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IMF Executive Board Concludes 2008 Article IV Consultation with the Philippines

On January 16, 2009, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Philippines.[1]

Background

Following solid economic performance in recent years, the economy faced headwinds initially from the commodity price shock and subsequently from the global economic and financial turmoil. After reaching 7.2 percent in 2007, GDP growth moderated to 4.6 percent during the first three quarters of 2008, led by weaker external demand and consumption as the oil and food price shock reduced real income. Headline inflation peaked in August at 12.4 percent, but fell to 8.0 percent in December as commodity prices receded. The external position has weakened due to high commodity prices, lower exports, and more recently, capital outflows. The exchange rate depreciated accordingly, compounded by a shift to long dollar position. Yet, international reserves remain at US$37 billion, 240 percent of short-term debt.

The spillover from the global financial turmoil to domestic financial and currency markets has intensified since September. Equity prices have declined by around 48 percent in 2008, with almost half of the decline taking place since the mid-September flare up in turmoil. The wealth effect has been limited, however, with less than 2 percent of the population invested in capital markets. Measures of credit risk have increased with

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

(market-based) expected default frequencies of banks at elevated levels and Philippine sovereign spreads wider by 300 bps (EMBI+ PHL) since end-August. Yet, spreads remain 150–200 basis points lower than the EMBI+ Global average, reflecting reforms in recent years and reserve accumulation during good times.

The exposure to failed and distressed global financial institutions is limited. As of end-September 2008, direct exposures to Lehman Brothers stood at US$350 million (3 percent of equity), but a large part has already been provisioned for. Combined exposure to Lehman Brothers and ten other distressed major global financial institutions amounted to US$1.5 billion or 13 percent of equity. However, banks are exposed to market risks through their large holdings of debt securities and credit linked notes. As such, recent changes in domestic interest rates and in sovereign spreads have led to mark-to-market losses. Nonetheless, the banking system remains on average well-capitalized.

Monetary policy was recently eased as the inflation outlook improved due to receding commodity prices and the expected economic slowdown. The Bangko Sentral ng Pilipinas (BSP) has taken a number of steps to help address the fallout from the global financial crisis on local banks. The reserve requirement was recently reduced by 2 percentage points to 19 percent and the amount allocated for the rediscount window was doubled. To address tightness in the dollar interbank market, the BSP opened a dollar-denominated deposit window and a dollar repurchase facility. The BSP has also enhanced its day-to-day monitoring of the banking system and stress-testing exercises, and mark-to-market rules have been relaxed to bring relief to banks.

The 2008 budget will likely record a deficit of 1 percent of GDP, an improvement over the 2007 deficit of 1.7 percent of GDP. The tax effort is expected to remain broadly unchanged at around 14 percent of GDP. Expenditures are expected to be slightly lower, partly due to lower capital expenditure reflecting weak absorptive capacity. Nonfinancial public sector debt in percent of GDP is projected to decline modestly in 2008.

Executive Board Assessment

Executive Directors noted that the Philippine economy faces strong headwinds, but starts from a position of strength. Directors expected growth to moderate over the near term as external demand falls, and private consumption wanes with more modest remittance inflows. Weaker domestic demand, accompanied by receding commodity prices, should anchor expectations of lower inflation.

Directors welcomed the strengthening of financial sector soundness and supervision in recent years, which should enable banks to better withstand the impact of the economic slowdown. Nevertheless, continuing strains in global financial markets could lead to further losses on banks' security holdings, reduce the availability of external financing, and raise risks related to banks' off-balance sheet activities.

To limit the fallout from the global financial crisis, Directors encouraged the BSP to continue to monitor closely the banking sector and maintain supervisory vigilance. While regulatory forbearance, including the relaxation of mark-to-market accounting rules, has provided banks with temporary relief, Directors emphasized the importance of maintaining transparency regarding banks' financial positions. Directors welcomed the BSP's proactive steps to address liquidity strains, and called for existing liquidity facilities to be used flexibly, as needed to relieve further stress.

Directors agreed that the prompt corrective action (PCA) framework to address financial sector vulnerability is broadly appropriate, but saw scope for improvement, including stepped-up surveillance of off-balance sheet activities. The BSP should be given legal authority to disclose enforcement actions when disclosure does not undermine market confidence, and the BSP's charter should be amended to strengthen the legal protection of bank supervisors. Directors called in general for setting in place a more rules-based PCA framework over the medium term, with a few Directors emphasizing the need to maintain flexibility to deal with specific situations.

Directors supported the proposed increase in the Philippines Deposit Insurance Corporation (PDIC) deposit coverage, and noted the importance of allowing for flexibility to temporarily raise it further if the financial sector experiences high stress levels. Recapitalization of the PDIC will be key to support the enhanced deposit protection. Directors welcomed the proposed enhancements to the bank resolution toolkit, including the bridge-bank facility, and several Directors encouraged the authorities to reconsider a more flexible application of the purchase-and-assumption tool. Directors recommended that bank restructuring decisions be made irreversible, and that the legal protection of PDIC staff be strengthened.

