GRAY/06/444

February 9, 2006

Statement by Mr. Kremers and Mr. Klein on the Philippines
(Preliminary)
Executive Board Meeting
February 13, 2006

General

Despite some political turbulence and unfavorable external conditions (i.e. higher oil prices and the intense competition in the region in 2005), macroeconomic stability was retained and economic activity recorded a strong growth of around 5 percent. We commend the authorities for conducting prudent policies, as reflected in fiscal consolidation, a shift to tighter monetary policy and the continuation of reforms that helped to regain (foreign) investors' confidence and to keep inflation in check. Having said that, multiple challenges remain for growth to reach its full potential and for further locking in macrostability. In this regard, reforms should be further enhanced in the areas of the business climate, public finances, and the power and banking sectors. Further investment to restore the infrastructure is also needed. Additionally, we agree with staff that downside risks, such as second-round effects stemming from high oil prices and the VAT-increase, deteriorating financing conditions, and avian flu could impair the outlook

Fiscal policy

The authorities' efforts to reduce the budget deficit are commendable, and the current strategy - increasing revenues alongside containing spending - appears appropriate. On the revenue side, the recent implementation of VAT reform has started to pay off as the tax collection has finally increased after several years of continuous decline. Noting that, compared to its peers, tax collection continues to be low, staff's recommendation to make further efforts to increase the revenues base appears reasonable. In this respect, enhancing tax administration and improving enforcement remain key challenges.

While welcoming the recent reduction in current expenditure, the fact that capital and social (health and education) spending are crowded out is worrisome, especially in view of the inadequate level of infrastructure and the currently limited public support of the poor population. Moving forward, to ensure the planned elimination of the budget deficit in the medium term, the authorities should cut costs and increase efficiency of public enterprises. In this connection, speeding up the reform of the power sector is essential. In addition, the long-term solvency of the pension funds should be secured by gradually raising contribution rates over time.

- over -

Monetary policy and the financial sector

As inflationary pressures have been increasing, the BSP's recent measures to reduce liquidity are welcomed. However, the fact that the BSP has been less aggressive than other central banks in the region may undermine its credibility and feed higher inflation expectations. Furthermore, the narrowing interest rate differentials may also increase the economy's vulnerability to a possible rise in the risk premium, if structural reforms are stalling. Against this background, and given the currently low real interest rate level, further tightening should be considered, especially given the fact that inflation is expected to decline only moderately and end up above the 2006 target. Staff comments on the assumptions underlying inflation projections and the interest rate path are welcome.

On financial markets, the moderate growth of bank lending poses a constraint on economic growth as it reflects limited access of the private sector in conjunction with poor performance of commercial banks. In this regard, recent measures taken to strengthen banks' balance sheets and to enhance supervision are encouraging, but should be accelerated also in view of the financial difficulties of the pre-need industry. In this context, we join the staff in urging further efforts to develop capital markets and non-bank financial channels to increase competition and deepen credit markets.

External sector

Despite political uncertainty and the higher level of oil prices, the external position has been recording some improvement, as the increase in remittances contributed to a higher current account surplus, and higher FDI and portfolio investment led to further reduction of the capital account deficit. This development reflected stronger investor confidence and Peso appreciation while the Philippines' EMBI-spread sharply declined. Nevertheless, in 2005, exports only recorded a mild growth after exceeding 9 percent in the previous year. This can be partially attributed to the weak business climate alongside intensive competition in the region. In this regard, the authorities should make greater efforts to improve external competitiveness by enhancing infrastructure and reducing manufacturing costs in order to maintain the economy on a high growth path. Moreover, higher productivity may offset the adverse effect of further appreciation of the real exchange rate on competitiveness where the large magnitude of remittances will continue to put upward pressures on the exchange rate.

Structural reforms

As investment has been declining in the last five years, and the current level compares unfavorably within the region, we agree with staff that improving the business climate is critical. Much remains to be done to enhance regulation of investor protection and business closure. A better bankruptcy system would allow resources to flow more efficiently to projects with the highest rate of return, and would encourage investment in general as banks are more willing to lend with higher recovery rates. Additionally, speeding up privatization is crucial to improve efficiency as well as to alleviate public liabilities and free up resources for priority sectors. In this regard, the fact that the privatization of state power sector assets (generation and transmission assets) is well behind schedule is regrettable and may hinder much needed investments to tackle the projected, sizable energy deficits. Last but not least, there is a need to firmly address civil service corruption, which firms perceive as the second highest constraint for activity (after macroeconomic instability).