FOR
AGENDA

EBS/89/59
Supplement 1

CONFIDENTIAL

May 1, 1989

To: Members of the Executive Board

From: The Secretary

Subject: Philippines - Staff Report on Request for an Extended Arrangement and Possible Access to Contingency Financing Under the CCFF

Attached for consideration by the Executive Directors is the staff report on the Philippines' request for an extended arrangement in an amount equivalent to SDR 660.6 million, and possible access to contingency financing under the compensatory and contingency financing facility. A draft decision appears on pages 47 and 48.

It is understood that the Executive Director for the Philippines will be requesting the Board for a waiver of the circulation period, to enable this subject to be brought to the agenda for discussion on Monday, May 22, 1989.

Mr. Baumgartner (ext. 7307) or Mr. Goldsbrough (ext. 4735) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

PHILIPPINES

Staff Report on the Request for an Extended Fund Arrangement and Possible Access to Contingency Financing Under the CCFF

Prepared by the Asian and Exchange and Trade Relations Departments

(In consultation with the Fiscal, Legal, Research, and Treasurer's Departments)

Approved by P.R. Narvekar and Anupam Basu

April 28, 1989

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I. Introduction

Discussions on a new economic program to be supported by an extended arrangement were held on several occasions in Manila since the expiration of the previous stand-by arrangement in August 1988. 1/ The Philippine representatives in these discussions included Finance Secretary Vicente Jayme, Central Bank Governor Fernandez, Trade and Industry Secretary Concepcion, and other senior officials including representatives of the key government corporations and financial institutions. Some members of the staff also met with President Aquino.

The authorities have now established a medium-term economic program for the period 1989-92 that aims to maintain strong growth and achieve substantial progress toward an orderly solution of the external debt problem. The letter from the Finance Secretary and the Governor of the Central Bank, dated March 20, 1989 (EBS/89/59), forwards a Memorandum on Economic Policies and requests a three-year extended arrangement in an amount equivalent to SDR 660.6 million (150 percent of quota), equivalent on a 12-month basis to 50 percent of quota (Table 1).

Following an initial purchase of SDR 94.4 million after approval of the requested arrangement, subsequent purchases of SDR 94.4 million each would be made at six-monthly intervals (Table 2). Reviews of the program with the Fund must be completed before each purchase beyond the first can be made, with the exception of the last purchase, which is governed by performance criteria for March 1992.

The authorities have also requested the attachment to the arrangement of external contingency financing, including the optional tranche, under the Compensatory and Contingency Financing Facility (CCFF). Maximum access to external contingency financing would be the equivalent of SDR 286.3 million (65 percent of quota). The proposed factors governing access to the contingency financing are set out in Section VI and Annex XII.

Full use of the requested amounts under the extended arrangement and possible use of the CCFF would raise the Fund's holdings of

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1/ Missions visited Manila during the periods August 22-September 2, 1988, November 1-22, 1988, January 26-February 1, 1989, and February 13-March 7, 1989. The staff members that were involved in some or all of the missions were: Messrs. Narvekar, Baumgartner, Goldsbrough, and Banerjee (all ASD), Regling (ETR), Lorie (FAD), Hicks and Drabek (both IBRD), and Cha (Resident Representative). Mr. Rye (Executive Director) attended part of the November 1988 discussions and Mr. Alfiler (Advisor to the Executive Director) attended part of the discussions during February-March 1989.

Table 1. Philippines: Fund Position, 1988-92 1/

	1988			3-year EFF 1989		1990		1991		1992
	April-June	July-Sept.	Jan.-Dec.	Jan.-June	July-Dec.	Jan.-June	July-Dec.	Jan.-June	July-Dec.	Jan.-June
						(Projections)				
					(In millions of SDRs)					
Purchases	35.0	35.0	70.0	94.4	94.4	94.4	94.4	94.4	94.4	94.4
Ordinary resources	11.7	11.7	23.4	94.4	94.4	94.4	94.4	94.4	46.0	--
Borrowed resources	23.3	23.3	46.6	--	--	--	--	--	48.4	94.4
Repurchases	-27.4	-16.9	-118.4	-62.3	-75.6	-122.6	-127.0	-102.6	-112.4	-51.6
Tranche policies	-27.4	-16.9	-118.4	-62.3	-75.6	-66.6	-71.0	-46.6	-56.3	-51.6
Special facilities	--	--	--	--	--	-56.0	-56.0	-56.0	-56.1	--
Net purchases/repurchases (-)	7.6	18.1	-48.4	32.1	18.8	-28.2	-32.6	-8.2	-18.0	42.8
Total Fund credit outstanding (end of period)	795.3	813.4	791.9	824.0	842.8	814.6	782.0	773.8	755.8	798.6
Tranche policies	571.2	589.3	567.8	599.9	618.7	646.5	669.9	717.7	755.8	798.6
Special facilities	224.1	224.1	224.1	224.1	224.1	168.1	112.1	56.1	--	--
					(In percent of quota) 2/					
Total Fund credit outstanding (end of period)	180.6	184.7	179.8	187.1	191.4	185.0	177.6	175.7	171.6	181.3
Tranche policies	129.7	133.8	128.9	136.2	140.5	146.8	152.2	163.0	171.6	181.3
Special facilities	50.9	50.9	50.9	50.9	50.9	38.2	25.4	12.7	--	--

Source: Staff calculations.

1/ Excluding possible use of CCFF

2/ The Philippines' quota is SDR 440.4 million.

Table 2. Philippines: Proposed Schedule for Drawings
Under the 1989-92 Extended Arrangement

Date of Drawing	Drawing Dependent on:	Amount (in millions of SDRs)
May 1989	Approval of extended arrangement	94.37
December 1989	Compliance with quantitative performance criteria for September 30, 1989 and completion of program review. 1/	94.37
June 1990	Compliance with quantitative performance criteria for March 31, 1990 and formulation of an economic and financial program for the second year and establishment of corresponding performance criteria.	94.37
December 1990	Compliance with quantitative performance criteria for September 30, 1990 and completion of program review. 2/	94.37
June 1991	Compliance with quantitative performance criteria for March 31, 1991 and formulation of an economic and financial program for the third year and establishment of corresponding performance criteria.	94.37
December 1991	Compliance with quantitative performance criteria for September 30, 1991 and completion of program review. 3/	94.37
May 1992	Compliance with quantitative performance criteria for March 1992	94.38

1/ Scheduled to be completed by Executive Board not later than December 31, 1989.
2/ To be completed not later than December 31, 1990.
3/ To be completed not later than December 31, 1991.

