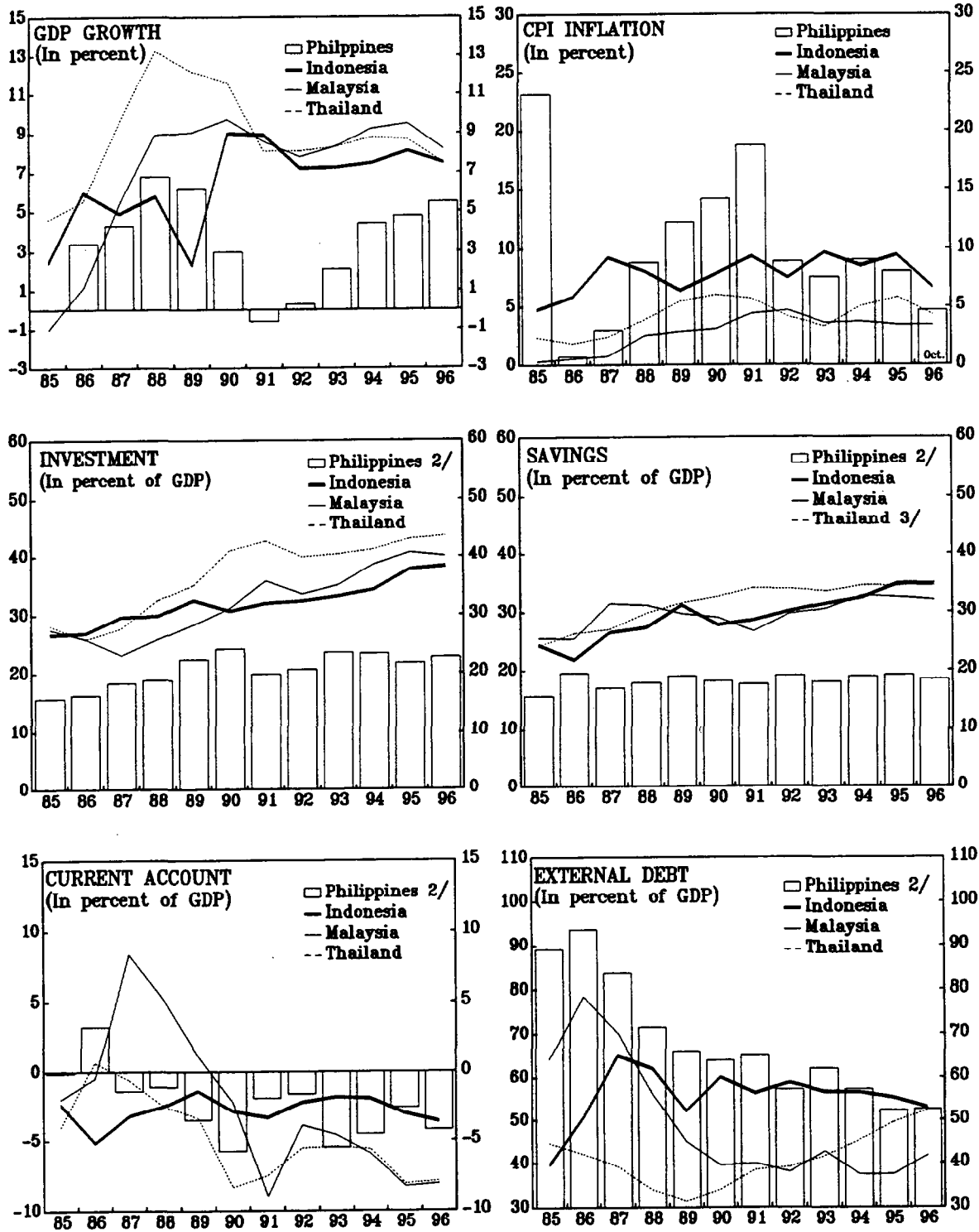
6. From a low point in 1991, GNP growth increased to 7 percent in the first half of 1996; inflation, at 20 percent in early 1991 has fallen—despite temporary setbacks—to well within single digits; and the external position has greatly improved, with reserve coverage maintained at over two and a half months of a much higher level of imports while the external debt service ratio has fallen sharply—from 37 percent in 1990 to 13 percent in 1996 (Table 3). The resurgence of confidence that has accompanied economic reform and political stability—particularly since 1992—has been reflected in sharply higher workers' remittances and capital inflows. With a restructuring of commercial bank debt in 1992, the Philippines has regained access to international capital markets on increasingly favorable terms, and in 1996 successfully exchanged a portion of its Brady bonds. The external debt burden has continued to decline—the external debt/GNP ratio fell from 65 percent in 1991 to 53 percent in 1996.

7. This steady improvement in the economy in the 1990s reflected forthright policy adjustment by the authorities, and a willingness to respond to setbacks. First, on the structural side, important sectors, such as banking and telecommunications, were liberalized and the strategy of encouraging export-oriented growth, adopted in 1986, was pursued with renewed vigor. To open up the economy, quantitative import restrictions were cut and most tariffs reduced, with a timetable introduced for further reduction. The foreign investment approval process was simplified, 100 percent foreign ownership was permitted in most sectors, and a significant privatization program was implemented. Virtually all current and capital account restrictions were removed by 1992. Industrial production remained limited by serious power shortages until the Administration in 1992 opened electricity generation to the private sector: a rapid supply response followed the restoration of power by late 1993.

8. Second, the authorities have adapted financial policies when necessary, with noticeable effect on the macroeconomic balances (Chart 3). Fiscal policy was sharply tightened from 1991, and the consolidated public sector deficit (CPSD) was reduced to broad balance by 1995 (Table 3). Privatization receipts have contributed to the improvement in the public finances, but delays in capital expenditures have also helped to meet fiscal targets. Monetary policy

PHILIPPINES

SELECTED REGIONAL COMPARISONS, 1985-96 1/



Sources: IMF: IFS and WEO databases.

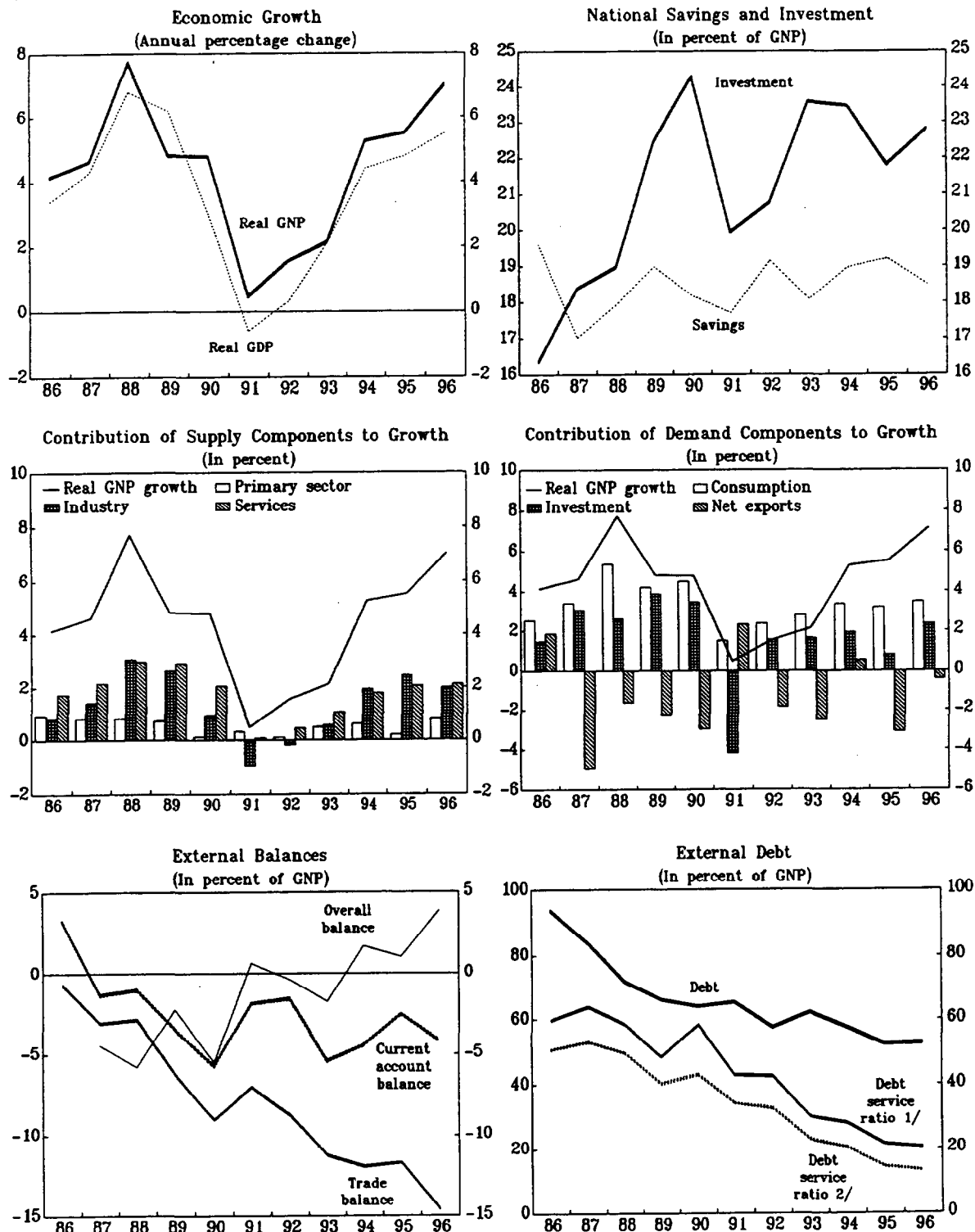
1/ Data for 1996 are projections.

2/ In percent of GNP.

3/ Excludes statistical discrepancy.

CHART 2

PHILIPPINES
SELECTED ECONOMIC INDICATORS, 1986-96

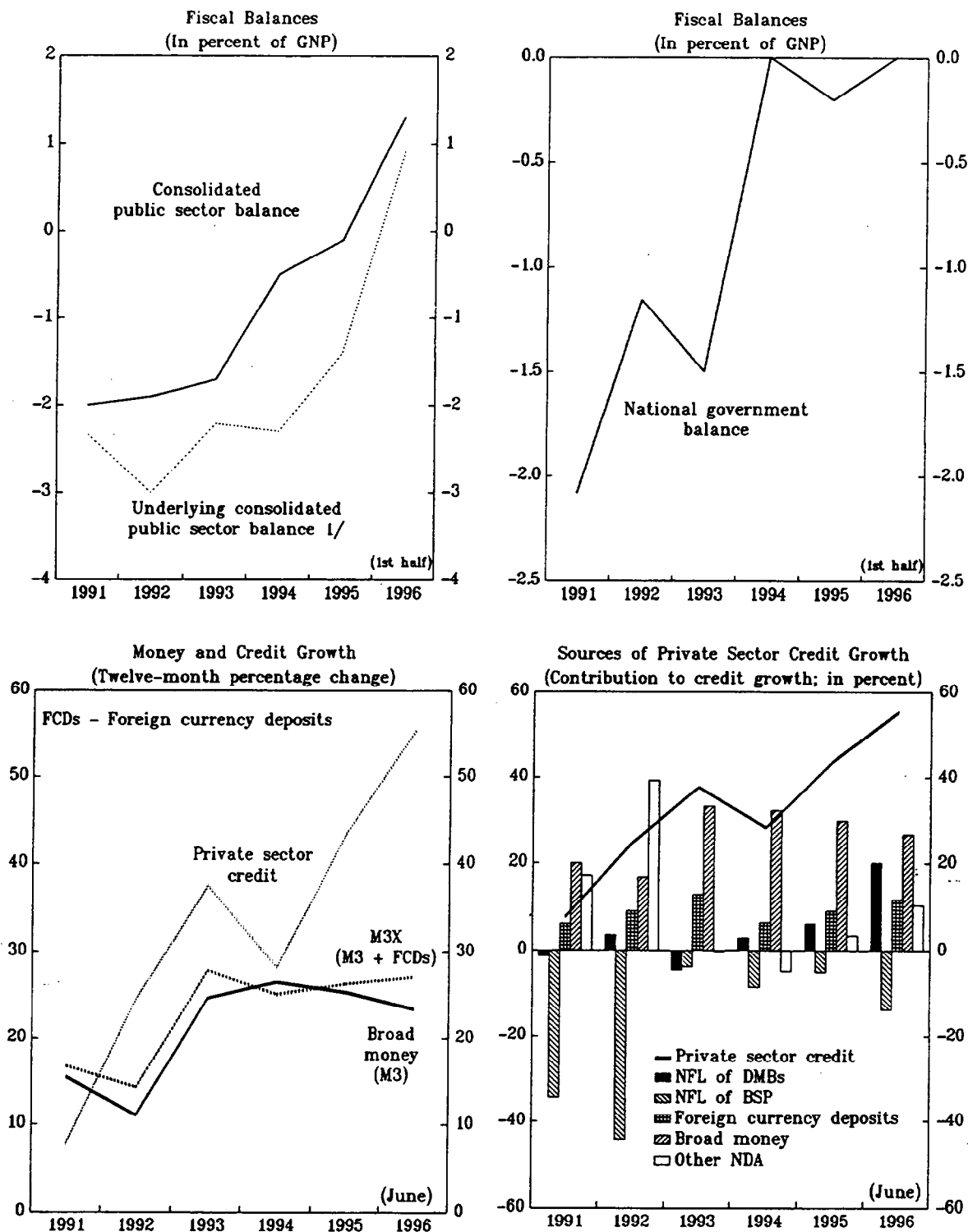


Sources: Data provided by the Philippine authorities, and Fund staff estimates.

1/ Debt service as percent of exports of goods and non-factor services.

3/ Debt service as percent of exports of goods and services.

PHILIPPINES
SELECTED FINANCIAL INDICATORS, 1991-96



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

1/ Excluding privatization revenues.

has also been tightened (Table 4), particularly so after episodes of premature easing that led to pressure on the exchange rate. Given substantial reintermediation since 1994, the monetary aggregates have become more difficult to interpret; nonetheless, monetary policy has been sufficiently tight to keep trend inflation in single digits—price increases induced by food shortages in 1995 proved temporary.

