



# *Office Memorandum*

To: Members of the Executive Board

July 14, 2014

From: The Secretary

Subject: **Philippines—Assessment Letter for the World Bank**

Attached for the **information** of Executive Directors is the Fund's assessment letter on the macroeconomic conditions in the Philippines, which was requested by the World Bank.

If the authorities of the Philippines consent to the publication of this assessment, it may be published by the World Bank.

Questions may be referred to Ms. van Elkan, APD (ext. 34763).

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

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## Philippines—Assessment Letter for the World Bank

July 11, 2014

The Philippine economy has continued to perform robustly. GDP grew by 7¼ percent in 2013, supported by strong remittances from overseas workers and accommodative monetary and financial conditions. Due to its occurrence late in the year, super-typhoon Yolanda's impact on 2013 growth was limited, but a somewhat greater effect is likely in 2014. Growth is expected to ease in 2014 also in response to normalizing domestic financial conditions. Already growth slowed in Q1:2014 partly due to temporary factors. Inflation remained below the bottom of the target band (4±1 percent) for much of last year, but picked up since late 2013 and is currently around 4½ percent on pass through of the weaker peso, typhoon-related disruptions to food production, increases in state-managed rice prices and higher electricity prices. The current account surplus rose to 3½ percent of GDP in 2013 on a narrowing trade deficit. Risks to the growth outlook are tilted to the downside, and could stem from both domestic and external sources.

Strong GDP growth in recent years has translated into improved social conditions. Growth has become less employment intensive, but still reduced the elevated under- and unemployment rates. Poverty incidence, although declining, remains high and a large share of the population remains vulnerable to falling into poverty as a result of natural disasters and other shocks.

On the policy front, domestic interest rates have been compressed by loose monetary policies abroad and ample domestic liquidity, partly reflecting the BSP's decision to restrict nonbanks' direct access to its Special Deposit Account (SDA)—one of its main sterilization instruments. Raising banks' reserve requirements by 2 percentage points earlier this year helped absorb part of the earlier net injection. Monetary and financial conditions have also been tightened by the more recent increase in the SDA rate by ¼ percentage point. In the banking system, financial soundness indicators signal continued strong performance, and capital adequacy ratios stand well above newly-introduced Basel III requirements. Bank credit growth recently accelerated to 21 percent and loan exposure to real estate has risen.

The level of public debt has moderated to 39 percent of GDP, alongside improvements in the maturity and currency composition. For 2014, the budget is targeting a deficit of 2 percent of GDP—up from the 1.4 percent of GDP achieved in 2013—that will accommodate post-disaster reconstruction spending. The government aims to double public infrastructure spending to 5 percent of GDP by 2016, financed by additional tax revenue, while keeping the deficit unchanged.

On July 8, 2014, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Philippines and considered and endorsed the staff appraisal without a meeting on a lapse-of-time basis.

## **Executive Board Assessment**

The Philippine economy continued to perform robustly in 2013. Strong macroeconomic fundamentals and financial sector buffers, together with the authorities' flexible policy response to evolving external conditions, cushioned the impact of volatile capital flows. However, domestic monetary and financial conditions are now very accommodative. Notable progress was also achieved in lowering the poverty rate, although the incidence of poverty and under- and unemployment remain elevated.

Macroeconomic prospects are expected to remain favorable going forward. Reconstruction from super typhoon Yolanda, infrastructure spending and remittance-driven private consumption will support rapid GDP growth, but the pace is likely to ease somewhat on more restrictive financing conditions that would help to temper inflation, narrow the positive output gap, and enhance financial stability. The current account surplus is forecast to decline gradually, with the real effective exchange rate moving in line with structural flows.

This favorable outlook could be buffeted by external and domestic events. Abrupt exit from exceptionally loose monetary policies abroad, a sharp slowdown in China or other emerging markets, or a major geopolitical incident could impact global or regional trade and capital flows and adversely affect the Philippine economy. On the domestic front, rapid credit growth or a disproportionate flow of resources to the property sector could boost short-term growth but heighten volatility thereafter, impacting over-leveraged households and corporates.

The challenge is to deliver high quality growth. Better realizing the Philippines' potential for rapid, sustained and more inclusive growth calls for further reducing bottlenecks to investment and formal sector employment that may be discouraging broad based business activities. A more diversified production structure would strengthen resilience to economic shocks, which unduly impact the poor. Favorable demographics are a missed opportunity if the economy cannot effectively absorb the growing working age population. Better domestic job opportunities would reduce poverty, thereby curtailing outward migration and the accompanying social hardships and sustained remittance inflows that can complicate macroeconomic management in the absence of compensating productivity gains.

The economy is well positioned for a more restrictive policy setting, together with a needed rebalancing of the policy mix towards an expansionary fiscal policy. The large buildup of reserves in recent years by leaning against the wind of sustained inflows suggests the external sector is moderately stronger than warranted by medium-term fundamentals. Incomplete sterilization and exceptionally loose monetary policies in advanced economies compressed domestic interest rates to low levels. A tighter overall policy stance is now needed to maintain macrofinancial stability, with a rebalancing of the policy mix in order to accommodate fiscal spending for post typhoon reconstruction and infrastructure upgrading.

Continuing to proactively tighten monetary conditions would address both potential inflation and generalized financial stability risks. With market interest rates well below the policy rate, the BSP's decisions to withdraw liquidity by drawing down reserves and raising reserve requirements earlier this year were appropriate. Additional tightening of monetary and financial conditions is needed with a focus on measures that would not encourage a further shift in financial intermediation to nonbanks, including by raising official interest rates. Providing the BSP with suitable instruments to undertake sterilization would improve the effectiveness of monetary policy. With official reserves more than adequate, the exchange rate should adjust more fully to structural balance of payments flows, while symmetrically smoothing the effect of cyclical capital flows.