Philippine pesos from the present level of 171 percent of quota (end-March 1989) to 246.3 percent of quota at the end of the period of the proposed arrangement. However, excluding possible use of the CCFF, the Fund holdings of Philippine pesos would increase only slightly to 181.3 percent at the end of the arrangement. In the view of the staff, the proposed access level is appropriate; the policies adopted by the authorities and the medium-term prospects point to the continued ability of the Philippines to remain current in its payments obligations to the Fund.

The Philippines has been a long-term user of Fund resources with a succession of stand-by arrangements since the 1960s. The most recent arrangement, for 1986-88, was successfully completed and all purchases were made. The 1988 Article IV consultation was concluded by the Executive Board on June 20, 1988 (EBM/88/96). The Philippines continues to avail itself of the transitional arrangements of Article XIV. 1/

II. Background: Crisis, Reform, and Recovery

1. The 1983-85 crisis and subsequent reform

The principal origins of the severe economic and financial crisis that engulfed the Philippines in the mid-1980s are well known: a distorted incentive structure favored the development of inefficient, import-dependent industries while it discouraged exports; in this environment, large investments, frequently for prestige projects with low economic return, led to a rapid accumulation of external debt but little additional capacity to service it. This pattern of development was sustained during the period of rising oil prices and a weakening world economy in the late 1970s and early 1980s, thus reinforcing the need for foreign borrowing. Growing political tensions weakened confidence and in late 1983 a standstill had to be declared on maturing principal payments on most external debt, leading to a virtual cutoff from new foreign finance. During the ensuing crisis in 1984-85, real GNP fell by a total of 11 percent, the investment/GNP ratio declined by

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1/ The Philippines does not maintain exchange restrictions under the transitional arrangements of Article XIV. The limitation on the remittance of certain dividends in connection with the debt to equity conversion scheme constitutes an exchange restriction subject to the approval of the Fund under Article VIII. (See Staff Report for the 1988 Article IV consultation, SM/88/113; 5/25/88). In addition, an exchange restriction, subject to approval under Article VIII, Section 2(a) is evidenced by the accumulation of arrears to Paris Club creditors since the end of the consolidation period (August 1988) under the last restructuring arrangement; agreement on the rescheduling of the accumulated arrears by Paris Club creditors is expected to take place soon after the extended arrangement becomes effective.

one half, and inflation reached a peak of 60 percent, while the current account deficit fell from 8 percent of GNP in 1983 to near zero in 1985 owing to severe import compression (Chart 1).

The task of rebuilding the economy was begun in 1984, with an initial emphasis on macroeconomic stabilization and a regularization of external financial relations so as to restore confidence. The next stage of the process, emphasizing economic reform, gained substantial momentum when a new government came to power in early 1986. A comprehensive, medium-term program to reorient the economic system was initiated, designed to tackle the root causes of the Philippines' economic difficulties. In agriculture, the reforms aimed at dismantling monopolies and enhancing the role of the private sector, especially in the foodgrain, sugar, and coconut sectors. In the area of public finances, a major tax reform was launched to remove distortions, improve equity and raise the low revenue elasticity. At the same time, government expenditure was reoriented toward rural, social and labor-intensive activities. Reform programs for the largest government financial institutions and the nonfinancial public corporations were also introduced. Furthermore, trade policy aimed (i) to remove progressively the import restrictions that had resulted in a sheltered market, (ii) to rely instead on protection through tariffs and (iii) to impart an outward-looking orientation to industry. As a result of these reforms, the principal distortions in the economy were removed.

2. The 1986-88 recovery 1/

The economic situation began to turn around in mid-1986, and in the period since then the economy has staged a remarkable recovery. In the two and a half years to end 1988, real GNP grew at an annual rate of about 6 percent. Gross domestic investment, at constant prices, increased by an annual average of 27 percent in 1987-88, rising from a low of 13 percent of GNP in 1986 to about 18 percent of GNP in 1988. This favorable development mainly reflected higher private investment, as greater political stability and regained confidence led to a construction boom and to sharply rising equipment investment. Public investment lagged behind, remaining broadly unchanged as a proportion of GNP at 3-3 1/2 percent. Consumption expenditure was boosted by the growth in wages and employment and by higher farmgate prices for sugar and coconut products following the reform of these sectors. Responding to strong domestic and external demand, output in the manufacturing sector rose by 8 percent a year. However, agricultural production, which was affected by drought in 1987 and severe typhoons in 1988, averaged under 2 percent growth. Reflecting the strengthening of demand as well as a temporary tightening of food supplies as a result of

1/ A more detailed review of developments under the 1986-88 stand-by arrangement is contained in Annex IV.

typhoons, the average inflation rate (CPI) increased from a low of 1 percent in 1986 to 9 percent in 1988.

The consolidated public sector deficit declined from 4.8 percent of GNP in 1986 to 2.7 percent of GNP in 1987 before widening to an estimated 3.4 percent of GNP in 1988, with broadly parallel movements in the deficit of the National Government. The tax reform, in combination with the recovery, lead to a marked increase in the tax revenue/GNP ratio in 1987. However, most of these gains were lost in 1988, owing to the impact on excise receipts of the lower world prices for oil and to weaknesses in tax administration. Current expenditure rose substantially in 1987-88, on account of (i) a rise in the wage bill reflecting general salary increases and the recruitment of additional personnel, especially teachers and the military; (ii) a boost in key operating and maintenance expenditures; and (iii) higher interest payments. The deficit of the major nonfinancial corporations, which fell by one half in 1987, turned to a surplus in 1988 as a result of sizable privatization receipts, the nonpayment of interest on National Government advances, and delays in capital expenditure.