9. Despite the considerable success in turning the economy around, the authorities face several serious challenges:

- **The Philippines' low saving and investment rates need to be increased**—they are considerably below those in fast-growing ASEAN neighbors (Table 2 and Chart 1). A significant increase in the investment rate (now 23 percent) is required to enable real GDP to grow at a sustained 7 percent rate, even with an increase in total factor productivity growth. However, it would be unwise to rely further on foreign savings to finance the higher investment. Although private savings are expected to increase, the major burden will fall on public savings; without improvement, continued growth and external sustainability are in doubt. To a large extent, this challenge will involve consolidating the fiscal position by raising the revenue effort, through comprehensive tax reform.

- **The economy remains susceptible to external shocks.** The extent of external vulnerability may be judged by a number of indicators. **First is the high and widening trade deficit in 1996** (14 percent of GNP). Although the estimated current account deficit—4.2 percent of GNP in 1996—is not high by regional standards (Table 2), the figure may well be an understatement.³ **Second, there is some slowdown in export growth in 1996**, though less pronounced than in some other Asian countries. **Third, the financing of the trade deficit** by very rapid increases in workers' remittances and other services—in addition to capital inflows—is vulnerable to slowdown or even reversal, either of which would put pressure on the peso. **Fourth, although international reserves have risen, they remain relatively low by regional standards.** Among other indicators that require careful monitoring, **external debt and debt service ratios are moderate** compared to some other ASEAN economies (Table 2 and Chart 2), and the **real effective exchange rate has appreciated**, but does not appear to indicate a general loss of competitiveness (Box 1).

- **Financial stability needs to be consolidated, by bringing inflation down to lower levels and ensuring that the banking system remains sound.** The authorities adapted their monetary program to a modified form of inflation-targeting in the wake of a shift in money demand relationships from 1994: nonetheless, there remain challenges in setting

³As mentioned in previous staff reports, balance of payments statistics have become increasingly unreliable in recent years. A growing proportion of transactions is being conducted through foreign currency accounts; without being able to identify fully the sources of these inflows, the central bank classifies the residual as remittance earnings. If this is an overstatement, it would tend to understate the current account deficit (See Annex II).

Box 1. Competitiveness of Philippines Exports

With the widening trade balance deficit in the Philippines, and the slowdown of exports, concerns have been raised about the competitiveness of the Philippines export sector. Three relevant factors are: the role of the exchange rate; the importance of structural factors; and the external environment.

The exchange rate: The conventional measure of the real effective exchange rate (REER), utilizing CPI data, shows an appreciation of some 20 percent of the peso between 1990 and 1995 (Table 1). To better capture the role of costs on competitiveness, alternative measures have been constructed by replacing data for the Philippines only—trading partner data were unavailable—with Unit Labor Costs (ULC), Wholesale Price Index (WPI) and the Producer Price Index (PPI) for manufacturing. The REER appreciation using these measures is significantly lower suggesting that the conventional REER may overstate the impact on competitiveness over the five-year period. It reflects the containment of labor costs in the early 1990s.

Table 1. Philippines: Exchange Rates
(Percent change; appreciation +)

	1991	1992	1993	1994	1995	Jun. 1996	Cumulative 1990-95
REER	-0.2	11.1	-0.4	6.2	2.7	4.8	20.4
REER (ULC-based)	1.0	-9.9	4.2	5.3	4.1	...	3.9
REER (WPI-based)	-4.6	6.5	-8.3	5.2	-1.9	5.4	-3.8
REER (PPI-based)	...	...	...	1.3	-1.0	3.7	...

Sources: Data provided by Philippine authorities and staff estimates.

Structural factors: The garments sector, which comprised 15 percent of merchandise exports in 1995, has witnessed a sharp decline in exports with a first half growth of only 1 percent. The sector's competitiveness has been eroded by the loss in market share due to, *inter alia*, the frequent brownouts of 1992/93, which made supplies unreliable as well as increasing competition from lower cost producers. In addition, the sector has been affected by the imposition of import quotas, as well as other restrictions such as the ban on synthetic dyes. While the sector is restructuring itself to produce higher value-added products, the impact of these changes will only be seen with a lag of one to two years.

External Environment: The Philippines is relatively less affected than other Asian economies by an export slowdown in 1996 (Table 2). In the case of electronics exports, the sharp fall in global prices for semiconductor related products has been responsible for a slowdown in export revenue growth in the Philippines from 49 percent in 1995 to 41 percent in the first half of 1996. Intra-regional trade in Asia has increased substantially over the past two decades and almost 40 percent of the region's exports are now destined for other Asian countries.

Table 2. Philippines. Export Growth Rates
(Annual dollar value change)

	Indonesia	Malaysia	Philippines	Thailand
1991-95 (average)	18.9	20.3	16.6	19.5
1996 (estimate)	11.7	9.2*	17.0	0.5*

* Export growth rates Jan.-Aug. 1996.

Sources: WEO and staff estimates and projections.

In conclusion, the available evidence does not seem to suggest a generalized lack of competitiveness of Philippine exports, but structural factors and to a lesser extent the international environment have had an adverse impact. Policies aimed at enhancing the performance of the export sector would therefore have to aim at further productivity linked improvements and structural enhancements.

monetary policy. Moreover, the larger volume of capital inflows intermediated through banks (with liberalization and renewed confidence), increased bank competition (with the opening of new branches), and rapid private sector credit expansion (56 percent in the 12 months to August 1996), all pose great challenges for supervision.

- **The government has stressed that the benefits of economic recovery need to be shared more widely.** More than a third of the population is below the poverty line. This is more than double the poverty incidence in Indonesia, although per capita income is broadly similar. Poverty reduction has been much slower than in other ASEAN countries, reflecting weaker economic growth, and structural problems in agriculture (Box 2).

10. **These vulnerabilities reflect—as the authorities recognize—the need for the economic policy framework to be adapted to meet new challenges:**

11. **The present fiscal stance needs strengthening to ensure sustainability,** and a more demanding stance is required to increase savings. This assessment applies even though fiscal developments in recent years have been encouraging—deficits and the stock of debt have declined as a share of GNP and output growth has been strong.⁴ The present balanced fiscal position relies on favorable short-term factors and cannot be maintained without wholly undesirable cuts in development spending. The contributions from tariffs and privatization receipts are likely to fall. At the same time, most current expenditure is nondiscretionary and the national government is transferring a significant portion of resources to local governments. Moreover, the Philippines' public saving rate has been less than half the regional average, not because expenditure has been excessive but because tax collections have been low. The need for a significant fiscal consolidation is therefore clear—not only to maintain the fiscal balance with development spending intact, but also to go beyond this to generate additional national savings to support higher growth.

12. While the authorities recognize the need for fiscal reform, the political obstacles have proved strong. Although the scope for expenditure reduction is limited, one clear candidate—civil service reform—has been delayed. Since 1993, only one major revenue measure (the expanded VAT) has been implemented, which, in 1996, will generate some improvement in public saving. Real progress, though, depends on the enactment of the Comprehensive Tax Reform Package (CTRP). This series of measures aims to establish a solid revenue base for the budget, augmenting revenue initially by 3/4 percent of GNP. Moreover, it would not do this by raising tax rates, but rather by overhauling the entire tax system, to broaden its base and simplify administration.

⁴ Gerson and Nellor (1996) show that data for the last two years, including a primary fiscal surplus, are indicative that present fiscal policy is sustainable in the sense that it will allow the country to satisfy its public debt obligations. However, analysis of the stock of public debt over 1970-93 suggests that policies would not lead to the eventual repayment of public debt.

Box 2. Poverty Alleviation

The Philippines is now beginning to enjoy growth rates close to those of its fast-track ASEAN neighbors. At the same time, poverty incidence, defined as the proportion of the population living below the official poverty line, remains one of the highest in the ASEAN region while the annual rate of reduction in poverty incidence is one of the lowest. Moreover, income distribution is heavily skewed, with the richest fifth of the population earning incomes eleven times that of the poorest; this compares to less than five times in Indonesia.

Why has poverty been coming down more slowly in the Philippines compared to other ASEAN countries? Two factors are largely responsible: (i) weak economic growth that has not been sustained long enough to reduce poverty in any significant way; and (ii) problems in the agricultural sector.

First, the **overall slow pace of economic progress**, particularly in the 1980s when the Philippines was struggling under the burden of the debt crisis, while the economies of other ASEAN countries were accelerating, prevented a rapid reduction in poverty incidence. Nevertheless, even when the Philippine economy was expanding during the 1960s and 1970s, poverty reduction was modest because development policies favored large scale enterprises with capital intensive methods of production. Second, **poverty in the Philippines is largely a rural phenomenon**—although urban poverty also requires attention—and rural poverty, in turn, is rooted in problems related to the agricultural sector. In particular, the inherent structure of the agricultural sector limited the benefits of growth to a small number of affluent farmers; these farmers not only controlled most of the agricultural land but also enjoyed greater access to credit as well as to irrigation and other infrastructure facilities. Hence, in 1987 an ambitious land reform program, the Comprehensive Agrarian Reform Program (CARP), which mandated the redistribution of public and private agricultural lands to landless farmers and workers, was introduced to promote more equitable growth. Implementation of the CARP has been slow. As of 1995, only 47 percent of the revised targeted distribution of 7.8 million hectares over 1987-88 had been completed. Furthermore, the uncertainty surrounding the CARP discouraged the flow of investments in the agricultural sector as well as diversification into nontraditional crops, and encouraged the use of land for nonagricultural purposes.

What is the Government's strategy for remedying this situation? Under the Social Reform Agenda, initiated in 1994, the government will **aim to reduce poverty incidence to 30 percent by 1998** by improving the provision of social services and the effectiveness of poverty alleviation programs. These programs will identify and meet the basic needs—water and sanitation provision, health and nutrition, basic education, credit access, environment resource management and housing—of the poorest population which include farmers, fisherfolk, indigenous people as well as the urban poor. In this connection, the 1997 budget will allocate 18 percent of total budgetary appropriations to poverty alleviation programs. Also, the government will target the development of the agricultural sector through the Agriculture, Productivity and Enhancement Act. Under this Act, budgetary resources will be channeled to improving irrigation and post-harvest facilities, as well as building more farm-to-market roads.

A Comparison of Poverty Incidence and Annual Reduction Rates

	Years	Annual reduction	Poverty incidence
Philippines	1971-91	0.7%	35.5 (1994)
Indonesia	1970-90	2.0%	16.7 (1990)
Thailand	1962-88	1.4%	13.1 (1992)
Malaysia	1973-87	1.6%	15.5 (1989)

Source: A Strategy To Fight Poverty: Philippines, World Bank, March 1996.

13. **Monetary policy has been constrained in several ways.** First, the choice of the appropriate nominal anchor has become difficult, with both money and exchange rate targeting having serious limitations. With the extent of the increase in money demand unclear since 1994, the appropriate monetary targets to reduce inflation became highly uncertain; however, reserves were too low and inflation too high for the alternative of an exchange rate anchor to be attractive, and such a regime would be vulnerable to speculative attack. Moreover, with an open capital market, the loss of monetary control—assuming prolonged sterilization would become increasingly ineffective and expensive—could have had an adverse impact on inflation performance. Since financial confidence was very sensitive to price developments, the authorities chose to maintain a base money target, but augmented by an inflation feedback rule. The Philippines has therefore made first steps toward formal inflation targeting, but improvements are required to ensure low single digit inflation.

14. Second, the authorities' monetary policy has had, in practice, several goals in addition to an inflation objective, which has led to conflicting signals, and the danger that no target is met. For example, a desire to keep interest rates low has contributed—together with external shocks—to policy cycles (Chart 4). Interest rates have been pushed down until external reserves declined, forcing the monetary stance to be tightened again, as in September-November 1995; subsequently, however, sharp falls in interest rates have been avoided. Since late 1995, the authorities have ensured by their intervention policy that the market fluctuations in the peso/U.S. dollar rate have been limited (Chart 5). Indeed, since January 1996, with upward pressure on the peso, the stable exchange rate has enabled the central bank to accumulate reserves—at least through September 1996—while avoiding an appreciation of the peso at a time of a slowdown in export growth.