Directors noted that the credibility of the inflation targeting framework has helped anchor inflation expectations. They considered appropriate the recent easing of monetary policy in light of the receding inflation pressures and the emergence of downside risks to growth. They saw scope for further monetary easing if inflation expectations continue to fall. They recommended that the exchange rate remain flexible so as to adjust to the changing external environment, with the central bank's participation in the foreign exchange market limited to smoothing erratic movements. A strategy of raising interest rates and limited unsterilized intervention, while preserving a prudently high level of foreign exchange reserves, should be considered in response to a temporary financial shock. A few Directors cautioned, however, that such a strategy should avoid inducing procyclical movements in interest rates.

Directors concurred with staff's assessment that the exchange rate of the Philippine peso is broadly in line with longer-term fundamentals and does not threaten external stability.

Noting that fiscal consolidation has reduced the public debt-to-GDP ratio significantly in recent years, Directors agreed that fiscal policy could help to cushion the current slowdown. However, given the still-high level of public debt, there should be a measured fiscal stimulus to avoid compromising fiscal sustainability and policy credibility. To provide more scope for fiscal easing and outlays on well-targeted pro-poor cash transfers, Directors suggested raising the tax collection effort, broadening the tax base, and rationalizing tax incentives. Directors welcomed the authorities' intention to limit the fiscal deficit to no more than 2 percent of GDP by being prepared to scale back expenditures in the event of a shortfall in tax revenues. They encouraged the authorities to develop specific contingency plans to address unexpected pressures on the fiscal accounts.

Directors considered that a formal medium-term fiscal framework would help strengthen fiscal policy planning. They supported the introduction of a fiscal rule, and a fiscal responsibility law providing for the full financing of new tax and expenditure measures.

Directors called for a further streamlining of the National Food Authority and other government-owned and controlled corporations. They looked forward to the completion of the privatization of the power sector.

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Philippines: Selected Economic Indicators, 2004−09

	2004	2005	2006	2007	Staff Proj. 1/ 2008	2009
Growth and prices (in percent change)						
GDP growth	6.4	5.0	5.4	7.2	4.4	2.9
CPI inflation (average)	6.0	7.7	6.2	2.8	9.3	4.8
Public finances (in percent of GDP)						
National government balance (authorities' definition)	-3.8	-2.7	-1.1.	-0.2	-0.5	-1.7
National government balance 2/	-4.2	-3.0	-1.4	-1.7	-1.1	-2.0
Nonfinancial public sector balance 3/	-5.0	-2.1	0.1	0.4	-0.6	-1.8
Revenue and grants 4/	20.5	22.1	23.0	24.1	23.1	21.5
Expenditures 5/	25.5	24.1	22.9	23.7	23.7	23.3
Nonfinancial public sector debt 6/	95.2	85.9	73.9	60.9	59.9	60.4
Money and credit (in percent change)						
Broad money (M3) 7/	10.3	10.3	22.7	10.6	13.1	....
91-day T-bill rate (end period, in percent) 8/	8.4	6.4	5.1	4.2	5.8	....
Credit to the private sector (net) 7/	4.9	-0.3	6.7	8.5	17.0	....
External sector						
Current account balance (in percent of GDP)	1.9	2.0	4.5	4.4	2.0	1.8
Gross international reserves, adjusted						
In billions of U.S. dollars 9/	15.2	18.0	23.0	33.8	37.2	37.2
In percent of short-term liabilities 10/	125.8	120.1	172.7	215.2	257.6	262.5

Sources: The Philippine authorities; IMF staff estimates and projections.
1/ Projections are based on baseline scenario.
2/ IMF definition. Excludes privatization receipts of the national government, and includes net deficit from restructuring the central bank.
3/ Includes the national government, Central Bank-Board of Liquidators, 14 monitored government-owned enterprises, social security institutions, and local governments.
4/ The sum of all nonfinancial public sector revenue net of intra-public sector payments. It is assumed that 80 percent of Bureau of Treasury revenue represents interest and dividends from other parts of the nonfinancial public sector. Privatization receipts are excluded.
5/ Defined as difference between nonfinancial public sector revenue and balance.
6/ Debt is consolidated (net of intra-nonfinancial public sector holdings of debt).
7/ As of October 2008.
8/ As of December 2008.
9/ In addition to monitoring the level of gross international reserves (GIR), the IMF also monitors Adjusted Reserves, which are calculated by subtracting from GIR the value of the BSP's foreign assets that have been pledged as collateral for short-term liabilities. These pledged assets (gold and other securities) remain foreign reserve assets of the BSP and so are considered part of GIR. However, they are not as readily usable as other components of GIR since pledged assets must be set aside while the short-term liabilities they secure remain outstanding.
10/ Short-term liabilities include medium- and long-term debt due in the following year, and exclude loans backed by gold and securities pledged as collateral.