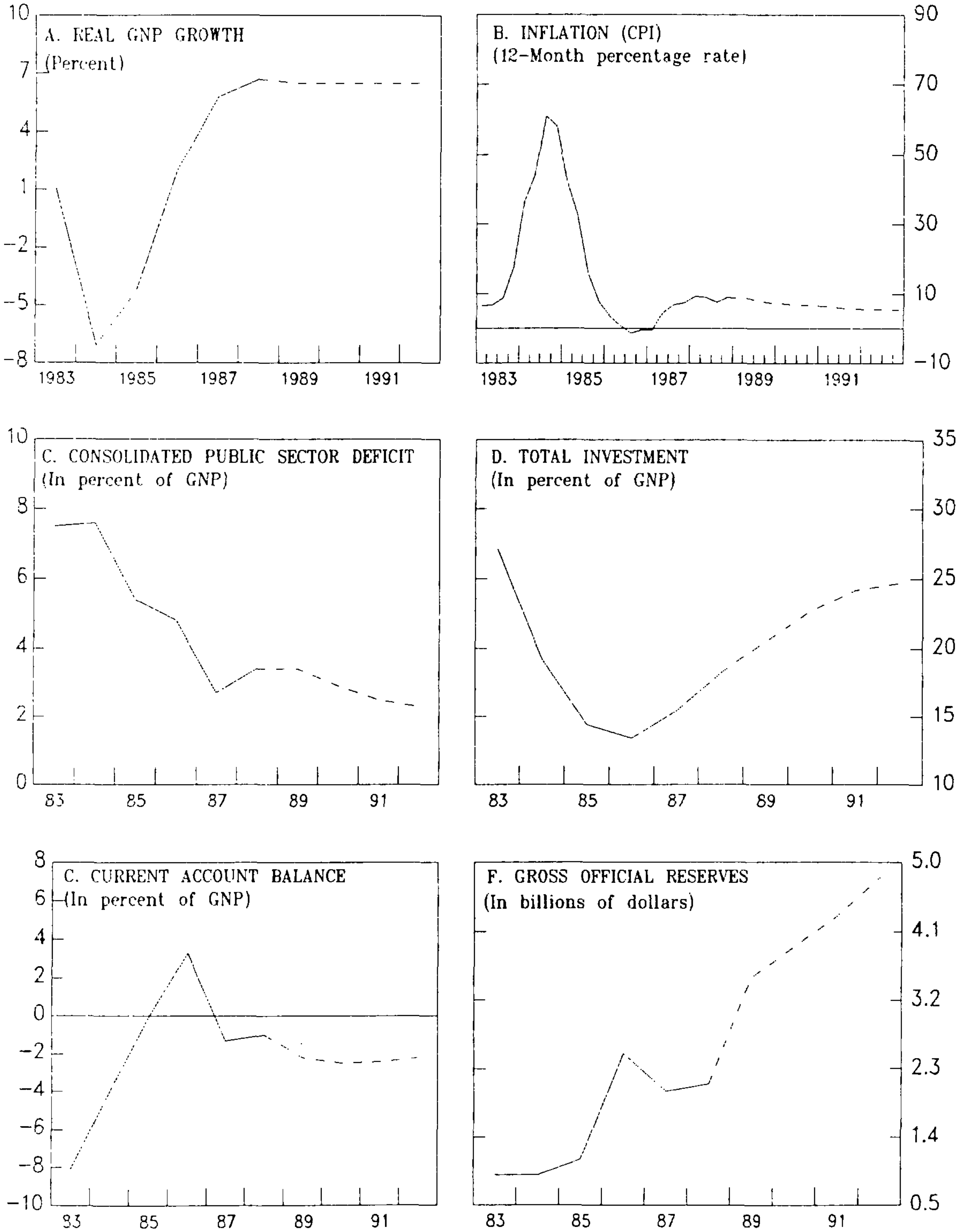
Despite the strength of the recovery, the external current account deficit amounted to only 1.3 percent of GNP in 1987 and 1 percent in 1988. Export volume growth accelerated from 6.5 percent in 1987 to over 11 percent in 1988, when the volume of nontraditional manufactures increased by 18 percent in response to strong external demand. Import volume rose by 31 percent in 1987 and 15 percent in 1988, reflecting higher inflows of capital goods and inputs for the export industries. An improvement of about 8 percent in the terms of trade--owing to a weakening of oil prices and higher prices for some traditional exports--helped contain the current account deficit. Inflows of medium- and long-term loans from official bilateral and multilateral sources, mainly from Japan, the World Bank, and the Asian Development Bank, rose substantially to some $900 million in 1986 and remained around this level during 1987-88. Maturing principal payments on bank debt and debt service to Paris Club creditors (100 percent of principal and 70 percent of interest) 1/ were rescheduled. Recorded inflows of foreign direct investment tripled to about $1 billion in 1988, mainly in the form of debt conversions. Gross official reserves amounted to slightly over $2.0 billion (equivalent to about 2 months of imports of goods and services) at the end of 1988. The debt service ratio (after rescheduling) remained unchanged at about 35 percent during 1986-88, while the external debt/GNP ratio declined from 93 percent in 1986 to 72 percent in 1988.

1/ The consolidation period under the 1987 Paris Club agreement extended through the end of August 1988.

Chart 1

PHILIPPINES

TRENDS IN KEY MACROECONOMIC VARIABLES, 1983-92



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

III. The Medium-Term Program, 1989-92

1. Principal objectives, policies, and external financing strategy

Against the backdrop of the economic success of the past 2-3 years, the Government has formulated a medium-term program that combines a strong growth orientation with a continuation of the comprehensive structural adjustments; it also contains measures, especially agrarian reform, that are designed to address directly the problem of poverty. The principal objectives of the program are (i) the continuation of strong growth of around 6.5 percent per year, which would restore pre-crisis per capita income levels by the early 1990s; (ii) a reduction in inflation from 9 percent to 5-6 percent; and (iii) a strengthening of the external payments position and an easing of the burden of external debt, with a view of eventual return to normal market access (Table 3).

The policy strategy adopted by the authorities to achieve these objectives has five main elements: First, there is the need to ensure a substantial increase in productive investment in order to allow rapid growth to continue. Second, financing of this investment effort requires higher national savings, in particular public sector savings. Third, prudent financial policies are to continue to support confidence both at home and abroad in the recovery of the economy. Fourth, structural reforms designed to increase efficiency remain a central element of economic policy. And fifth, substantial external support is being sought, both through the provision of new financing and voluntary debt reduction.

a. Investment and savings

The program provides for an increase in the investment/GNP ratio from about 18 percent in 1988 to close to 25 percent by 1992 (Table 4). The existence of substantial idle capacity after the recession made it possible for the economy to grow strongly despite relatively low investment. However, as the recovery gained strength, capacity constraints were increasingly felt and, unless alleviated quickly, would constrain future growth. The program incorporates an increase in public investment from less than 3.5 percent of GNP in 1988 to over 5 1/2 percent in GNP in 1991-92. The World Bank staff believes that such an expansion is critical to the removal of key infrastructural bottlenecks. In addition, private investment is projected to continue its recovery, rising from about 15 percent of GNP in 1988 to almost 19 percent of GNP in 1992. These investment ratios imply an increase in the gross ICOR from about 2.5 in 1988--this low level reflected the availability of unused capacity--to above 3.5 in the early 1990s, a level similar to that of comparable countries.