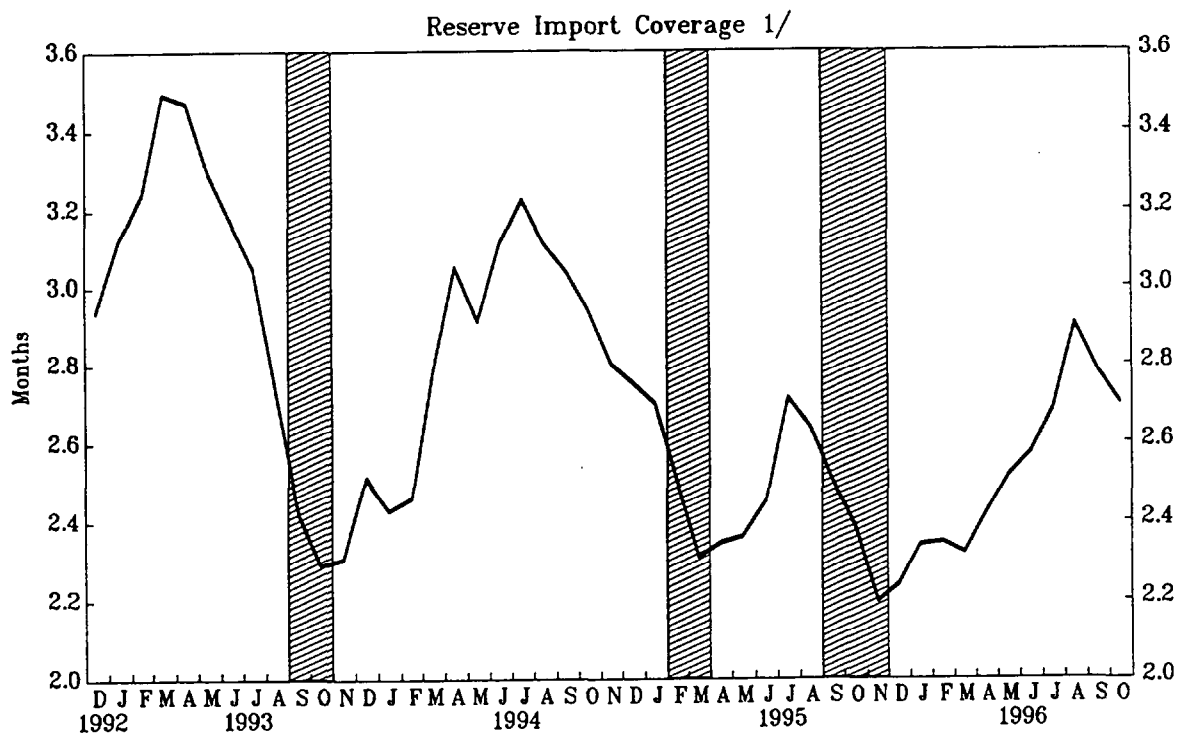
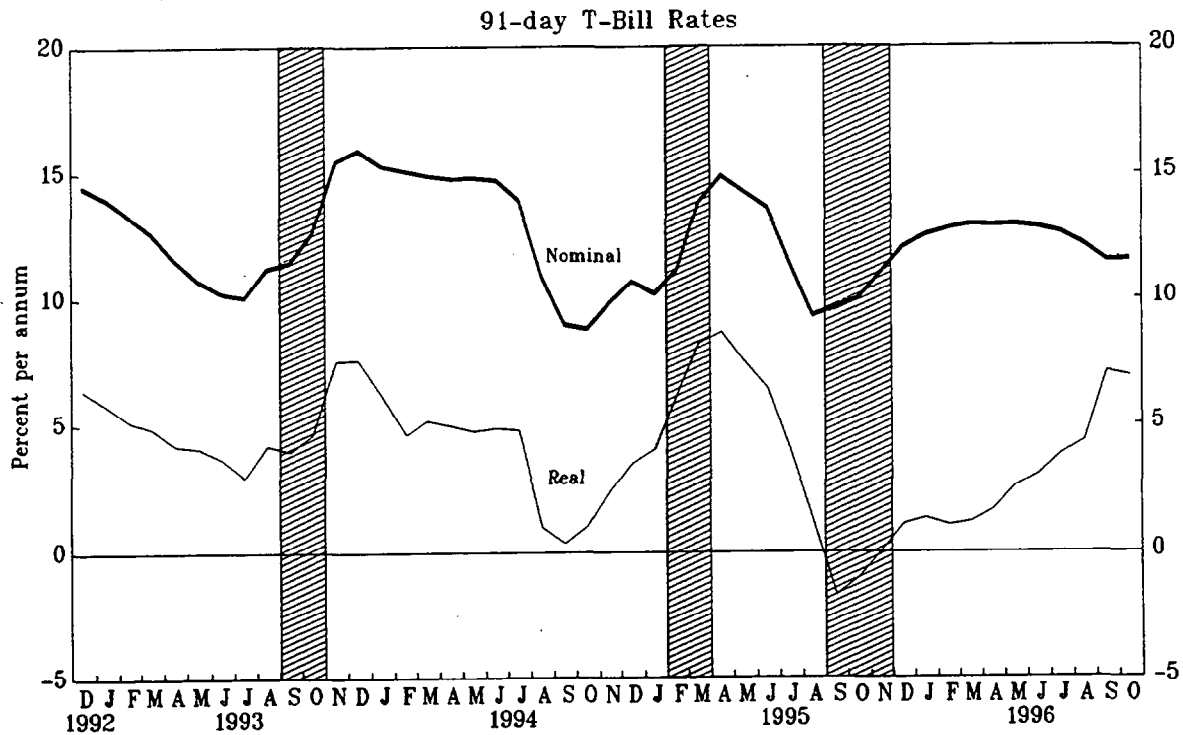
15. **There remain several areas where further structural reform could help reduce vulnerability,** while supporting growth and poverty alleviation. Reforms in the agricultural sector, in particular, have lagged behind those that have stimulated manufacturing. The lack of infrastructure has clearly posed constraints on rural development, but contentious issues such as land reform also need to be revisited, as does the pace of trade reform.

III. Report on the Discussions

A. The Economic Outlook

16. The starting point for the discussions was the near-term outlook, which indicated that the authorities' macroeconomic program for 1996 was broadly on track, and that 1997 would demonstrate further strength (Table 3). For 1996 as a whole, GDP growth was expected to reach 5 1/2 percent, buoyed by faster growth in manufacturing and services, and a recovery in agriculture. Recorded remittances had increased rapidly, spurring GNP growth to some 7 percent, thereby exceeding the target of 6 1/2 percent. The recovery of agricultural supply in 1996 and the overall policy framework had ensured a rapid decline in 12-month inflation, from 12 percent in March 1996 to less than 5 percent in October 1996. Inflation was expected to be some 6 1/2 percent by December (slightly above the target of 6 percent). Domestic demand

PHILIPPINES
INTEREST RATES AND RESERVE IMPORT COVERAGE,
December 1992-October 1996



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

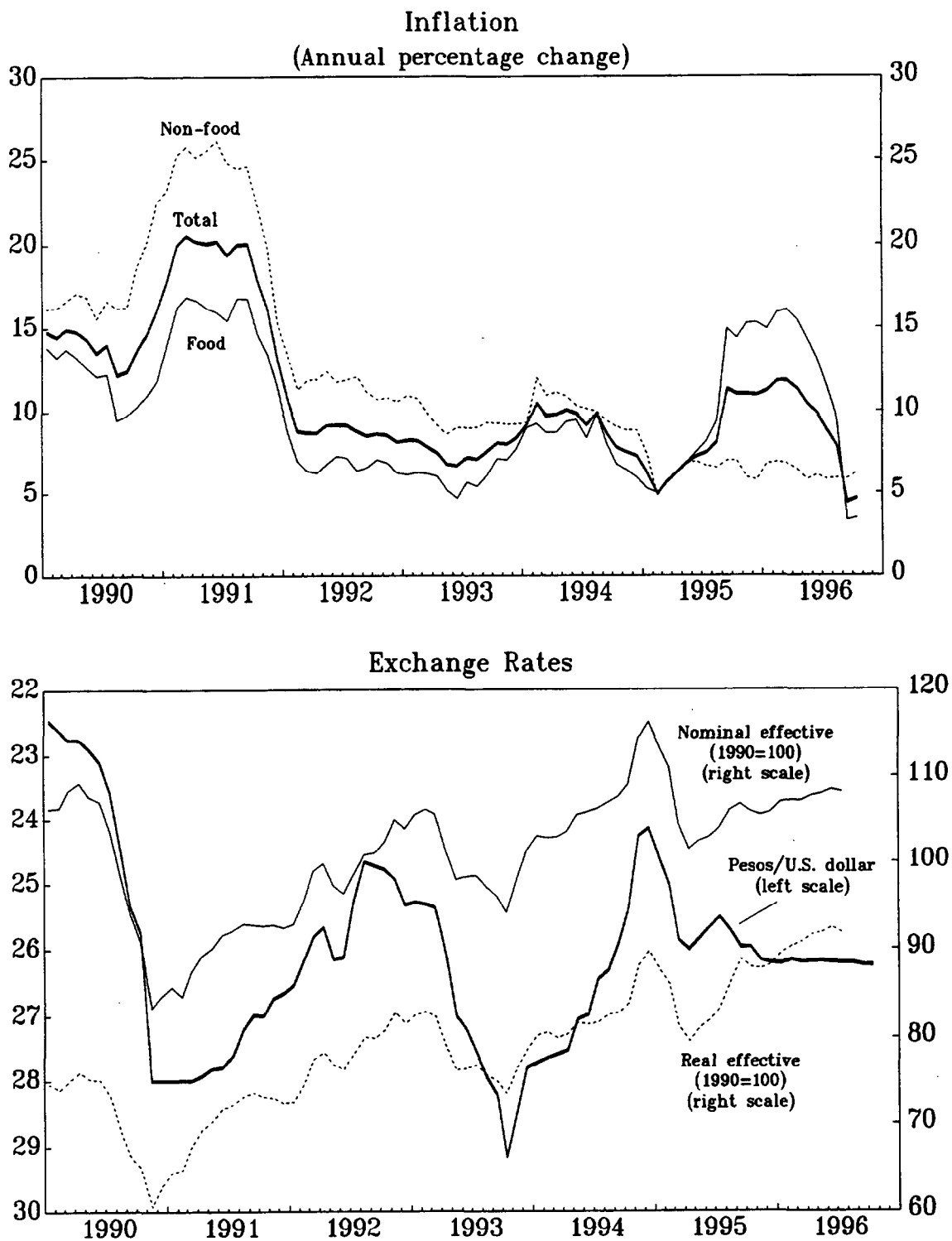
1/ Reserves, gross reserves less gold- and security-backed loan in months of imports of goods and services.

▨ The shaded areas indicate periods of intense exchange market pressures.

CHART 5

PHILIPPINES

INFLATION AND EXCHANGE RATE DEVELOPMENTS, 1990-96



Sources: Data provided by the Philippine authorities; and IMF, Information Notice System.

expansion—from both investment and consumption—was likely to exceed GDP growth in 1996 and was associated with a further increase in the trade deficit. This deficit was being financed by an increasing capital account surplus—in addition to the substantial remittance inflows. Indeed, adjusted foreign exchange reserves were projected to exceed the end-December 1996 target of 2.4 months of import coverage.

17. There were few indications of major capacity constraints or bottlenecks on the scale of the power shortage that thwarted recovery in the early 1990s. In these circumstances, the staff team concurred with the authorities that further output expansion could be envisaged in 1997 without rekindling inflation, provided wages and other costs were contained (despite large increases in civil service and minimum wages). The authorities' macroeconomic framework for 1997 envisaged GNP growth in the 7-8 percent range, with average inflation of 6 ½ percent. Further demand expansion would leave the trade and current account deficits high, but on present trends of sizeable inflows of remittances and capital—including direct and portfolio investment as well as short term inflows—reserve coverage would remain adequate.

18. **The favorable outlook reflected the cautious fiscal and monetary policies that had been maintained in 1996** (Tables 4 and 6). However, achieving the fiscal targets in the first semester of the year—including balance in the CPSD—masked disappointing shortfalls in domestic tax and privatization receipts that were more than offset by a slow pace of capital expenditure, including in the National Power Corporation, where it reflected right-of-way and other implementation problems. The authorities noted that continued slow capital spending would help the 1996 fiscal targets to be met; however, the fiscal structure would remain far from ideal—with too little capital expenditure and overall revenue too low—adding further weight to the argument for fiscal consolidation. Monetary policy continued to overperform relative to program, and the authorities intended to keep base money substantially below the target levels, in order to ensure that the progress in reducing inflation was maintained.

19. Given the relatively favorable short-term prospects, discussion focused on the medium-term framework that would be required for the Philippines to enjoy sustained economic performance comparable with its ASEAN neighbors. **The authorities agreed that the policy mix needed to be strengthened if the Philippines was to sustain rapid growth.**

20. The staff team presented an illustrative medium-term scenario, with growth accounting assumptions (Table 3 and Annex VI), that indicated the magnitude of the task. A reasonable assumption was that structural reforms—including prospective reforms such as further trade liberalization and restructuring of the power sector—would improve total factor productivity growth to about 1 1/2 percent per year, still somewhat below the ASEAN average, but above the average for 1991-96.⁵ In this case, investment would need to increase by about 3 percentage points of GNP between 1996 and 2001—to reach 26 percent of GNP—just to

⁵Sarel (1996) estimates that total factor productivity in the Philippines increased markedly to an average of 0.7 percent in 1991-96, fully accounting for the increase in output per person.

sustain 7 percent growth. Even at this rate it would be difficult for the Philippines to catch up with its neighbors. For example, even with a 3 percentage point of GNP increase in government capital spending, it would take about two decades to reach the per capita stock of government capital that now prevails in Thailand.⁶ To finance this increase in investment, while reducing reliance on foreign saving, national saving would need to increase by at least 4 percentage points of GNP to some 23 percent of GNP.

21. The authorities broadly agreed with these and other key aspects of such a scenario, in particular that a medium-term inflation target of 5 percent or less was appropriate; foreign savings (the external current account deficit) should not exceed 2-3 percent of GNP in the medium term to continue to improve the debt profile and maintain stability; and reserve coverage should increase to at least 3 1/2 months of imports (Table 7). While there was great uncertainty about the level of investment required for sustained growth, it was clear that substantial changes in fiscal policy were central to successful medium term prospects.

B. How to Sustain The Economic Recovery

22. Given the medium-term framework, there was broad agreement that continued economic revival depended on finding the answers to four key questions.

1. How to increase savings

23. The staff team adopted a conservative assumption of little increase in **private savings** over the next five years—the ratio to GNP was assumed to remain at about 15-16 percent. Although the shift to a higher growth path—already under way—should, together with favorable economic situation and institutional changes, encourage higher private savings, there were several reasons to be cautious. First, the effects of financial liberalization and financial deepening were ambiguous, for although new savings opportunities arose, so did the opportunities to borrow. As an example, the large credit expansion in 1995-96 may have contributed to the apparent decline in private savings in 1996, and reflected in part structural changes in the banking system, including increasing competition for consumer lending and greater use of ATMs. Second, to the extent that public savings could be increased—for example by revenue increases and lower spending on some categories—evidence pointed to a large offset in private savings in countries with high public debt, such as the Philippines (some 100 percent of GNP).⁷ The authorities, however, expected private savings to increase over the medium term; indeed, this was a national priority, and the Secretary of Finance was chairing a

⁶ See Gerson and Nellor (1996), who also provide a more detailed account of the medium term implications for investment, saving and fiscal policy.

⁷ Preliminary staff estimates, based on the period 1978-95, point to a high coefficient of -0.76. While this is similar to estimates found for heavily-indebted Latin American countries, it is significantly higher than the estimate of -0.20 found in a pooled sample of ASEAN countries (Dayal-Gulati and Thimann, 1996). This suggests that as fiscal consolidation proceeds in the Philippines, the offsetting impact on private savings might diminish.

national commission to propose new initiatives. To encourage savings, the authorities were beginning to explore the possibilities of a provident fund along the lines of that in Singapore. Also, legislation had been introduced that would encourage greater use of mutual funds.