Additional targeted action is needed to contain specific risks to the financial system. Early adoption of Basel III capital requirements, monitoring a broader definition of banks' real estate exposure, standardizing "contract to sell" financing arrangements for developers, and establishing the Financial Stability Coordination Council were appropriate preemptive responses to deepening financial intermediation. Taking further measures is advised to contain risks in the property sector and to improve oversight and better manage risks from large exposures. Therefore, the recently-announced bank stress tests for real estate exposure are commendable. Widening the BSP's mandate to include financial stability would help prevent diversion of systemic risk to the shadow-banking sector and strengthen powers for managing risks associated with greater cross border financial integration.

Continuing to focus on mobilizing stable sources of revenue would ensure room for structural spending priorities while preserving fiscal prudence. Increasing the national government deficit to 2 percent of GDP deficit in 2014 and maintaining it thereafter is appropriate to continue to build fiscal buffers and moderate the debt ratio. To achieve sustainable and inclusive economic growth, larger public spending is needed for disaster remediation, infrastructure upgrading and to support improved social outcomes. Meeting these spending demands requires a sizable tax effort, which should focus mainly on broadening the tax base by reducing exemptions and allowances and adopting a new mining strategy, supported by improvements in tax administration.

Further reforms to attract investment and create new employment would help sustain vibrant economic growth and make it more inclusive. Relaxing limits on foreign ownership, reducing red tape, and limiting tax holidays that tend to favor incumbents and distort the tax system would increase market contestability, support execution of PPPs, and better position the Philippines to benefit from the growth and employment opportunities of deeper regional integration. Increasing job creation in agriculture and in micro and small firms calls for establishing clear property rights for small-scale farms, expanding access to formal credit, and reducing labor market rigidities.

**Philippines: Selected Economic Indicators, 2010–15**

	2010	2011	2012	2013	2014 Proj.	2015 Proj.
<b>GDP and prices (percent change)</b>						
Real GDP	7.6	3.7	6.8	7.2	6.2	6.5
CPI (annual average)	3.8	4.7	3.2	2.9	4.4	3.8
CPI (end year)	3.6	4.2	3.0	4.1	4.1	3.5
<b>Investment and saving (percent of GDP)</b>						
Gross investment	20.5	20.5	18.1	19.7	20.7	21.1
National saving	25.0	23.6	21.0	23.1	23.9	23.7
<b>Public finances (percent of GDP)</b>						
National government balance (authorities' definition)	-3.5	-2.0	-2.3	-1.4	-2.0	-2.0
National government balance 1/	-3.6	-2.1	-2.4	-1.4	-2.0	-2.0
Nonfinancial public sector balance 2/	-3.3	-0.8	-1.0	0.3	-0.5	-0.6
Revenue and grants	18.5	18.6	19.0	19.8	20.2	20.1
Expenditure	21.7	19.4	20.0	19.5	20.7	20.7
Nonfinancial public sector debt	54.8	55.3	52.9	50.1	45.6	41.6
<b>Monetary sector (percent change, end of period)</b>						
Broad money (M3)	10.0	7.1	9.4	31.8	32.1 3/	...
Interest rate (91-day treasury bill, end of period, in percent) 4/	1.3	1.7	0.5	0.5	1.2 5/	...
Credit to the private sector (in percent)	8.9	19.3	16.2	16.4	20.9 3/	...
<b>External sector</b>						
Export value (percent change)	26.2	4.1	21.2	-3.6	5.5	6.6
Import value (percent change)	24.7	9.5	11.3	-3.1	8.2	9.0
Current account (percent of GDP)	3.6	2.5	2.8	3.5	3.2	2.6
Capital account (US\$ billions)	0.1	0.2	0.1	0.1	0.1	0.1
Financial account (US\$ billions) /6	-11.5	-5.3	-6.8	0.6	1.7	-1.5
Direct investment (net) /6	1.6	0.3	1.0	-0.2	-0.8	-1.5
Errors and omissions (US\$ billions)	-3.5	0.3	-4.6	-3.8	-3.2	-2.5
Overall balance (US\$ billions)	15.2	11.4	9.2	5.1	4.5	7.7
Total external debt (percent of GDP) 7/	36.9	33.7	31.9	28.8	27.9	25.5
Debt service ratio 8/	13.6	13.6	9.9	10.3	11.9	11.3
Reserves(US\$ billions)	62.4	75.3	83.8	83.2	87.7	95.4
Reserves/short-term liabilities 9/	402.0	475.3	407.2	369.0	372.9	381.8
<b>Exchange rate (period averages)</b>						
Pesos per U.S. dollar	45.1	43.3	42.2	42.4	44.6 10/	...
Nominal effective exchange rate (2005 =100)	110.0	108.9	112.9	116.0	111.3 10/	...
Real effective exchange rate (2005 =100)	127.0	127.8	134.1	139.4	136.0 10/	...

Sources: Philippine authorities; World Bank; and IMF staff projections.

1/ Fund definition. Excludes privatization receipts and includes deficit from restructuring of the previous central bank (Central Bank-Board of Liquidators).

2/ Includes the national government, 14 government-owned enterprises, social security institutions, and local governments.

3/ April 2014 (year-on-year).

4/ Secondary market rate.

5/ May 2014.

6/ In BPM6. An increase in either assets or liabilities is always positive and a decrease is always negative. Net investment is assets minus liabilities.

7/ Includes external debt not registered with the central bank, and private capital lease agreements.

8/ In percent of exports of goods and nonfactor services.

9/ Reserves as a percent of short-term debt (including medium- and long-term debt due in the following year).

10/ Average January-May 2014.