Table 3. Principal Objectives of the Adjustment Program, 1986-92

	1986	1987	1988 Prel.	1989 Program	1990 Program	1991 Program	1992 Program
GNP and prices (percent change)							
Real GNP	2.0	5.9	6.7	6.5	6.5	6.5	6.5
CPI (average)	0.8	3.8	8.8	8.0	6-7	5-6	5-6
External objectives							
Current account							
Billions of U.S. dollars	1.0	-0.4	-0.4	-1.0	-1.2	-1.3	-1.3
Percent of GNP	3.3	-1.3	-1.0	-2.2	-2.5	-2.4	-2.2
Exports (percent change in $ value)	4.6	18.1	23.7	13.7	12.0	14.9	14.9
Imports (percent change in $ value)	-1.3	33.6	20.6	17.6	12.7	11.6	11.7
Overall balance (billions of U.S. dollars) 1/	1.2	0.3	0.5	1.6	0.7	1.1	0.7
Gross official reserves							
Billions of U.S. dollars	2.5	2.0	2.1	3.5	3.9	4.3	4.8
Months of imports 2/	3.7	2.3	2.1	3.0	3.0	3.0	3.0
Debt service ratio (percent, after rescheduling)	34.0	35.7	33.7	33.8	32.3	31.1	29.4
External debt							
Billions of U.S. dollars	28.3	28.6	27.9	29.1	29.5	30.1	30.7
Percent of GNP	92.9	83.4	72.2	66.7	61.2	56.3	52.1
Public sector (percent of GNP)							
National Government deficit 3/	5.1	2.9	3.1	1.6	0.9	0.9	1.4
Monitored public sector borrowing requirement 3/	4.3	2.1	2.4	2.1	1.6	1.8	2.0
Consolidated public sector deficit	4.8	2.7	3.4	3.4	2.9	2.5	2.3
Public investment expenditure 4/	3.1	3.6	3.4	4.2	4.7	5.6	5.8
Money (percent increase; end period)							
Broad money	13.4 5/	11.4	23.1	13.5	15.5	13.7	13.7
Base money	19.6 5/	11.0	14.9	10.2	13.9	11.9	11.2
Central Bank net domestic assets	15.9 5/	2.5	-1.3	0.1	-0.3	0.6	-1.1

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

1/ After rescheduling and concerted lending.

2/ Months of imports of goods and services of the current year.

3/ Includes the impact of the phased transfer of Central Bank losses to the National Government, beginning in 1990.

4/ Excludes expenditure on land acquisition and credit support under the CARP.

5/ There is a break in the series in 1986 because of a number of statistical changes made following a recent mission from the Bureau of Statistics.

Table 4. Philippines: Savings, Investment, and Growth, 1986-92

(In percent of GNP)

	1986 Act.	1987 Act.	1988 Prel.	1989	1990	1991	1992
				Program Projections			
1. Foreign savings 1/	-3.3	1.3	1.0	2.2	2.5	2.4	2.2
2. Gross national savings	16.5	14.1	17.2	18.3	20.2	21.8	22.5
a. Public 2/	-0.9	1.5	0.6	1.4	3.0	4.0	4.4
b. Private 3/	17.4	12.6	16.6	16.9	17.2	17.8	18.1
3. Gross domestic investment	13.2	15.4	18.2	20.5	22.7	24.2	24.7
a. Public	3.1	3.6	3.4	4.2	4.7	5.6	5.8
b. Private	10.1	11.8	14.8	16.3	18.0	18.6	18.9
4. Capital transfers from public to private sector 4/	0.8	0.8	0.7	0.6	1.2	0.9	0.9
5. Consolidated public sector deficit (2a - 3a -4)	-4.8	-2.7	-3.4	-3.4	-2.9	-2.5	-2.3
Memorandum items:							
Real GNP growth rate (percent)	2.0	5.9	6.7	6.5	6.5	6.5	6.5
Gross ICOR 5/	6.9	2.4	2.5	3.0	3.3	3.6	3.8
Growth rate of total investment (percent)	-9.1	27.9	26.0	20.0	17.9	13.5	8.7
Growth rate of total real consumption (percent)	0.8	6.3	2.8	5.1	4.0	4.4	5.5

Source: Date provided by the Philippine authorities and Memorandum on Economic Policy, 1989-92.

1/ External current account surplus (-)/deficit (+).

2/ Total revenues less current expenditures of consolidated public sector.

3/ Derived as a residual, i.e., includes statistical discrepancy.

4/ Includes net lending of social security systems, agrarian reform expenditures on land acquisition and credit for which financing is already identified, and transfers to nonmonitored corporations.

5/ Average of current and previous years' ratio of total investment/GNP divided by current year's growth rate.

The financing of this investment effort will require an increase in gross national savings from about 17 percent of GNP in 1988 to 22.5 percent of GNP in 1992; the access to foreign savings would also rise from about 1 percent of GNP in 1988 to 2-2 1/2 percent of GNP during the program period. Most of the growth in national savings would come from an improvement in public savings from 0.6 percent of GNP in 1988 to 4.4 percent by 1992. By contrast, the increase in the private savings rate is expected to level off owing to stronger consumption growth. The program assumes real private consumption growth of around 4 percent per year, compared with annual population growth of 2.4 percent.

The targeted increases in both public savings and investment imply a gradual reduction in the consolidated public sector deficit from an estimated 3.4 percent of GNP in 1988 to less than 2.5 percent of GNP by 1992. To attain the targets for public savings, the Government has already introduced measures to improve tax administration, restrain the growth of personnel expenditures, and strengthen the internal cash generation of public enterprises. These measures are estimated to be equivalent to about 1 percent of GNP on a full-year basis. The size of the fiscal gap to be closed through additional measures in 1990-92 is also about 1 percent of GNP. It is envisaged that most of this adjustment will be carried out in 1990 and would include new revenue measures.

b. External financing

The external financing strategy focuses on ensuring sufficient new resources for growth and investment while achieving substantial reductions in debt in relation to GNP and in the debt service ratio, thereby paving the way to eventual restoration of normal market access. The current account deficit is projected to widen somewhat during the program period, rising to a peak of 2 1/2 percent of GNP in 1990-91 but to decline steadily thereafter (Table 5). An important aspect of the balance of payments scenario is a rebuilding of reserves to the equivalent of three months of imports of goods and services. A large part of the external financing for the current account deficit and the reserve build-up is to come from official bilateral and multilateral sources; such flows are projected to double from less than $1 billion in 1988 to about $1.9 billion in 1992. At the same time, continued substantial inflows of direct foreign investment--in part reflecting the repatriation of flight capital--are expected. The balance of payments scenario assumes debt conversions of $2.1 billion during the period 1989-92, equivalent to 16 percent of total external liabilities to banks at end-1988, through a revised debt to equity conversion scheme and similar swaps; no other debt reduction operations have been assumed. Most principal payments to commercial banks falling due during 1989-92 have already been rescheduled. Assuming rescheduling of debt service to Paris Club creditors during the program period on terms comparable to the last rescheduling, the financing gap would amount to about

Table 5. Philippines: Balance of Payments, 1986-95

(In millions of U.S. dollars)