24. However successful these efforts to increase private savings would be over the medium term, it was clear that the **bulk of the required increase in national savings, perhaps 3 percent of GNP, would need to be provided by the public sector.** An indication of how quickly the fiscal position could deteriorate in the absence of tax reform could be determined from the draft 1997 budget, now with Congress. Revenues and privatization receipts, including those delayed from 1996, were sufficient to cover budgeted expenditure, which was set to increase by almost 1/2 percent of GNP to 19.1 percent of GNP. However, without the additional receipts—estimated at 3/4 percent of GNP—that would flow from successful passage of the CTRP, overall spending would have to be constrained in order to maintain budget balance. Since, as noted earlier, there is only limited discretion to cut current spending, the cutbacks would apply to capital spending, implying a sharp reduction from the already low ratio of only 2.8 percent of GNP.

25. Looking further ahead, on unchanged tax policies, the present level of capital spending would not be restored until 2000 if broad fiscal balance were maintained. The prospective fiscal structure would therefore be deleterious to growth. Moreover, the authorities indicated that the planned civil service reform was now unlikely to be considered until after the 1998 elections; however, the program to double civil service salaries between 1994-97 was being implemented, markedly increasing current expenditure. There was no doubt, therefore, that the CTRP was of critical importance, and, with good reason, the authorities reiterated that its passage through Congress was their first priority.

26. Progress—in several important steps—has been made in 1996 toward a satisfactory tax reform package, although the pace has been slower than initially anticipated:

- **Oil product tariffs were reduced** in April and **excise taxes introduced** in August.
- In November, **a new excise bill was signed** that rationalized duties on tobacco and alcohol products, in part by levying specific rather than ad valorem duties to reduce evasion. The staff team had supported the authorities' view of the importance of securing some indexation of specific excises, despite the reluctance of Congress to make indexation automatic. Ultimately, the bill included provision to increase duties in three years time by 12 percent, representing partial indexation. However, the authorities projected the revenue gain to substantially exceed their initial estimates, given the classification of products. This was particularly significant, since the excise bill was expected to yield the bulk of the initial revenues from the entire CTRP.
- The **income tax bill**, covering individuals and corporations, was at the House stage and major elements of the bill were under discussion, including the introduction of a minimum assets tax, the lowering of business deductions, and the modification of rates on the individual

income tax. This element of the CTRP would not yield additional revenue in the short term. However, over the medium term, it would be a key element in achieving the objectives of the CTRP, namely to raise revenues, to ensure overall equity, and to improve administration.

27. The authorities explained that progress had also been made in moving to **full deregulation of domestic oil product prices**, due by March 1997. In August, new firms were permitted to enter the sector, either as domestic refiners or as oil product importers, facilitating the development of a competitive market environment before complete liberalization. During a transitional period beginning in August 1996, oil prices were to have been increased in line with a formula linked to Singapore Posted Prices, with a maximum increase of P 0.50 per liter per month. (To cover potential drawdowns on the OPSF resulting from this cap, a buffer fund of P 1.0 billion was established.) However, in the wake of substantial increases in world prices since September, the monthly increases announced by the Energy Regulatory Board have sometimes been less than called for, and the mid-November increases were delayed for all products until December 4 (Chart 6). As a result, there has been some drawdown of the buffer fund in addition to that arising from the price cap.

28. **On December 4, most product prices were increased by the maximum of P 0.50 per liter:** the increases in all cases except for premium gasoline exceeded those that the formula would have deemed necessary in mid-November, thereby helping to offset the adverse impact of the delays on the buffer fund. Although progress has been less than ideal, the price increases have been substantial and mark a significant step forward toward full deregulation, to which the authorities remain committed. Moreover, the increases have to a large extent protected the budget from what would have become significant expenditures. (Indeed, as Chart 6 shows, the buffer fund would have been depleted by mid-October in the absence of any price increase since August, and would have been in large deficit by mid-December.) **The forward cover provided to oil importers**—which has at times given rise to a multiple currency practice—would be abolished on January 1, 1997, allowing existing contracts to expire by end-March 1997, when Fund approval of this practice will expire.

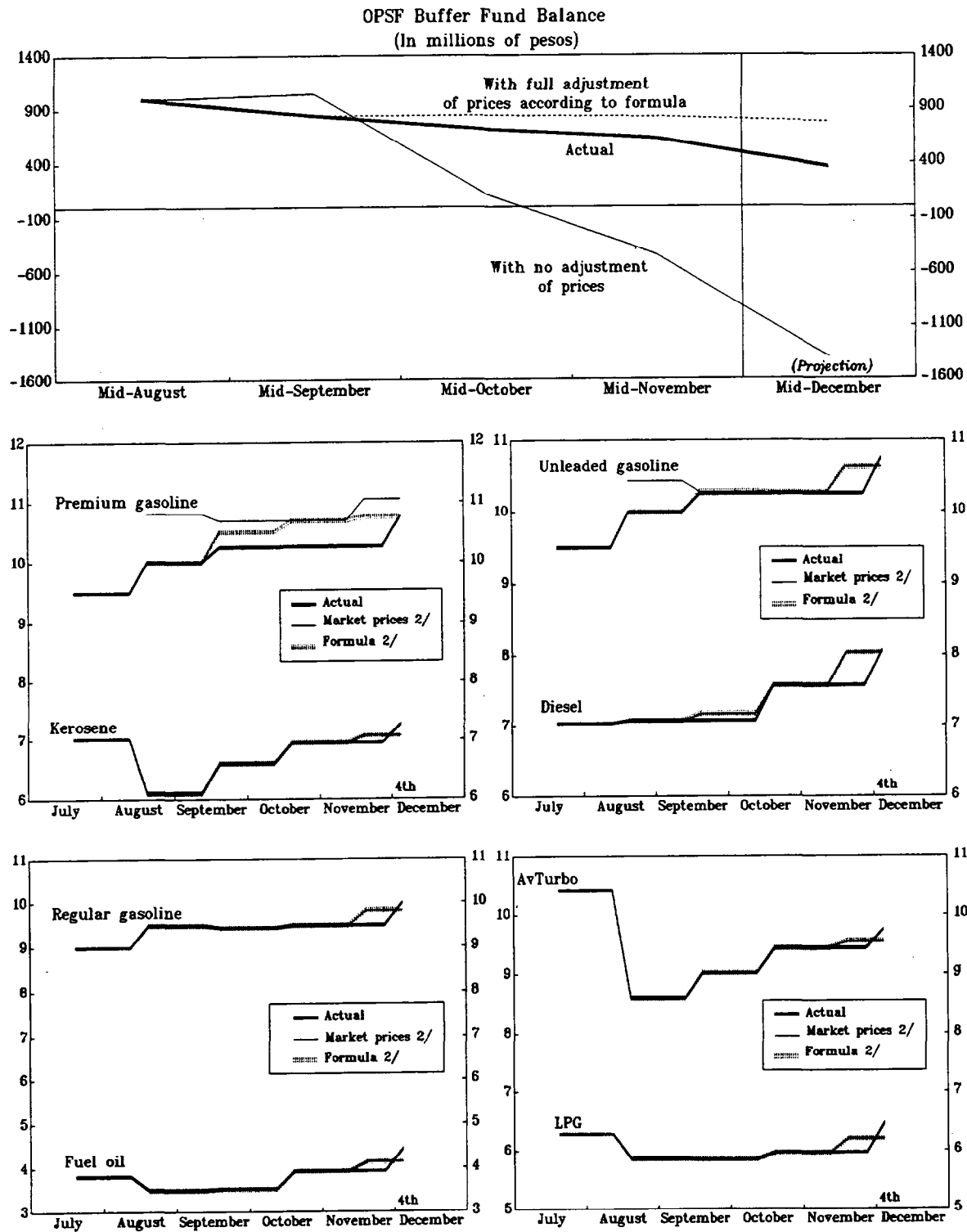
2. How to reduce external vulnerability

29. The authorities agreed that a current account deficit in the order of 4-5 percent of GNP represented a higher dependence on foreign savings than was desirable. **In addition to the fiscal policy response**, there was discussion of other action to reduce such dependence.

30. The extent of appropriate action depended, in part, on the composition of the current account deficit. The authorities' view was that the high trade deficit reflected imports of raw materials and investment goods, which were likely to continue. Special factors, including rice imports in the wake of the domestic shortage, and aircraft purchases were of a shorter duration. On the export side, the slowdown to 17 percent growth in 1996 needed to be put in perspective. Although this represented a decline from the average 21 percent growth recorded in 1993-95, the Philippines had maintained or increased market share in electronics despite a slowdown in world demand that was thought to be temporary. The garment sector was

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OPSF Buffer Fund and Oil Price Adjustments, 1996 1/



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

1/ Oil prices are in pesos per liter.

2/ The market prices are Singapore Posted Prices (SPP). Formula prices are SPP prices with a cap of P 0.50 per liter increase per month. Market and formula prices show only if they differ from SPP.

showing signs of weakness, but there was no evidence of a generalized loss of competitiveness. The staff concurred with this view; however, the favorable factors that had allowed the economy to remain competitive despite an appreciation of the real exchange rate, namely, productivity increases and wage restraint, would need to continue.

31. Despite the temporary nature of some of these factors, **there were important implications for monetary and exchange rate policy.** First, the authorities agreed that any loosening of monetary policy, with the effect of depreciating the peso, should be avoided. (Previous attempts to follow this path had undermined confidence, increased inflation and reduced reserves, and there had been no lasting effect on the real exchange rate (Chart 5).) Keeping monetary policy on a steady course would also imply not increasing NDA once the targets for international reserves had been achieved. In addition, if short-term sentiment were to shift against the Philippines, interest rates would need to be increased to discourage capital outflows.

32. **Second**, the staff team noted that, while in principle the achievement of the program objectives required a flexible exchange rate policy, the authorities had since late 1995 responded to strong remittance and capital inflows by intervening and maintaining the exchange rate close to P 26.2 per dollar. While this policy had been consistent with building up reserves—an important objective—the staff team noted that it was not without risks. In particular, it had encouraged large short-term capital inflows to take advantage of relatively high returns on Philippine assets. The authorities believed that some of the capital inflows were of longer maturity, and that the prospect of reversal of inflows such as remittances—which were increasingly being intermediated through the banking system—was quite small. Nonetheless, the authorities reiterated their commitment to allowing the exchange rate to move substantially, if needed in reaction to market pressure. This would take place in the context of an increase in interest rates, in particular if there were downside pressures on reserves.

3. How to maintain financial stability

33. Two aspects of financial stability were key: **lowering inflation further, and maintaining the soundness of the banking system.**

34. Faced with the constraints in formulating monetary policy, and the potential dilemma between giving priority to the domestic or the external objective, the central bank had modified its monetary framework to incorporate a feedback rule. Under this approach, the main operating target was net domestic assets of the central bank and priority was given to building reserves—consistent in the short run with maintaining a stable exchange rate. However, if inflation exceeded the targeted path by 1 percentage point or more, the central bank was to respond quickly to preserve confidence: the operating target switched to base money, allowing it to bear down directly on inflation. If excess inflation persisted for three consecutive months, the entire monetary program was to be reviewed.

35. The authorities' caution in implementing this policy—and in particular in **keeping base money growth substantially below program target**—had been successful in 1996 in meeting both the external target of reserve accumulation, and the domestic target of bringing inflation down sharply, so that the inflation feedback rule was not applied. Nonetheless, there were several aspects in which this policy could be refined. First, the **case for a flexible exchange rate**, noted above, was strengthened by its role in achieving a money target, and hence an inflation objective, without sterilized intervention. Since the policy pursued in 1996 had resulted in annualized costs of NDA reduction equivalent to about 1/2 percent of GNP, there may be occasion, in the context of sustained inflows, to allow the exchange rate to appreciate. However, in this case, a tightening of fiscal policy would also be advisable to counter the appreciation. Second, there was an **inherent weakness in responding to past inflation**, rather than to prospects for inflation. In this context, the authorities noted that they were developing leading indicators of inflation.

36. To maintain bank soundness, the central bank was taking steps to **improve bank regulation and supervision**, and in the short term was considering moving to the Basle system of risk-weighted capital adequacy rules. Increases in capital requirements were announced in November 1996. The staff team supported such moves, pointing to the **very rapid rise in private credit in 1995-96**, and the significant rise in credit to real estate and consumption, which could increase banks' vulnerability to economic downturns. The authorities noted that the share of bank credit to the real estate sector remained modest at 9 percent; however, it was important to distinguish between types of exposure—low cost housing, for example, did not appear to be subject to the same risks of oversupply that could affect other elements of the property market. There were also sectoral limits on credit exposure, and down payment requirements; nonetheless, the authorities were monitoring developments closely.

37. The staff team pointed to the **potential risk posed by the way in which the large credit expansion was financed**. Banks' net foreign liabilities and foreign currency deposits had increased sharply in 1996, as banks maintained the overall limits on foreign exchange exposure in part by lending domestically in foreign exchange and by holding forward positions, mostly with exporters. The **potential market risks of this financing structure warranted close attention**; moreover, there was a case for reducing the relative attractiveness of foreign currency intermediation. In this context, although the authorities were rightly opposed to direct control over capital inflows, other steps were possible. There was a policy of gradually reducing the reserve requirement on peso deposits—a reduction from 17 percent to 15 percent by July 1997 was announced in November—thereby reducing the bias against peso intermediation. The tax regime on financial instruments was also a relevant factor; the authorities have sought FAD advice in the context of a broader review of taxation of the financial sector.

4. How to share the benefits of faster growth

38. In 1994 the authorities had set the objective of reducing poverty incidence to 30 percent by 1998, within the framework of their social reform agenda, by provision of social services and effective poverty alleviation programs. New initiatives were being contemplated that could improve income distribution, in part by broadening the base of the fast-growing economy. The slow pace of reducing poverty and the high levels of underemployment were major concerns for the medium term. The authorities' strategy was to pay increasing attention to these issues as the objectives of macroeconomic stabilization and achieving steady economic growth appeared more assured. At this stage, several components of the policy direction had been identified:

- **Agriculture—key to poverty reduction—could benefit from structural reforms** to improve competitiveness. Land reform, begun in 1987, had not yet led to the most efficient use of resources: less than half of targeted distribution had occurred, and uncertainty over policy direction discouraged investment. A new emphasis on land reform, the development of rural credit opportunities and accelerated trade reforms, including the reduction of tariffs on agricultural imports (which had been excluded from the generalized tariff reduction program by 2004), would be important aspects of promoting agriculture and agro-processing.
- **Provision of social services and poverty alleviation programs** was necessary to improve the regional distribution of income. Agriculture would be a key beneficiary of increased **infrastructure spending** (Box 2). Thus, fiscal reform would clearly support equity.
- The relatively **high educational standards were advantages** that could be put to good use by encouraging service industries with strong export potential. Examples mentioned by the authorities were tourism and medical services, but comparative advantage had also been demonstrated in the financial service sector, which was growing rapidly.
- It was noted that the **peace agreement in Mindanao**, and the planned economic development of the region, was an important boost for the economy, including for agriculture.

* * *

39. The support of neighboring countries in securing the peace accord in Mindanao is one important example of **increased regional cooperation**. In addition, growth zones—areas spanning several countries—have been targeted for development, and on trade policy the ASEAN countries have set timetables for the reduction of tariffs by 2004. In the monetary area, contacts between many Asian central banks have increased since 1995, and the Philippines has participated in several bilateral swap agreements with other central banks, as a signal of the enhanced cooperation.

IV. Program Review

40. The third review focuses on the overall performance under the 1996 program and progress of key structural reforms. In sum, as discussed above, the macroeconomic program remained broadly on track: all quantitative performance criteria for end-September 1996 are estimated to have been met (see Table 1), except for the performance criterion for the elimination of the OPSF deficit; in addition, significant progress has been made on the two other structural reforms that were the focus of this review: oil sector deregulation, and the CTRP. The authorities in a letter of intent (Attachment) outline policy developments in these areas, and include a request for a waiver of the end-September, and a modification of the end-December, OPSF performance criterion.

- The authorities were unable to clear all of the **OPSF obligations** incurred prior to the introduction of the automatic pricing mechanism for petroleum products. The budgetary appropriation for clearing OPSF obligations in 1996 was prematurely exhausted due to higher than expected world oil prices. Resolution of the remaining P 2.4 billion (0.1 percent of GNP) is now expected to be achieved before end-March 1997 by including a provision in the 1997 budget. Since the unsettled OPSF balance is relatively small, and provision in the 1997 budget would eliminate the balance, the staff considers the deviation from the program to be temporary and would support the authorities' request for a waiver and modification.
- Significant progress has been made on the **CTRP** and **oil price deregulation**. In light of this—particularly the passage of the excise bill and the December 4 oil product price increases—and despite the delays that have taken place, the authorities have made much progress toward the objectives of fundamental tax reform and full oil price deregulation.

41. The extended arrangement is due to expire in June 1997. The fourth review is due to be completed by March 31, 1997, by which time the authorities expect the comprehensive tax bill to be fully enacted and the oil sector fully deregulated. Performance criteria would be set for end-March 1997, in the context of the authorities' financial program for 1997.

V. Staff Appraisal

42. The impressive performance of the Philippine economy has continued in 1996. Economic expansion has been sustained for a third year, helping to lift the Philippines toward the ranks of the fast-growing neighboring countries and paving the way eventually for a widespread reduction of poverty. The broad policy framework responsible for this significant change in the nation's fortunes has been the combination of prudent policies with major structural and social reforms. The increasing realization of the authorities' commitment to sound policies has led to rising confidence and investment. The substantial reduction in external debt and debt service, together with the prospect of continued growth, has generated strong capital inflows and increasingly favorable terms for the Philippines in capital markets.

43. The authorities' policy framework augurs well for continued growth and a further reduction in inflation, but durable success crucially depends on minimizing delays in implementing identified structural reforms. As the authorities are well aware, key aspects of the reform agenda remain to be implemented, including, in the near term, passage of all delayed components of the CTRP and liberalization of oil prices in accordance with the law passed in April; and the delay in civil service reform is unfortunate. Moreover, the new-found success brings with it new challenges; those now faced by policymakers in the Philippines are similar to others being addressed in many successful emerging market economies. An increasingly important task is to anticipate trends that could, if left unattended, jeopardize sustained rapid growth, and to take decisive action to modify the policy mix when necessary.

44. A substantial strengthening of the fiscal position is an essential ingredient of the Philippines' prospects for sustained economic growth, for external sustainability, and for progress in reducing poverty. The progress in passing the CTRP this year has been significant: despite opposition, there appears to be a growing constituency that sees the necessity of these actions to maintain financial soundness, and to improve equity. Nonetheless, the authorities will need to ensure passage of the income tax and tax administration components. With the signing of the excise bill, the 1997 budget may be able to proceed without cuts in capital spending, an outcome that would have compromised the growth objective. The task is now to realize substantially higher public savings, and to expand investment rapidly. Other key reforms, such as energy sector restructuring and a review of local government financing should be pursued expeditiously.

45. Action on oil price deregulation is also pressing. Regular monthly adjustments according to the formula are important, not only to minimize the fiscal costs, but also to remove price increases from political considerations. On a related issue, the deficit in the OPSF has been reduced but not eliminated as intended: this should be rectified as soon as possible. Despite the frustrations, the progress on oil price deregulation in 1996 does represent a major step forward: frequent small price changes are now expected, after many years of enormous resistance, and a large fiscal cost in the wake of world oil price increases has been avoided. It will, however, be crucial to build the momentum for full deregulation on schedule in March 1997.

46. The wider trade deficit in 1996, while easily financed, raises the question of the vulnerability of the economy to external shocks. In the staff's view, action is required to reduce the risk that a sudden slowdown of financing would put in jeopardy the remarkable progress made in reestablishing confidence and reducing inflation. Besides the stronger fiscal policy, which should help to dampen demand, monetary policy needs to be kept tight, and the authorities should resist temptation to lower interest rates prematurely. Any loosening would risk sharp fluctuations in policy that the authorities are, quite rightly, anxious to avoid. On the other hand, continued tight policies and sustained inflows will maintain pressure for exchange rate appreciation. This pressure could be countered by more rapid progress in fiscal reform. The real appreciation of the peso should be monitored carefully, but at this stage does not appear to signify a generalized problem of competitiveness, largely because increased

confidence in the policy framework, wage restraint, and productivity increases—all of which need to be maintained—have spurred investment and growth. Further structural reforms to improve competitiveness, including infrastructure spending and accelerated trade reform, would also help to improve the income distribution.

47. Financial stability—achieving lower inflation and strengthening the banking system—is subject to new challenges, even as inflation is reduced and competition in the banking system increases. The present monetary framework has served the authorities well, but improvements could nonetheless be made. In moving toward inflation targeting, the development of leading indicators will be helpful. In the staff's view, there are also strong arguments for allowing some greater flexibility of the exchange rate. While sustained upward pressure on the peso from strong inflows would appropriately be met by tighter fiscal policy, some additional degree of day-to-day flexibility would help to maintain monetary control. Moreover—and importantly—the increased uncertainty would help to discourage short term and potentially volatile inflows. The present bias against peso intermediation can also be reduced in other ways, including, as the authorities intend, by reduced reserve requirements on peso deposits; this needs to be implemented in such a way that monetary conditions are kept tight. The rapid credit expansion, and its financing from foreign exchange liabilities, pose significant challenges to maintaining a sound banking system. The staff strongly supports the authorities' decision to raise capital requirements, and the intention to move to risk-based capital adequacy ratios. In improving supervision, the authorities should also give increased attention to the potential market risks, including from exchange rate changes and the use of new instruments.

48. The authorities are aware of the importance of producing timely and accurate data, both for policymakers and for market participants, and their subscription to the SDDS is welcomed. Available data are provided on a timely basis to the Fund staff, and steps have been taken in the past year to improve the balance of payments data, in the context of ongoing technical assistance. Nonetheless, further improvement is warranted, particularly to establish more accurately the size of the external current account deficit and to ensure consistency with the national income accounts.

49. In light of the strong macroeconomic performance in 1996, the commitment of the authorities to the program objectives, and the authorities' intention to include a provision in the 1997 budget to clear the outstanding OPSF balance of P 2.4 billion—thus ensuring the deviation is both small and temporary—the staff supports the authorities' request for a waiver of the end-September, and a modification of the end-December performance criterion relating to the OPSF balance.

50. It is recommended that the next Article IV consultation with the Philippines be conducted on the standard 12-month cycle.

VI. Proposed Decision

The following decision is proposed for adoption by the Executive Board:

Review Under the Extended Arrangement

1. The Philippines has consulted with the Fund in accordance with paragraph 3(b) of the extended arrangement for the Philippines (EBS/94/117, Supplement 2), as amended, and paragraph 4 of each of the letters of June 1, 1994, September 8, 1995, and June 28, 1996 from the Governor of Bangko Sentral ng Pilipinas and the Secretary of Finance of the Philippines.
2. The letter dated December 5, 1996 from the Governor of Bangko Sentral ng Pilipinas and the Secretary of Finance of the Philippines, shall be annexed to the extended arrangement, and the letters of June 1, 1994, September 8, 1995, and June 28, 1996 with their attached memoranda shall be read as supplemented and modified by the letter of December 5, 1996.
3. Accordingly, the floor on the cumulative balance of the Oil Price Stabilization Fund for end-December 1996 referred to in paragraph 3(a) (iii) of the extended arrangement shall be as specified in paragraph 5 of the letter of December 5, 1996.
4. The Fund decides that the review contemplated in paragraph 3(b) of the extended arrangement, as amended, and the letters of June 1, 1994, September 8, 1995, and June 28, 1996 is completed, no additional understandings are necessary, and, notwithstanding the nonobservance of paragraph 3(a) (iii), the Philippines may proceed to make purchases in accordance with the phasing provisions of the extended arrangement.

Table 1. Philippines: Performance Criteria for Domestic and External Policies, 1995-97

	1995				1996			1996			1997
	March	June	Sept.	Dec.	March	June	Sept.	June	Sept.	Dec.	March
	Actual				Actual			Program			Indicative
(In billions of pesos)											
Domestic Sector Floors/Ceilings											
Base Money 1/	195.8	181.6	185.9	221.3	216.6	214.4	214.6	224.8	227.7	270.3	264.2
Public Sector Borrowing Requirement (PSBR)	9.8	9.7	12.9	16.6	7.1	5.4	4.4	13.9	13.0	16.7	8.1
OPSF Outstanding Balance	2.5	-0.4	-4.4	-6.6	-4.5	-1.4	-1.6				
Floor	...	...	...	...	...	...	...	-3.0	0.0	-2.4	2/
Ceiling	...	...	...	...	...	...	...	...	...	...	...
(In millions of U.S. dollars)											
External Sector Floors/Ceilings											
Net International Reserves (NIR) of the Monetary Authority (Floor) 3/	4,652	5,528	6,081	5,928	6,817	8,344	9,677	7,806	7,972	8,490	9,516
Approvals of External Borrowing with Maturities of over 1 year 4/ 5/	140	839	1,865	2,522	1,174	2,914	4,420	3,250	6,750	7,500	9,500
Approvals of External Borrowing with Maturities of 1-5 years 4/	28	248	325	470	21	101	107	150	450	600	750
Short-term External Debt Outstanding 6/	0	0	0	0	0	0	0	100	100	100	100

Source: Data provided by the Philippine authorities.

1/ Data are for ten-day test period.

2/ The December 1996 program target reflects a proposed modification of the outstanding balance from zero to -P2.4 billion.

3/ Program figures for 1996 include adjustments for the cumulative shortfall of program loans.

4/ Cumulative from beginning of calendar year, except for 1997 targets which are cumulative from beginning of 1996, applies to nonconcessional borrowing only.

5/ Actual numbers for 1995 are based on maturities of 1-12 years.

6/ Debt of public sector, excluding normal import-related credits.

Table 2: Philippines and selected ASEAN countries: Comparative Economic Indicators, 1991-96

(In percent of GDP) 1/

	Indonesia	Malaysia	Thailand	Philippines	
	1991-95 Average			1991-95 Average	1996 2/
Growth, Investment and Saving					
GDP Growth (percent change)	7.8	8.7	8.4	2.2	5.5
Investment	32.7	36.8	41.0	21.9	22.8
Private Investment	25.5	24.6	33.0	16.7	17.9
Public Investment	7.2	12.2	8.0	5.2	4.9
National Saving	30.2	30.4	34.8	18.6	18.5
Private Savings	23.3	15.7	24.6	15.4	14.3
Public Savings	7.0	14.8	10.2	3.2	4.2
Tax revenue	9.9 3/	16.3 3/	16.9	15.2	16.1
External Indicators					
Current Account	-2.4	-6.3	-6.4	-3.2	-4.2
Trade Balance	4.3	1.1	-7.9	-10.1	-14.2
Exports (growth rate)	18.9 4/	20.3	19.5	16.6	17.0
Official Reserves (months of imports)	6.2	5.2	6.4	3.1	2.8
Debt	56.4	39.1	42.9	58.8	52.6
Financial Indicators					
Inflation (percent)	8.9	4.0	4.8	10.4	8.8
Private sector credit (percent change)	20.2	16.4	24.2	28.3	56.0 5/

Sources: IMF World Economic Outlook; and staff estimates.

1/ For the Philippines, all ratios are in percent of GNP.

2/ Estimates.

3/ Non-oil tax revenue.

4/ Non-oil exports.

5/ As of August 1996.