	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
Trade balance	-202	-1,017	-1,054	-1,520	-1,770	-1,670	-1,530	-1,360	-1,125	-925
Exports, f.o.b.	4,842	5,720	7,074	8,040	9,005	10,350	11,895	13,640	15,630	17,870
Imports, f.o.b.	-5,044	-6,737	-8,128	-9,560	-10,775	-12,020	-13,425	-15,000	-16,755	-18,795
Services and transfers (net)	1,198	573	677	561	551	367	206	63	32	149
Services (net)	757	--	-112	-304	-428	-620	-859	-1,066	-1,235	-1,270
Receipts	3,791	3,454	3,606	4,078	4,298	4,555	4,741	5,042	5,404	5,821
Nonfactor payments	988	1,347	1,526	1,828	2,069	2,332	2,636	2,977	3,356	3,815
Interest payments	2,046	2,107	2,192	2,553	2,657	2,843	2,964	3,131	3,282	3,278
Transfers (net)	441	573	789	865	979	987	1,065	1,129	1,267	1,419
Current account	996	-444	-377	-959	-1,219	-1,303	-1,324	-1,297	-1,093	-776
(In percent of GNP)	(3.3)	(-1.3)	(-1.0)	(-2.2)	(-2.5)	(-2.4)	(-2.2)	(-2.0)	(-1.5)	(-1.0)
Capital account	-864	-882	-564	-185	65	184	685	441	43	628
Medium- and long-term loans	-295	-1,431	-1,753	-1,371	-1,184	-1,067	-628	-891	-1,337	-863
Inflows	1,435	1,008	948	1,328	1,591	1,838	1,893	1,950	2,008	2,068
Outflows	-1,730	-2,439	-2,701	-2,699	-2,775	-2,905	-2,521	-2,841	-3,345	-2,931
Direct investment (net)	140	326	986	880	850	850	875	875	900	900
Of which: debt conversion	43	287	806	696	568	382	321	55	--	--
Short-term capital (net)	-814	80	-205	-89	-26	-54	-47	-53	-75	-19
Other	105	143	408	395	425	455	485	510	555	610
Rescheduling 1/	1,110	1,590	1,214	801	956	921	748	625	625	--
Paris Club	379	733	382	--	--	--	--	--	--	--
Commercial banks 2/	731	857	832	801	956	921	748	625	625	--
Financing gap	--	--	243	1,926	916	1,259	579	1,102	1,535	1,730
Possible further Paris Club rescheduling 3/	--	--	243	572	530	498	--	--	--	--
Residual exceptional financing	--	--	--	1,354	386	761	579	1,102	1,535	1,730
Net international reserves (- increase)	-1,242	-264	-516	-1,583	-718	-1,089	-688	-871	-1,110	-1,582
Gross reserves (- increase)	-1469	22	-710	-1,518	-485	-522	-665	-648	-776	-1,039
Of which: Central Bank	-1,398	500	-100	-1,426	-390	-424	-457	-521	-571	-624
Liabilities (+ increase)	227	-286	194	-65	-233	-567	-23	-223	-334	-543
Use of Fund credit (net)	4	-152	-72	70	-85	-37	-22	-69	-96	-152
Purchases	275	161	91	260	263	267	135	--	--	--
Repurchases	-271	-313	-163	-190	-348	-304	-157	-69	-96	-152
Memorandum items:										
Gross official reserves	2,459	1,959	2,059	3,485	3,875	4,299	4,756	5,277	5,848	6,472
(In months of imports)	3.7	2.3	2.1	3.0	3.0	3.0	3.0	3.0	3.0	3.0

Sources: Central Bank of the Philippines; and staff estimates.

1/ Excludes rescheduling of maturing monetary liabilities.
2/ Includes in 1988 an interest rebate of $33 million.
3/ On terms comparable to the last rescheduling by Paris Club creditors.

$750 million per year during 1989-92. The Government expects that the Philippine Assistance Program/Multilateral Assistance Initiative would provide the broad framework for increased flows from multilateral institutions, official and private bilateral sources, and foreign commercial banks.

Discussions of a new financing package from banks for the two-year period 1989-90 were initiated in October 1988 and a further meeting took place in April 1989. The Philippine authorities have requested banks to fill the residual financing gap of $1.7 billion in 1989-90. While no detailed quantified proposals were made, the Philippine authorities indicated that they were aiming for the provision of new money, voluntary debt reduction and a restructuring of the 1985 new money loan. The issue of waivers of negative pledge and sharing clauses has yet to be discussed. It was decided to meet again in late May to discuss a financing package in concrete terms. At this stage, substantial uncertainties remain regarding the size and features of a financing package from commercial banks as well as the timing of an agreement.

The medium-term balance of payments projections show financing gaps of about $1.1-1.7 billion per year in the three year period (1993-95) following the extended arrangement, suggesting that the need for exceptional external financing might well extend beyond the period of the proposed arrangement. (The size of the gaps is highly sensitive to changes in exogenous variables, Annex VII). The financing gaps in 1993-95 could be closed through new money and further rescheduling of debt to banks and official creditors, while debt and debt service indicators continue to decline. Nevertheless, the persistence of financing gaps into the mid-1990s indicates that, subject to the caveats applying to medium-term projections, a return to normal market access could lie outside the projection period and a significant discount on Philippine debt could well persist. Such a set of circumstances could pose risks to savings, private capital flows and investment. Voluntary debt reduction could quicken the return to normal market relationships, strengthen confidence, and improve the environment for savings and investment. Thus, debt reduction could provide additional assurance that the program objectives will be achieved. (Issues related to investment, growth and the external financing gaps are briefly discussed in Annex VII).

2. Fiscal policy

Within the consolidated public sector, the borrowing requirement (PSBR) of the monitored public sector (the National Government and the 14 major nonfinancial government corporations) is programmed to decline from 2.4 percent of GNP in 1988 to 1.6 percent of GNP in 1990 and to be contained within the range of 1.5-2.0 percent of GNP during 1991-92 (Table 6). The PSBR will be mainly financed domestically in 1989, as a