Table 3. Philippines: Selected Economic Indicators, 1993-2001

	1993	1994	1995	1996 Program	1996 Proj.	1997 Proj.	1998 Proj.	1999 Proj.	2000 Proj.	2001 Proj.
GNP and prices										
Nominal GNP (in billions of pesos)	1,500	1,737	1,968	2,267	2,278	2,596	2,945	3,308	3,717	4,176
Real GNP	2.1	5.3	5.5	6.5	7.0	7.0	7.0	7.0	7.0	7.0
Real GDP	2.1	4.4	4.8	5.8	5.5	5.6	5.9	6.1	6.3	6.6
Domestic demand	4.2	4.9	3.7	7.3	5.9	6.2	5.9	5.7	5.7	5.7
CPI (year average)	7.6	9.1	8.1	8.5	8.8	6.5	6.0	5.0	5.0	5.0
CPI (end of period)	8.4	7.2	10.9	6.0	6.5	6.8	6.0	5.0	5.0	5.0
(in percent of GNP)										
Investment and saving										
Gross investment	23.6	23.5	21.6 1/	22.7	22.6	23.7	24.4	24.8	25.3	25.7
Private	17.8	18.2	17.0	17.3	17.7	18.3	18.8	19.0	19.2	19.2
Public	5.8	5.3	4.6	5.4	4.9	5.4	5.6	5.8	6.1	6.5
National saving	18.1	19.0	19.0	19.8	18.4	19.2	20.2	21.7	22.4	23.2
Private	14.5	16.0	15.7	15.5	14.2	14.1	13.9	15.0	15.4	15.8
Public	3.6	3.0	3.3	4.3	4.2	5.1	6.3	6.7	7.0	7.4
Foreign Saving	5.5	4.5	2.6	3.0	4.2	4.5	4.2	3.1	2.9	2.5
Public finances										
Consolidated public sector balance	-2.0	-0.6	-0.1	0.0	0.1	0.2	0.6	0.9	0.9	0.9
National Government 2/ 3/	-1.5	0.0	-0.2	0.3	-0.1	0.4	0.4	0.6	0.7	0.7
Central bank net income	-1.1	0.3	0.2	0.0	0.0	0.1	0.2	0.2	0.2	0.2
CB-BOL net income 4/	...	-0.5	-0.3	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2
Monitored corporations	-1.7	-0.6	-0.1	-1.2	-0.5	-0.7	-0.5	-0.5	-0.5	-0.5
Oil price stabilization fund	-0.5	0.1	-0.5	0.3	0.2	0.1	0.0	0.0	0.0	0.0
Other and adjustments	2.8	0.0	0.7	0.8	0.7	0.5	0.7	0.7	0.7	0.7
Underlying consolidated public sector balance 5/	-2.2	-2.4	-1.4	-1.1	-0.7	-0.3	0.7	0.9	0.9	0.9
National Government 5/										
Total revenue	17.2	18.4	17.9	18.5	18.1	19.1	19.6	19.8	20.0	20.0
Tax revenue	15.3	15.6	15.8	16.4	16.1	17.4	17.9	18.1	18.3	18.4
Non-tax revenue	1.9	2.7	2.1	2.1	2.0	1.7	1.8	1.7	1.7	1.6
Total expenditure	18.8	20.1	19.2	18.9	18.7	19.1	19.2	19.2	19.2	19.2
Current expenditure	15.1	17.1	15.5	15.1	15.0	15.2	14.9	14.7	14.4	14.0
Non-interest	10.0	10.8	10.4	10.4	10.3	11.4	11.6	11.6	11.7	11.6
Interest 2/	5.1	6.2	5.1	4.6	4.6	3.9	3.4	3.2	2.8	2.4
Capital expenditure	3.0	2.5	3.3	3.5	3.4	3.7	3.9	4.2	4.5	4.9
o/w: NG investment	2.5	1.9	2.7	2.9	2.8	3.0	3.2	3.4	3.7	4.1
Net lending and equity transfers	0.7	0.5	0.4	0.3	0.3	0.2	0.4	0.3	0.3	0.3
Balance	-1.6	-1.7	-1.4	-0.4	-0.5	0.0	0.4	0.6	0.7	0.7
Privatization receipts	0.1	1.7	1.2	0.7	0.4	0.4	0.0	0.0	0.0	0.0
National Government debt										
Domestic	45.5	38.6	37.1	33.1	34.2	29.0	24.7	22.0	19.8	17.7
Foreign	39.9	32.1	29.3	25.1	25.7	23.4	21.1	19.3	17.5	15.5
(Percentage change)										
Monetary sector										
Broad money	24.6	26.5	25.3	25.8	21.0	...	...	...	...	...
Base money 6/	14.5	11.6	17.0	22.1	17.1	...	...	...	...	...
Interest rate (91-day Treasury bill, in percent)	12.5	13.6	11.3	12.5	...	...	...	...	...	...
Inverse velocity 7/	14.2	9.4	11.1	9.3	4.4	...	...	...	...	...
Bank credit to private sector	37.6	28.2	43.5	45.6	...	...	...	...	...	...
External sector										
Export value	15.8	18.5	29.4	24.6	17.0	23.9	16.2	16.1	16.1	16.0
Import value	21.2	21.2	23.7	22.7	23.8	22.4	13.9	10.6	12.7	12.7
Current account (percent of GNP)	-5.5	-4.5	-2.6	-3.0	-4.2	-4.5	-4.2	-3.1	-2.9	-2.5
Reserves, adjusted (months of imports) 8/	2.5	2.7	2.2	2.4	2.5	2.7	2.9	3.2	3.3	3.5
External debt (percent of GNP)	62.0	57.3	52.3	53.3	52.6	54.8	53.7	51.9	49.7	47.8
Debt service ratio 9/	22.9	20.4	14.4	12.1	13.4	9.7	8.3	7.1	6.8	6.1
Exchange rate (P/US\$, average)	27.1	26.4	25.7	...	26.3	...	...	...	...	...

Sources: Philippine authorities and staff estimates.

1/ The decline in investment in 1995 reflects a sharp fall in agriculture stocks.

2/ Post central bank restructuring.

3/ Includes privatization receipts as revenue.

4/ The Central Bank Board of Liquidators was established in 1993 to retire the debts of the old central bank.

5/ With all privatization receipts below the line.

6/ Growth rates refer to end-period data; program targets refer to 10-day test periods.

7/ Ratio of money and near-money to GNP.

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

9/ Before rescheduling, as a percentage of exports of goods and services.

Table 4. Philippines: Base Money Program, 1994-97

(In billions of pesos)

	1994		1995		1996				1997	
	Dec.		Dec.		March		June		Sept.	
	Actual	Actual	Actual	Actual	Actual	Actual	Program	Program	Program	Revised projections
Base money 1/	196.1	229.4	222.8	219.0	224.8	214.9	227.7	270.3	259.2	249.8
Less:										
Reserves held as government securities	9.6	12.5	12.5	13.3	12.6	13.6	13.4	15.0	13.9	14.4
Reserve-eligible securities	4.1	4.2	4.2	4.2	4.2	4.3	4.2	4.2	4.2	4.2
Reserve deficiency	0.0	0.0	0.0	0.0	1.0	0.5	0.0	0.0	0.0	0.0
Reserve money	182.4	212.7	206.1	201.5	207.0	196.5	210.1	251.1	241.1	231.2
Net foreign assets	91.9	118.8	142.6	184.0	169.2	219.9	174.9	192.5	216.6	247.8
Net domestic assets	90.5	93.9	63.5	17.5	37.8	-23.4	35.3	58.6	24.5	-16.6
Credit to the Public Sector	151.3	156.0	193.2	140.1	149.9	...	127.6	163.0	163.1	163.1
Of which:										
Net credit to National Government	139.2	151.8	189.3	136.0	145.7	...	123.4	158.8	159.0	159.0
Central bank holdings of T-bills	120.6	137.2	154.1	138.3	148.0	128.1	142.6	137.2	126.7	126.7
Deposits	-84.5	-73.4	-65.1	-101.4	-102.3	-147.5	-119.2	-78.4	-78.4	-78.4
Other NG	103.1	88.0	100.3	99.1	100.0	...	100.0	100.0	110.7	110.7
Open market instruments 2/	-31.5	-23.3	-81.7	-84.2	-76.9	-77.8	-56.7	-67.7	-91.9	-137.1
Others	-29.2	-38.7	-48.0	-38.4	-35.2	...	-35.6	-36.7	-46.7	-42.6
Memorandum item:										
Base money adjusted for seasonality and changes in reserve requirements 3/ (12-month change)	13.9	19.8	16.9	18.5	24.5	15.9	23.1	22.5	17.6	15.7

Sources: Philippine authorities and staff estimates.

1/ Actual figures are for last day of month; program figures refer to ten-day test period.

2/ Mainly reverse repurchase agreements

3/ Refers to test period. Figures for 1994, 1995, and March 1996 are adjusted for reserve requirement reductions of three percentage points in August 1994 and two percentage points in May 1995.

Table 5. Philippines: Monetary Survey, 1994-1997

	1994		1995		1996				1997	
	Dec.	Actual	Dec.	Actual	March	June	June	Aug	Sept.	Dec.
					Actual	Program	Est.	Program	Program	Dec.
										Revised projections
(In billions of pesos, end of period)										
Total Liquidity	630.8		786.4	801.4	813.7	861.3	811.3	875.2	998.0	964.5
Broad money	607.6		761.4	769.1	776.7	826.9	776.4	840.2	958.0	921.1
(12 month percent change)	26.5		25.3	20.5	23.4	31.4	17.6	28.2	25.8	21.0
Other Liabilities	23.2		25.0	32.3	37.0	34.5	34.9	35.0	39.9	43.4
Net Foreign Assets	123.7		118.3	89.4	74.3	76.9	75.0	121.0	148.9	63.1
Central bank	91.9		118.8	142.5	183.9	169.2	225.9	174.9	192.5	214.9
Deposit Money Banks	31.9		-0.5	-53.1	-109.7	-92.3	-150.9	-53.9	-43.6	-151.8
Net Domestic Assets	507.2		668.1	712.1	739.4	784.4	736.3	754.2	849.1	901.4
Net domestic credit	821.6		1084.0	1241.0	1319.6	1334.1	1337.0	1310.9	1443.9	1572.9
Public sector credit, net	299.8		335.3	382.9	371.5	349.2	343.5	331.1	353.9	411.0
National Government	243.5		283.9	339.3	310.2	297.4	286.8	277.3	305.4	349.7
Others	21.4		21.4	22.2	27.7	24.7	23.2	26.7	21.4	27.7
Claims on CB-BOL 1/	34.9		30.0	21.4	33.6	27.1	33.6	27.1	27.1	33.6
Private Sector Credit	521.7		748.7	858.1	948.2	984.9	993.5	979.8	1090.0	1162.0
(12 month percent change)	28.2		43.5	49.4	55.3	61.3	56.0	48.3	45.6	55.2
FCDs, residents 2/	-158.8		-206.7	-230.5	-254.6	-247.8	-266.6	-251.8	-287.1	-301.9
Other Items, Net	-155.6		-209.2	-298.4	-325.6	-301.8	-334.2	-304.8	-307.7	-369.6
(In percent of GNP)										
Broad money	35.0		38.7	33.9	34.3	36.5	34.3	37.1	42.3	40.6
Currency in circulation	5.5		5.6	4.4	4.3	4.3	4.2	4.3	5.6	5.3
Net foreign assets	7.1		6.0	3.9	3.3	3.4	3.3	5.3	6.6	2.8
Net domestic assets	29.2		34.0	31.4	32.6	34.6	32.5	33.3	37.5	39.8
Private sector credit	30.0		38.0	37.9	41.8	43.4	43.8	43.2	48.1	51.3

Sources: Philippine authorities and staff estimates.

1/ The Central Bank-Board of Liquidators was established in 1993 to retire the debts of the old central bank.

2/ Foreign currency deposits.

Table 6. Philippines: National Government Cash Budget, 1993-97

	1993	1994	1995		1996	1996	1997
	Actual	Actual	Program	Actual	Program	Proj.	Proj.
(In billions of pesos)							
Revenue and grants	258.8	319.0	356.1	352.0	428.2	423.4	496.3
Tax revenue	230.2	271.3	311.5	310.5	371.0	367.1	451.7
Domestic-based taxes	145.9	187.5	215.3	210.2	259.4	262.8	334.0
International trade taxes	82.0	81.5	93.3	97.6	108.6	101.3	114.5
Other offices	2.3	2.3	2.8	2.7	3.1	3.0	3.2
Nontax revenue	28.6	47.7	44.6	41.5	57.3	56.3	44.6
Central bank	0.0	12.7	16.5	13.4	18.4	16.7	14.0
Other	28.6	35.0	28.1	28.0	38.9	39.6	30.6
Total expenditure and net lending	282.3	348.8	386.0	378.6	437.7	435.1	496.2
Current operating expenditure	226.6	296.4	314.6	305.7	351.2	351.1	395.0
Personnel services	78.7	92.7	111.1	109.1	134.8	135.0	171.4
Maintenance and operations	34.6	46.8	38.6	47.0	48.6	48.3	56.2
Interest payments	76.5	108.1	114.9	101.0	105.3	105.7	100.1
Domestic	56.2	88.8	89.3	79.2	84.6	87.0	81.9
NG	56.2	59.8	57.9	50.8	55.8	59.3	56.0
Central bank/CB-BOL	..	29.0	31.4	28.4	28.8	27.7	25.8
External	20.3	19.3	25.6	21.9	20.7	18.7	18.2
Subsidies	9.1	11.4	8.4	7.2	7.2	6.8	10.4
Tax expenditure	3.9	4.4	4.6	3.6	3.7	3.3	4.6
Local government allotment	27.8	37.4	41.5	41.4	45.3	45.3	56.8
Transfers to OPSF	0.0	0.0	0.0	0.0	10.0	10.0	0.0
Capital expenditure and net lending	55.6	52.4	71.4	72.9	86.5	84.0	101.3
Capital expenditure	44.7	43.4	61.4	64.5	79.5	77.8	95.1
NG investment	37.8	33.6	49.5	52.7	66.4	64.7	78.7
Local government allotment	6.9	9.8	11.6	11.8	13.1	13.1	16.4
Equity and net lending	10.9	9.0	10.0	8.4	7.0	6.1	6.2
Balance	-23.5	-29.7	-29.9	-26.6	-9.4	-11.9	0.1
Total financing	23.5	29.7	29.9	26.6	9.4	11.9	-0.1
Net foreign financing	12.9	-11.6	-7.9	-13.3	-14.9	-6.7	-9.6
Disbursements	38.2	13.3	26.9	16.8	14.7	21.7	16.8
Amortization	25.3	24.9	34.8	30.2	29.6	28.4	26.4
Net domestic financing	10.6	41.4	37.8	39.9	24.4	18.7	9.5
Net sales of government securities	-28.6	-10.4	-9.6	24.3	6.9	45.0	-24.7
Non-budgetary accounts	13.3	-17.8	-7.1	-24.4	5.9	-4.6	6.3
Change in cash	24.2	39.8	24.0	17.2	-5.0	-31.8	16.9
Privatization	1.6	29.8	30.5	22.7	16.6	10.0	11.0
(In percent of GNP)							
Memorandum items							
Revenue and grants 1/	17.2	18.4	17.9	17.9	18.5	18.1	19.1
Tax revenue	15.3	15.6	15.7	15.8	16.4	16.1	17.4
Nontax revenue 1/	1.9	2.7	2.2	2.1	2.1	2.0	1.7
Total expenditure and net lending 1/	18.8	20.1	19.4	19.2	18.9	18.7	19.1
Current operating expenditure 1/	15.1	17.1	15.8	15.5	15.1	15.0	15.2
Interest payments	5.1	6.2	5.8	5.1	4.6	4.6	3.9
Non-interest 1/	10.0	10.8	10.0	10.4	10.4	10.3	11.4
Personnel	5.2	5.3	5.6	5.5	5.9	5.9	6.6
Capital expenditure and net lending	3.7	3.0	3.6	3.7	3.8	3.7	3.9
Capital expenditure	3.0	2.5	3.1	3.3	3.5	3.4	3.7
NG investment	2.5	1.9	2.5	2.7	2.9	2.8	3.0
Equity and net lending	0.7	0.5	0.5	0.4	0.3	0.3	0.2
Balance	-1.6	-1.7	-1.5	-1.4	-0.4	-0.5	0.0
Privatization	0.1	1.7	1.5	1.2	0.7	0.4	0.4

Sources: Philippine authorities and staff estimates.

1/ For 1996, excluding the P10 billion transfer from the PNOC to the OPSF.

Table 7: Philippines—Balance of Payments Projections, 1993 - 2001

(In billions of U.S. dollars)

	1993	1994	1995	1996	1996	1997	1998	1999	2000	2001
	Act.	Act.	Act.	Prog.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Trade Balance	-6.2	-7.9	-8.9	-10.7	-12.3	-14.7	-16.2	-16.3	-17.2	-18.0
(in percent of GNP)	-11.2%	-11.9%	-11.7%	-12.4%	-14.2%	-15.7%	-15.8%	-14.5%	-14.0%	-13.4%
Exports	11.4	13.5	17.4	21.7	20.4	25.3	29.4	34.1	39.6	46.0
Imports	17.6	21.3	26.4	32.4	32.7	40.0	45.5	50.4	56.8	64.0
Services (net)	2.5	4.0	6.1	7.2	7.8	9.6	10.9	11.7	12.5	13.5
Service receipts	7.5	10.6	15.4	19.3	22.3	27.4	31.7	35.5	39.8	44.7
Remittances/FCD withdrawals	4.0	5.8	9.6	12.3	12.7	15.9	18.5	20.3	22.4	24.6
Other	3.5	4.7	5.8	7.0	9.6	11.5	13.2	15.2	17.4	20.1
Service payments	5.0	6.6	9.3	12.1	14.5	17.8	20.8	23.8	27.2	31.2
Interest	1.5	1.6	1.9	1.8	1.9	1.9	1.9	1.8	1.9	2.0
Other	3.5	5.0	7.5	10.3	12.6	15.9	18.9	22.0	25.4	29.2
Transfers	0.7	0.9	0.9	1.0	0.8	0.9	1.0	1.0	1.1	1.1
Current Account	-3.0	-3.0	-2.0	-2.6	-3.6	-4.2	-4.3	-3.5	-3.6	-3.4
(in percent of GNP)	-5.5%	-4.5%	-2.6%	-3.0%	-4.2%	-4.5%	-4.2%	-3.1%	-2.9%	-2.5%
Financial Account	2.0	4.1	2.8	5.1	7.0	7.4	7.4	6.9	7.2	7.7
Foreign investment	0.8	1.6	2.3	3.1	2.9	3.5	3.9	4.3	4.8	5.3
Direct investment	0.9	1.3	1.1	1.8	1.8	2.0	2.2	2.4	2.6	2.8
Portfolio investment	-0.1	0.3	1.2	1.3	1.1	1.5	1.7	1.9	2.2	2.5
MLT loans	1.3	0.7	1.3	1.4	1.8	2.0	1.7	1.3	1.1	1.1
Inflows	4.0	3.7	3.8	4.2	5.3	5.0	4.8	4.4	4.6	4.6
Outflows	2.7	3.1	2.5	2.8	3.5	3.0	3.1	3.0	3.5	3.5
Short-term capital	-0.1	1.0	-0.1	0.3	0.2	0.6	0.6	0.7	0.8	0.9
Commercial banks' NFA (increase -)	-0.5	0.5	1.3	0.7	5.6	1.1	1.0	0.4	0.3	0.2
Other (including ed&o)	0.6	0.4	-2.1	-0.3	-3.5	0.2	0.2	0.2	0.2	0.2
Overall balance	-1.0	1.1	0.8	2.5	3.4	3.2	3.2	3.4	3.6	4.3
Rescheduling	0.8	0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Technical arrears 2/	0.0	0.2	-0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net international reserves (increase-)	0.2	-1.8	-0.6	-2.5	-3.4	-3.2	-3.2	-3.4	-3.6	-4.3
BSP Gross reserves (increase-)	-0.6	-1.2	-0.6	-2.3	-3.2	-3.0	-3.1	-3.4	-3.6	-4.3
Fund credit (net)	0.1	-0.2	-0.3	-0.3	-0.3	-0.2	-0.1	-0.1	0.0	0.0
Memorandum items:										
BSP gross reserves	5.9	7.1	7.8	10.1	11.0	14.0	17.0	20.4	24.0	28.3
(in months of imports of G&S)	3.1	3.1	2.6	2.7	2.8	2.9	3.1	3.3	3.4	3.6
BSP adjusted gross reserves 3/	4.7	6.4	6.7	8.9	9.8	12.8	16.3	19.7	23.2	27.6
(in months of imports of G&S)	2.5	2.7	2.2	2.4	2.5	2.7	2.9	3.2	3.3	3.5
External debt	34.3	37.7	40.0	45.9	45.6	51.4	54.9	58.1	61.1	64.3
(in percent of GNP)	62.0%	57.3%	52.3%	53.3%	52.6%	54.8%	53.7%	51.9%	49.7%	47.8%
Debt service ratio 4/										
Before rescheduling	22.9%	20.4%	14.4%	12.1%	13.4%	9.7%	8.3%	7.1%	6.8%	6.1%

Sources: Philippine authorities and staff estimates.

1/ 1992-94 balance of payments (and EFF program) are based on a different methodology that estimates lower service inflows.

2/ Arrears resulting from the voluntary cancellation of the July 1994 Paris Club rescheduling arrangement.

3/ Gross reserves less securities and gold pledged as collateral for short-term loans.

Philippines: Fund Relations
(As of September 30, 1996)

I. **Membership Status:** Joined 12/27/45; Article VIII

II. General Resources Account:	SDR Million	% Quota
Quota	633.40	100.0
Fund holdings of currency	882.61	139.3
Reserve position in Fund	87.10	13.8

III. SDR Department:	SDR Million	% Allocation
Net cumulative allocation	116.60	100.0
Holdings	0.54	0.5

IV. Outstanding Purchases and Loans:	SDR Million	% Quota
Stand-by arrangements	168.08	26.5
Extended arrangements	168.22	26.6

V. Financial Arrangements:			Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Type	Approval Date	Expiration Date		
EFF	6/24/94	6/23/97	474.50	36.50
Stand-by	2/20/91	3/31/93	334.20	334.20
EFF	5/23/89	2/19/91	660.60	235.92

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

	-----Forthcoming-----					
	Overdue <u>9/30/96</u>	<u>1996</u>	<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>
Principal	--	54.4	156.9	58.2	39.5	6.1
Charges/Interest	--	5.0	14.8	9.3	7.1	5.6
Total	--	59.4	171.7	67.5	46.6	11.7

VII. **Exchange Arrangement**

The value of the Philippine peso is determined in the interbank foreign exchange market; the central bank participates in the market in order to limit fluctuations in the exchange rate.

From 1990 to late 1995, the peso has generally appreciated; between November 1995 and August 1996 the peso has been stable at around P 26.2=US\$1. Since September, it has depreciated slightly to P 26.3=US\$1.

VIII. Last Article IV Consultation:

The 1995 Article IV Consultation and Review under the Extended Fund Arrangement report (EBS/95/153) was discussed by the Executive Board on September 29, 1995.

IX. Consultation Cycle:

Philippines is on the standard 12-month cycle.

X. Technical Assistance:

During the past five years, the Philippines has received technical assistance from the Monetary and Exchange Affairs Department, the Legal Department, the Statistics Department, and the Fiscal Affairs Department. An expert from the MAE was in Manila in December 1989 to advise the authorities on measures to improve the operation of the foreign exchange market, and an MAE mission visited the country in December 1992 to advise the authorities on base money management. In September 1994, an expert from the Legal Department visited Manila to help draft legislation on a minimum business tax. In January 1995 a Statistics Department mission advised the authorities on balance of payments reporting. Fund staff also participated in two World Bank missions on central bank restructuring during 1993 and a World Bank mission on public expenditure review in September 1994.

Several proposals for reforms of the tax and customs system have been made in the course of technical assistance from FAD. To assess the progress of the implementation of the five-point Bureau of Internal Revenue and the eleven-point Bureau of Customs administration reform package, four FAD missions visited Manila between 1992 and mid-1994. An FAD expert was assigned as an advisor to the Bureau of Customs from February 1992 to September 1993. An FAD mission visited Manila in May-June 1995 to review proposals to improve the structure of the individual and corporate income taxes and to rationalize tax incentives. A joint FAD/World Bank technical assistance mission to review the scope for integrating macroeconomics and the environment was conducted during April 17-30, 1996.

XI. Resident Representative:

A Resident Representative has been stationed in Manila since January 1984. Mr. David Nellor assumed the post of Resident Representative in November 1995.

Philippines—Statistical Issues

Outstanding Statistical Issues

a. Real sector

Reporting in the framework of *International Financial Statistics (IFS)* of yearly and quarterly national accounts data is current. A report on the national accounts of the Philippines in 1993 found that, despite an impressive and sophisticated array of tables prepared in a timely fashion, the reliance on sparse source data of dubious quality raised serious questions about the adequacy of the national accounts to measure either short-term movements or structural change.

Other *IFS* reporting of real sector data by the Philippines shows incidental gaps. The reporting of global volume and price indices of merchandise imports and exports were abandoned in 1992.

b. Monetary accounts

Monetary data for the central bank, the deposit money banks, and other banking institutions are reported on a regular basis. Data for the central bank and the deposit money banks are reported in the format of analytical accounts (tables 10G and 20G, respectively). It would be preferable if, in addition to tables 10G and 20G, these data were reported using the report forms 10R and 20R that were developed by STA.

c. Balance of payments

Over the last five years, the compilation of the balance of payments has become an increasingly difficult task, because of difficulties in accurately recording the growing volume of resident transactions channeled through the Foreign Currency Deposits Units (FCDUs) of domestic banks. Because of the strict secrecy provisions that are attached to these accounts, the authorities are not permitted to conduct inquiries into the nature of the underlying transactions that give rise to increases/decreases in these accounts. As a consequence, various ad hoc methodologies have been devised to construct estimates of the value and the classification of the balance of payments transactions channeled through FCDUs which, at times, have produced implausible swings in the current account and raised concerns of possible duplication with trade statistics compiled from other sources.

The authorities are well aware of the problem, and have taken a number of steps to address them. Since January 1996, commercial banks have been required to submit reports on the sources and uses of FCDs; the reporting format was further revised in August to include more details on services account and foreign investment; in May 1996 a survey of selected banks was undertaken to monitor the loans and investments of FCDUs. Meanwhile, the NSCB is coordinating efforts to reconcile worker remittances data with data on overseas worker stock count and deployment. Nevertheless, it is recognized that without any changes in the legal provisions that underpin these deposits accounts, improvements in the quality of the data may be difficult to achieve.

Reporting of Main Statistical Indicators

(As of end-October 1996)

	Exchange Rates	International Reserves	Reserve/ Base Money	Central Bank Balance Sheet	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Federal Government Balance	GDP/GNP	External Debt
Date of latest observation	Oct. 31	Oct. 31	Oct. 31	Jun.	Aug.	Oct. 31	Oct.	Sept. 1996	1996 Q2	Sept. 30 1/ 1996 Q 2/	1996 Q2	1995 Q4
Date received	Oct. 31	Nov. 12	Nov. 12	Sept.	Nov. 5	Oct. 31	Nov. 5	Nov. 13	Sept. 15	Oct. 17 1/ Sept. 15 2/	Sept. 13	May 1996
Frequency of data 3/	D	M	D	M	M	D	M	M	Q	M/Q	Q	Q
Frequency of reporting 4/	D	M	W	M	M	D	M	M	Q	M/Q	Q	Q
Source of data 5/	C	A	A	A	A	C	N	N	N	A/A	A	A
Mode of reporting 6/	E	C	C	C	C	E	C	C	C	C/C	C	C
Confidentiality 7/	C	C	A	A	C	C	C	C	C	C/C	C	C

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

Philippines: Social and Demographic Indicators

	15-20 years ago	Most recent estimate
General		
Land area (sq. km.)	300,000	300,000
GNP per capita (U.S. dollars)	340	1,089
Poverty incidence (percent)	52	35.5
Income distribution (percent)		
Lowest 20 percent	5	6.5
Highest 20 percent	56	47.8
Demographic		
Population (million)	42	70.7
Growth rate (percent)	2.6	2.4
Population density (per sq. km.)	144	220
Urban population (percent of total)	35.6	53.1
Life expectancy (years)	59.1	65.3
Crude birth rate (per '000 population)	36.6	30.0
Crude death rate (per '000 population)	9.7	6.0
Labor force		
Total labor force (million)	16	28
Agriculture (percent of total)	53.3	39.0
Industry (percent of total)	16.1	14.6
Education		
Adult illiteracy (percent)	...	5.4
Pupil/teacher ratio: primary school	29	36.3
Enrollment (percent of age group)		
Primary	108	109
Secondary	46	74
Tertiary	27.7	27.8
Health		
Infant mortality (per '000 live births)	54.0	40.1
Population per physician	9,100	8,117
Population per nurse	2,691	2,684
Access to safe water (percent of population)	50	81

Sources: World Bank; and data provided by the Philippine authorities.