Table 6. Philippines: Consolidated Public Sector Deficit, 1986-92

	1986	1987 1/	1988 Prel. Actual 1/	1989	1990	1991	1992
				Program			
			(In billions of pesos)				
National government deficit	-31.3	-20.1	-25.6	-15.3	-9.7 2/	-11.2 2/	-20.1 2/
Monitored corporations' deficit	-6.8	-3.2	2.1	-7.8	-11.1	-14.5	-12.4
National government net lending and equity to monitored corporations	10.5	9.8	5.4	4.1	3.6	3.8	4.7
NPC transfer to the National Government	1.2	-1.4	--	--	--	--	--
National Government transfer to PNOC	...	...	-1.5	-1.0	--	--	--
Monitored public sector borrowing requirement (PSBR)	-26.4	-14.9	-19.6	-20.0	-17.2	-21.9	-27.8
Deficit of government financial institutions (GFIs) 3/	-12.0	1.3	2.1	3.1	1.9	2.1	2.2
Net income of the Central Bank	-18.2	-10.8	-16.9	-23.3	-20.6 2/	-16.7 2/	-12.0 2/
Other 4/	5.9	5.3	5.2	7.8	4.4	5.4	5.0
National government net lending and equity to GFIs	20.3	1.0	1.4	--	--	--	--
PNB transfer to the National Government	0.7	-0.7	--	--	--	--	--
Consolidated public sector deficit	-29.7	-18.7	-27.8	-32.4	-31.5	-31.1	-32.6
Memorandum items:							
Financing of PSBR	26.4	14.9	19.6	20.0	17.2	21.9	27.8
Net external	-1.7	6.5	0.9	-0.4	12.5	20.4	15.1
Net domestic	28.1	8.4	18.7	19.6	4.7	1.5	12.7
Bank	-4.9	-36.1	-9.4	-7.9	-4.8	1.8	2.2
Nonbank	33.0	44.5	28.1	27.5	9.5	-0.3	10.5
Public sector securities outstanding (end of period) 5/	124.5	159.7	198.7	226.6	237.5	238.2	253.4
Issued by: National Government	89.8	145.7	186.1	214.1	225.1	227.5	240.7
Central Bank 6/	29.9	10.9	9.9	7.6	7.7	7.1	7.1
Monitored corporations	4.8	3.1	2.7	4.9	4.7	3.6	5.6
			(As percent of GNP)				
National government deficit	-5.1	-2.9	-3.1	-1.6	-0.9	-0.9	-1.4
Monitored corporations' deficit	-1.1	-0.5	0.3	-0.8	-1.0	-1.2	-0.9
PSBR	-4.3	-2.1	-2.4	-2.1	-1.6	-1.8	-2.0
Consolidated public sector deficit	-4.8	-2.7	-3.4	-3.4	-2.9	-2.5	-2.3
Capital expenditure of monitored public sector	3.1	3.6	3.4	4.2	4.7	5.6	5.8
Public sector saving	-0.9	1.5	0.6	1.4	3.0	4.0	4.4

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

1/ Data for 1987 and 1988 have been adjusted to be consistent with Central Bank figures on financing of the PSBR.
2/ The targets for 1990-92 reflect the impact of the phased transfer of the Central Bank deficit to the National Government.
3/ Philippine National Bank (PNB), Development Bank of the Philippines (DBP), the Philippine Export and Foreign Loan Guarantee Corporation (Philguarantee), and the Land Bank.
4/ Includes the Local Government Units (LGUs) and the social security institutions.
5/ Excludes public sector securities held by the monetary authorities, but includes securities held by commercial banks.
6/ Includes reverse repurchase agreements.

result of large foreign amortization payments by the National Government. However, foreign financing is expected to cover about three fourths of the PSBR during 1990-92 as foreign project lending accelerates. The total of public sector securities outstanding will decline steadily as a share of GNP from over 24 percent in 1988 to under 19 percent by 1992.

a. National Government

The deficit of the National Government is projected to decline from 3.1 percent of GNP in 1988 to 0.9 percent of GNP by 1990, and to rise thereafter to 1.4 percent of GNP by 1992, reflecting the impact of the transfer to the National Government of a growing share of the Central Bank deficit. Excluding this, the National Government deficit would decline to 0.4 percent of GNP in 1990 and 0.1 percent by 1992. Since total expenditures are projected to remain at around 17.5 percent of GNP throughout the program period, revenue mobilization will be a key element of fiscal adjustment (Table 7).

The tax revenue/GNP ratio is targeted to rise from 11 percent in 1988 to about 14 percent by 1992. A key element in achieving this target will be a major strengthening of tax administration; however, new revenue measures will also be needed, beginning in 1990. An initial package of specific administrative measures is already being implemented (Section IV.2 and Annex V) and is projected to yield revenue amounting to 0.6 percent of GNP in 1989 and 0.8 percent of GNP (on a full-year basis) in 1990. Additional measures will be designed, with technical assistance from the Fund, in time for implementation at the beginning of 1990.

The authorities have undertaken to adopt additional revenue measures to cover any fiscal gaps remaining for 1990-92, which are currently projected at 0.8 percent of GNP in 1990, rising to 1.1 percent of GNP by 1992 Appendix Table 14). New tax measures, possibly including additional excise taxes on alcohol and tobacco, will be formulated in the course of 1989 in time for implementation with the 1990 budget and discussion at the time of the first program review. On present projections, these measures would also cover most of the fiscal gaps for 1991-92.

Excluding the transfer of the Central Bank deficit, total expenditure and net lending is targeted to decline from 17.0 percent in 1988 to 16.4 percent of GNP by 1992. Capital expenditure would rise from 2.2 percent of GNP in 1988-89 to 3.5 percent of GNP by 1992. These targets include only those expenditures in connection with the comprehensive agrarian reform program (CARP) for which resources have already been identified.