Philippines—Relations with the World Bank Group

A. World Bank Lending up to 1996

Total World Bank financing in the Philippines amounted to \$8,512 million under 162 loans and \$277 million under seven IDA credits, as of October 31, 1996. IFC total gross investments as of October 31, 1996 amounted to \$1,063 million.

During FY 94–96, the World Bank approved 7 loans for approximately \$953 million in loans, and one IDA credit for approximately \$70 million.

The Bank has financed projects in nearly all sectors of the economy, with particular emphasis on agriculture, infrastructure, energy, and industry. Lending for structural and sectoral adjustment (nine operations since 1980) also played an important role, with only one remaining outstanding policy-based loan: the Environment and Natural Resource Management Loan (Ln. 3360-PH), a hybrid loan of \$150 million approved in June 1991. The final tranche for the Economic Integration Loan (Ln. 3539-PH) of \$200 million, approved in December 1992, was released in March 1995.

There were 30 projects under supervision in the FY 96 portfolio, amounting to \$2.87 million (before closings). In FY 96, disbursements totaled \$377 million. In comparison, disbursements totaled \$673 million in FY 93, \$480 million in FY 94, and \$398 million in FY 95.

The FY 97 portfolio consists of 24 projects, amounting to \$2,524 million. Three projects were approved in FY 96: the Second Rural Finance, Transmission Grid Reinforcement, and Second Manila Sewerage Projects. Four projects are scheduled to go to the Board in November 1996: Elementary Education III (\$113.4 million); Agrarian Reform (\$50 million); Water Resources Development (\$58 million); and Subic Bay (\$60 million).

The World Bank is engaged in a number of economic and sector studies that will help to define development issues and future lending strategies in key sectors such as financial sector development, pension and housing reform, devolution, gas strategy and pricing, and urban development strategy.

Table 1. Loan Approvals between January 1994 and October 31, 1996
(In millions of U.S. dollars)

	IBRD amount	IDA amount	Effective date
Urban Health and Nutrition	...	70.00	04/07/94
Leyte Cebu Geothermal	211.00	...	07/18/94
Subic Bay Freeport	40.00	...	08/17/94
Leyte Luzon Geothermal	227.00	...	03/01/95
Women's Health and Safe Motherhood	18.00	...	07/07/95
Second Rural Finance	150.00	...	04/23/96
Transmission Grid Reinforcement	250.00		10/12/96
Second Manila Resource Management	57.00		09/17/96
Total	953.0	70.00	...

B. Financial relations

1. IBRD/IDA lending operations as of October 31, 1996

(In millions of U.S. dollars)

	IBRD	IDA
162 loans and 7 credits fully disbursed 1/	6,264.95	171.18
Total commitments	8,511.76	277.18
Total undisbursed	1,283.45	85.43
Total repaid	2,921.21	11.76

1/ Net of cancellations.

2. IFC investments as of October 31, 1996

Total gross commitments	1062.96
Less: Repaid, terminated, sold, or canceled	546.99
Total commitments held by IFC	515.97

C. Technical assistance

The World Bank has provided technical assistance to the Philippines through its standard lending operations. In addition, the Policy and Human Resource Development Grant Facility (formerly called the Japan Grant Facility) has helped in the preparation of several projects in lending operations. Technical assistance for capacity building initiatives are also being provided through the Institutional Development Fund (IDF). The FY 1997-98 technical assistance program will involve work in financial sector development, privatization, environmental management, upgrading skills and technology, and private sector infrastructure initiative.

D. Aid Consultative Group

The Consultative Group, under the chairmanship of the World Bank, met on December 7-8, 1995 in Tokyo. An update of the Country Economic Memorandum and the Public Expenditure Review and Poverty Strategy, prepared by the World Bank, were distributed and discussed at this meeting. The members of the Consultative Group committed loans and grants amounting to \$2.9 billion in 1996. The next Consultative Group meeting is scheduled for December 10-11, 1996 in Tokyo.

Philippines—Relations with the Asian Development Bank

The Asian Development Bank (AsDB) has provided 152 loans for a total of \$5,867 million to the Philippines since 1968. Approximately 55 percent of the loans were for projects in the energy and agricultural sectors. The AsDB approved seven loans totalling \$572 million in 1995, primarily in the energy, agriculture, finance, water supply, and health sectors. During 1995, the AsDB also approved 17 technical assistance (TA) grants amounting to \$6.06 million. Since January 1996 to the present (August 31, 1996), six loans for four new projects have been approved amounting to an additional \$96 million, and 7 TAs for \$3.7 million.

Table 1. Cumulative AsDB Lending to the Philippines

(As of August 31, 1996)

Sector	Number of loans	Amount of loans (in US\$ million)	Percent
Energy	24	1,760.9	30.0
Agriculture and agro-industry	54	1,441.9	24.6
Transport and communications	22	760.9	13.0
Urban development, water supply, and sanitation	20	761.8	13.0
Finance	15	615.0	10.5
Multisector	7	303.7	5.2
Education	6	180.0	3.1
Industry and nonfuel minerals	4	42.8	0.7
Total	152	5,867.0	100.0

Note: Includes private sector loans.

Philippines: Medium-Term Scenario

Substantial reforms undertaken in the past decade—including privatization of nearly all productive activity, the dismantling of monopolies, especially the deregulation of the telecommunications industry, the liberalization of the trade and financial sectors, as well as the elimination of most foreign investment restrictions, have created a strong foundation for growth over the medium-term. On this basis, **real GDP growth** is projected to increase to about 6 1/2 percent over the medium term, consistent with an annual increase in total factor productivity of 1 1/2 percent. Assuming a gradual decline in the contribution to growth of net factor income from abroad, **real GNP growth** will expand by 7 percent a year. **Inflationary pressures** are expected to ease as the Central Bank keeps monetary policy firm, with inflation falling to the ASEAN norm of 5 percent by 2001. On the **external side**, both the trade and current account balances are projected to improve. This would allow for a gradual increase in gross reserves while reducing the debt service ratio. To achieve these macroeconomic objectives, **fiscal consolidation** is required. Higher public saving would help preserve the favorable debt dynamics as well as reduce the economy's dependence on foreign saving, and channel much needed funds to public infrastructure expenditure. Furthermore, as confidence in the economy grows, private investment is expected to play a major role in driving economic growth, and with the envisaged decline in foreign saving, private saving will need to increase further.

On the basis of this policy-adjustment scenario, the **external position** would be expected to strengthen over the medium term with the current account deficit narrowing to 2.5 percent of GNP in 2001 from 4.2 percent of GNP in 1996. The improvement is expected to stem from a reduction in the trade deficit—albeit still substantial at 13 percent of GNP—as well as projected stable growth in services receipts. Nevertheless, in 1997, the current account deficit is projected to worsen to 4.5 percent of GNP on account of imports of aircraft by PAL. From 1998, the expected slowdown in export growth, as the export market matures and stable market shares are achieved, will lead to a decline in imports. This is because, assuming the share of consumption goods in imports remains unchanged, imports mostly consist of capital and intermediate inputs which are used in export processing. Growth in remittances is expected to slow over the medium term as reintermediation through the banking system is completed in the next year.

On the **capital account**, foreign investment—both direct and portfolio—are expected to continue to grow, attracted by the high growth rates and low inflationary environment. As a result, medium- and long-term loans will fall while adjusted international reserves will rise from \$10 billion at present to some \$28 billion by 2001, equivalent to 3.5 months of imports of goods and services. The stock of external debt is projected to decline to less than 50 percent of GNP and the debt service ratio to single digits.

The main factor accounting for the substantial increase in **public saving** would be the national government: national government savings are projected to double from their current

3 percent of GNP to 6 percent of GNP by 2001. Two-thirds of the increase in national government savings will come from the revenue side, with total revenues increasing from 18 percent of GNP in 1996 to 20 percent by 2001. This will require a substantial increase in domestic tax revenues, as both non-tax revenues and taxes on international trade are expected to fall relative to GNP (the latter due to tariff reform). The required 2 percentage point increase in revenues is expected to come from the authorities' comprehensive tax reform package (CTRP). However, should the CTRP fail to deliver the necessary savings required, other revenue-enhancing measures would be needed.¹

Current expenditure by the national government is projected to fall by only 1 percent of GNP by 2001. In fact, noninterest expenditure is projected to rise, mainly due to increases in transfers to local government units as mandated by the local government act, and increases in maintenance and operating expenses, which are currently at minimum sustainable levels. However, interest expenditure is projected to decline substantially relative to GNP, on account of the strong overall fiscal position and continued rapid output growth.

Higher national government saving will allow for a significant increase in **capital expenditure** by the national government—from 3.4 percent of GNP in 1996 to some 5 percent of GNP in 2001—while still allowing the government to run a substantial surplus, which is projected to reach 0.7 percent of GNP by 2001. As a result, the stock of debt of the national government is projected to fall sharply by the end of the projection period.

Alternative medium-term projections were made to assess the sensitivity of the external accounts to changes in the growth in remittances. The baseline scenario discussed above assumes remittances will grow at an annual average rate of 11-12 percent during 1997-2001. If remittances grow at a slower pace—e.g., at an average annual rate of 10-11 percent during 1997-2001—the external current account deficit relative to GNP would remain essentially unchanged over the medium term. Assuming the same reserve targets, this would imply higher debt and debt service ratios—the external debt to GNP ratio would be 4 percentage points higher in 2001 than in the baseline scenario while the debt service ratio would be 1 percentage point higher.

¹ Current estimates of the impact of the CTRP do not include the impact of eliminating various tax incentives. The benefit of removing these incentives will be realized over time, as existing incentives expire and are not renewed, and could be very substantial.

Manila, Philippines

December 5, 1996

Mr. Michel Camdessus
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. Camdessus:

1. In our letter to you dated June 24, 1996, the Government of the Philippines set out its economic goals and policy intentions for 1996 under the extended arrangement. We are pleased to report that macroeconomic developments in 1996 remain on track. Inflation has come down as anticipated, economic growth is higher than projected, and international reserves presently exceed the end-year target. In this letter we outline progress on two key structural policy elements under the program—the comprehensive tax reform package and the liberalization of the energy sector—that are, along with macroeconomic developments, the focus of the third review. Since the external position remains strong, and as indicated at the time of the first review, we do not anticipate making further purchases under the arrangement.
2. Comprehensive tax reform is at the center of our structural reform effort and we are pleased to report substantial progress in this area. Earlier in the year, we enacted reduced tariffs on oil imports and an effective set of excises on oil products—this measure has been implemented. We have now made a second step—and the most critical in terms of revenue contribution. The reform to excise taxation of tobacco and alcoholic beverages has been enacted and will be implemented from the beginning of 1997 as planned. The excise reform adopts specific rates of taxation to make tax collections more effective. We will continue to monitor the developments in excise tax revenues to ensure that they grow in line with the economy. We expect passage of the remaining elements of the Comprehensive Tax Reform Package—the personal income tax, the corporate income tax, the rationalization of tax incentives, and the tax administration measures—toward the end of 1996 or in early 1997. These measures are presently under deliberation by Congress. We will seek to ensure that the comprehensive tax reform package as a whole meets the objectives of improving collection efficiency, enhancing overall equity and improving tax administration.
3. Progress in liberalizing the oil sector and abolishing the Oil Price Stabilization Fund (OPSF) is proceeding according to the timetable outlined in our earlier letter. Full deregulation will occur by March 1997. In August 1996, pursuant to the Oil Industry Deregulation Act, we permitted entry of new firms to the sector—either as domestic refiners

or as oil product importers—and this is helping develop a competitive market environment before complete liberalization. The Act likewise introduced Automatic Pricing Mechanism (APM) in August 1996. Unfortunately, not all of the OPSF obligations incurred prior to the introduction of the APM were cleared. The budgetary appropriation for clearing OPSF obligations in 1996 (P 9 billion) was exhausted prematurely due to higher-than-expected world oil prices. It is our intention to settle the remaining audited claims—estimated to be P 2.4 billion (0.1 percent of GNP)—before end-March 1997 by seeking the inclusion of an appropriate provision in the 1997 budget.

4. Since the passage of the Downstream Oil Industry Deregulation Act, oil product prices have been adjusted reflecting the increase in world prices. The Act which introduced the Automatic Pricing Mechanism (APM) has served the purpose of introducing the public to market-determined pricing of oil products. During the transition period, the Act mandates a limit of 50 centavos per liter for any adjustment per month. In addition, the Act has sought to phase in the required adjustments for a number of oil products over several months. These have enhanced public acceptability of deregulation. The buffer fund remains adequate and stood at P 0.66 billion at end-October. On December 4, the Energy Regulatory Board (ERB) adjusted prices based on the formula for November. Although this timing represented a delay in implementing the formula, prices were adjusted, subject to the 50 centavos ceiling, by an amount greater than the formula so as to offset the consequences of the delay. It is our expectation that the formula will be implemented in the coming months until the oil sector is fully liberalized by March 1997.

5. All quantitative performance criteria for end-September 1996 under the arrangement have been met except for the performance criterion for the elimination of the deficit of the OPSF as explained above. Accordingly, we wish to request a waiver for the nonobservance of this criterion at end-September and a modification of the same for end-December (modifying the floor on the OPSF outstanding balance for end-December from zero to - P 2.4 billion). The fourth review of the extended arrangement is due to be completed by March 31, 1997, by which time we will have enacted the remaining elements of the comprehensive tax package and fully deregulated the oil sector; the fourth review will also set performance criteria for end-March 1997 in the context of our macroeconomic framework for next year.

6. The Philippine Government is confident that completion of the above measures will be sufficient to ensure that the objectives of the program will be achieved, but it stands ready to take additional measures that may be needed for this purpose. The government will consult with the Fund on any such measures, consistent with the policies of the Fund on such consultations.

Sincerely yours,

/s/
Gabriel C. Singson
Governor
Bangko Sentral ng Pilipinas

/s/
Roberto F. de Ocampo
Secretary of Finance

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