Table 7. Philippines: National Government Cash Budget, 1986–92

	1986	1987 1/	1988 Prel. Actual 1/	1989	1990	1991	1992
				Program			
			(In billions of pesos)				
Revenue and grants	79.2	101.2	112.9	149.9	180.0	204.5	227.9
Tax revenue	65.4	85.4	90.3	116.2	144.8	169.1	198.3
Domestic-based taxes	47.6	59.4	64.7	81.0	93.7	108.0	124.7
International trade taxes	17.8	26.0	25.6	35.2	42.4	48.9	57.7
Measures not yet identified					8.7	12.2	15.9
Nontax revenue (including ESF)	13.8	15.8	22.5	33.7	35.2	35.4	29.5
Total expenditure and net lending	110.5	121.3	138.5	165.1	189.7	215.6	248.0
Current operating expenditure	65.7	93.6	113.1	137.1	146.9	159.3	169.6
Of which: Personnel services	(25.0)	(32.5)	(40.4)	(47.4)	(52.0)	(57.2)	(62.9)
Maintenance and operations	(15.0)	(18.9)	(20.3)	(25.9)	(29.5)	(34.0)	(38.3)
Interest payments	(21.6)	(37.0)	(47.0)	(54.2)	(54.2)	(55.7)	(55.6)
Subsidies	(1.7)	(2.4)	(2.4)	(6.2)2/	(7.2)2/	(7.8)2/	(7.6)2/
Of which: Tax expenditure	(0.4)	(0.5)	(1.0)	(0.7)	(0.2)	(0.2)	(0.2)
Impact of transfer of Central Bank deficit (net) 3/					5.1	11.1	18.1
Capital expenditure and net lending	44.8	27.7	25.4	28.0	37.7	45.2	60.2
Capital expenditure 4/	(12.9)	(15.6)	(17.9)	(20.6)	(27.1)	(35.4)	(49.5)
Equity and net lending	(31.9)	(12.0)	(7.5)	(7.4)	(10.6)	(9.8)	(10.3)
Of which: To monitored public corporations	(10.5)	(9.8)	(5.4)	(4.1)	(3.6)	(3.8)	(4.7)
Assistance to government financial institutions (GFIs)	(20.3)	(1.0)	(1.4)	(—)	(—)	(—)	(—)
Deficit (-)	-31.3	-20.1	-25.6	-15.3	-9.7	-11.2	-20.1
Financing	31.3	20.1	25.6	15.3	9.7	11.2	20.1
Foreign (net)	3.6	7.7	4.5	-1.1	4.8	8.6	9.5
Gross borrowing	(9.8)	(16.3)	(17.1)	(17.7)	(22.0)	(24.9)	(22.8)
Amortization	(-6.2)	(-8.6)	(-12.6)	(-18.8)	(-17.2)	(-16.3)	(-13.3)
Domestic (net)	27.7	12.4	21.1	16.4	4.9	2.6	10.6
Bank	(-5.8)	(-36.2)	(-9.3)	(-6.4)	(-4.7)	(0.2)	(-3.8)
Nonbank	(33.5)	(48.6)	(30.4)	(22.8)	(9.6)	(2.4)	(14.4)
			(In percent of GNP)				
Memorandum items:							
Revenue and grants	12.9	14.4	13.8	15.8	16.7	16.6	16.2
Tax revenue	10.7	12.2	11.1	12.3	13.4	13.7	14.1
Of which: Measures not yet identified					(0.8)	(1.0)	(1.1)
Total expenditure and net lending	18.1	17.3	17.0	17.5	17.6	17.5	17.7
Of which: Personnel services	4.1	4.6	5.0	5.0	4.8	4.6	4.5
Maintenance and operations	2.5	2.7	2.5	2.7	2.7	2.8	2.7
Capital expenditure 3/	2.1	2.2	2.2	2.2	2.5	2.9	3.5
Deficit (-)	-5.1	-2.9	-3.1	-1.6	-0.9	-0.9	-1.4

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

1/ Data for 1987 and 1988 have been adjusted to be consistent with Central Bank figures on financing of the PSBR.
2/ The increase in subsidies reflects largely the provision of explicit subsidies for interest payments by corporations on National Government advances; the corresponding larger interest receipts are included in nontax revenue.
3/ Including interest payments on resulting higher National Government deficit, or interest receipts foregone.
4/ Including capital transfers to Local Government Units (LGUs), but excluding the transfers on land acquisition and credit in connection with the comprehensive agricultural reform program (CARP), which are part of equity and net lending.

Current expenditures are targeted to rise temporarily to 14.5 percent of GNP in 1989 and then to decline steadily to around 12 percent of GNP by 1992. The increase in 1989 reflects, in part, the one-time impact of an early retirement scheme that is part of a broader effort to restructure the civil service. The aim of the reorganization is to identify functions and responsibilities more clearly and to shift staff to regional offices. Beyond this, a Compensation Standardization Bill will be implemented in the second half of 1989 to integrate most allowances within the basic pay and to establish a uniform salary structure across government agencies; the bill also provides for an increase in the basic minimum salary by around 20 percent. During 1990-92, the growth in total personnel costs will be held to no more than 10 percent a year and the growth in new positions will be limited to at most 1 percent a year. Thus, the total wage bill will decline from about 5 percent of GNP in 1988-89 to 4.5 percent by 1992. After an initial increase in 1989, maintenance and operating expenditures are targeted to grow at about the same rate as GNP in order to provide adequate support for public infrastructure. Interest payments are projected to amount to about one third of total expenditure in 1989, equivalent to close to 6 percent of GNP. Over the program period, interest payments are to decline steadily as a share of GNP as a result of the lower deficits and a gradual fall in domestic interest rates. 1/

b. Central Bank net income position

The Central Bank has incurred large deficits that stem from quasi-fiscal activities undertaken during the early 1980s, including the provision of forward foreign exchange cover at nonmarket rates for the imports of selected public enterprises; significant losses were also incurred on foreign exchange swap arrangements. At their peak in 1983-84, these deficits amounted to over 4 percent of GNP. The potential impact on monetary aggregates was offset by the sale of additional open market instruments, which helped contain inflation but resulted in a substantial interest burden for the Central Bank. Thus, although the quasi-fiscal activities have now been halted (the last of the previously negotiated forward cover contracts was eliminated in 1986), the Central Bank still has a significant deficit arising from large interest payments on domestic and foreign liabilities that are not matched by equivalent earning assets. The concentration of these expenditures in the Central Bank has complicated monetary policy and obscured the true size of the fiscal deficit.

1/ The projections do not include those interest expenditures incorporated in the Central Bank deficit. Nor do they include the extra interest payments that would arise from the support by the National Government of open market operations in the form of a further build up of National Government deposits at the Central Bank; these interest payments would be matched by higher interest receipts, and hence the deficit would remain unchanged.

The Central Bank deficit is projected to rise moderately to about 2.4 percent of GNP in 1989, reflecting domestic and foreign interest rates that are higher, on average, and a larger stock of interest-bearing liabilities. The program provides for a phased reduction in the deficit, with the aim of eliminating it completely by 1995. The bulk of the reduction will have to be achieved by means of direct or indirect budgetary support from the National Government, including the transfer to the Government of selected Central Bank liabilities. The first stage of this transfer will take place in 1990 and will reduce the Central Bank deficit by ₱ 5 billion (i.e., around one fifth) with a corresponding increase in the deficit of the National Government. The corresponding total shift in deficits in later years would amount to about ₱ 11 billion (0.9 percent of GNP) in 1991 and ₱ 18 billion (1.3 percent of GNP) in 1992. The specific arrangements to complete the transfer will be discussed at the time of the first review.

c. Public enterprises

The overall deficit of the 14 monitored corporations is programmed to be about 1 percent of GNP and internal cash generation about 1.3 percent of GNP throughout the period (Appendix Table 15). While the target for cash generation is approximately the level obtained in 1988 (when receipts were boosted temporarily by the privatization of a large subsidiary), it is substantially higher than the average of 1986-87 (0.4 percent of GNP). The strong cash generation will occur despite the phasing out of tax subsidies and will reflect: (i) phased increases in tariffs for electricity, water, port facilities, and in the distribution price for rice; (ii) actions undertaken to improve collection efficiency--in particular, at the National Irrigation Authority (NIA) and National Housing Authority (NHA)--and billing efficiency, especially at the Metropolitan Waterworks and Sewerage System (MWSS); as well as (iii) further proceeds from privatization, including of the National Steel Corporation by 1991. The cumulative financial impact of these measures is estimated at ₱ 2-3 billion a year during 1989-90 and at over ₱ 8 billion a year during 1991-92.

Capital expenditures of the monitored corporations are targeted to more than double as a share of GNP in 1988 to about 2.5 percent by 1991-92. Higher expenditures of the National Power Corporation (NPC) would account for the bulk of the increase, as new generating capacity in place of the now mothballed nuclear power plant is installed to meet growing demand.

d. Investment program 1/

The level of public investment fell substantially short of target in 1986-88 owing to a reappraisal of projects by the new Government, changes in key management personnel, the imposition of tight administrative controls in reaction to previous abuses, and procedural bottlenecks that hampered foreign-assisted projects. As a result, capacity constraints have tightened for key infrastructure, most notably power generation and transportation. The program provides for a significant increase in public investment to ease these constraints as well as to strengthen the provision of services to disadvantaged groups, including improved agricultural support facilities and an expanded system of secondary schools. Public investment as a share of GNP is targeted to rise from an estimated 3.4 percent in 1988 to 5.8 percent by 1992, with a little over half of the total expenditure being undertaken by the National Government. The World Bank staff has reviewed the investment program and considers it appropriate and necessary as a foundation for future economic growth.

A number of measures have already been taken to speed up implementation of key projects, especially those that are foreign financed. Streamlined procedures for the review and approval of large contracts will also be established in 1989. To track the progress of these measures, a monitoring system has been established, in collaboration with the World Bank, that will report the size and composition of capital expenditures on a quarterly basis. Indicative quarterly targets for total public investment will be established under the program. Furthermore, the PSBR will be adjusted upwards (downwards) for any excess (shortfalls) in capital expenditures financed by external project loans in order to provide some flexibility for a faster-than-projected pace of implementation on key projects while tightening fiscal targets in the event of any shortfall in these expenditures. 2/

3. Monetary policy

The growth of monetary aggregates during the program period has been targeted consistent with the objectives of strong output growth and a steady decline in inflation. Average annual growth in broad money (M3) is projected to decline gradually from around 20 percent in 1988 to 13-14 percent by 1991, in line with a projected income elasticity of demand of about 1.2 (Table 8). The velocity of broad money would decline gradually, but would still be above the levels observed prior to

1/ A more detailed appraisal of the medium-term public investment program and of measures to improve the pace of implementation, prepared by the World Bank staff, is contained in Annex VI.

2/ Excesses and shortfalls will be measured by deviations of actual receipts of foreign financing from program levels.

Table 8. Philippines: Monetary Survey, 1986-92 1/

(In billions of pesos; end of period)

	1986	1987	1988	1989			1990		1991	1992
	Act.	Act.	Act.	June	Sept.	Dec.	March	Dec.	Dec.	Dec.
				Program						
Total liquidity	167.1	181.8	221.5	230.7	236.6	258.8	264.7	298.9	340.5	387.9
M3 2/	152.6	170.0	209.2	212.6	217.5	237.4	242.8	274.2	311.8	354.5
(12-month change in percent)	(13.4)	(11.4)	(23.1)	(16.8)	(15.8)	(13.5)	(14.8)	(15.5)	(13.7)	(13.7)
Currency	29.3	35.4	40.6	34.2	33.8	41.8	39.8	46.4	51.1	55.1
Deposits and deposit substitutes	123.3	134.6	168.6	178.4	183.7	195.6	203.0	227.8	260.7	299.4
Other liabilities	14.5	11.8	12.3	18.1	19.1	21.4	21.9	24.7	28.7	33.4
Net foreign assets	-140.9	-135.8	-119.8	119.2	-115.3	-111.2	-109.4	-99.9	-90.2	-74.0
Net international reserves	-35.2	-30.1	-18.7	-21.3	-5.6	9.8	12.0	22.7	42.3	54.7
Other foreign liabilities	-105.7	-105.7	-101.1	-97.9	-109.7	-121.0	-121.4	-122.6	-132.5	-128.7
Net domestic assets	308.1	317.6	341.3	349.9	351.9	370.0	374.1	398.8	430.7	461.9
Public sector credit	44.7	7.1	0.2	-15.1	-18.9	-7.6	-9.5	-12.4	-10.6	-8.4
Credit to National Government (net)	24.5	-9.3	-16.5	-30.4	-32.6	-22.9	-27.4	-27.6	-27.4	-31.2
Monitored corporations	9.4	7.0	6.5	5.1	3.5	5.1	7.7	5.0	6.6	12.6
Other government entities	10.8	9.4	10.2	10.2	10.2	10.2	10.2	10.2	10.2	10.2
Private sector credit	141.3	162.1	183.2	195.5	201.3	209.2	212.7	237.6	267.3	295.8
Other items (net)	122.1	148.3	157.9	169.5	169.5	168.4	170.9	173.6	174.0	174.5
Of which: Central Bank security issues outside the banking system	-18.3	-4.3	-4.4	-3.2	-3.2	-2.7	-2.7	-2.8	-2.3	-2.3
Memorandum items:										
Currency/deposit ratio	0.238	0.263	0.241	0.192	0.184	0.214	0.196	0.204	0.196	0.184
Base money multiplier	2.715	2.724	2.918	3.122	3.166	3.005	3.101	3.047	3.096	3.165

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

1/ Foreign assets and liabilities are converted into pesos at a constant exchange rate of P 18.002 per U.S. dollar. Beginning in June 1986, certain liabilities of the Philippine National Bank were transferred to the National Government; for consistency purposes, all data presented here are on a before-transfer basis. Data also include a number of statistical changes made following a recent mission from the Bureau of Statistics (including the *incorporation* of the Land Bank).

2/ M3 includes currency, time and demand deposits, and various deposit substitutes.

the onset of the economic and financial crisis in 1983 (Chart 2). Quasi-money (time deposits and various deposit substitutes) is expected to remain the fastest growing component of liquidity, reflecting the strong growth in financial savings. The growth in M3 and the external targets of the program are consistent with private sector credit expansion of about 14 percent a year during 1989-90 and about 12 percent in later years.

The targets for the monetary base (base money) assume that, as a result of the more stable financial conditions, the decline in the currency-deposit ratio from the historically high levels of 1986-87 will continue but at a slower rate than in 1988. Reflecting these developments, the rise in the base money multiplier is expected to slow during 1989-90 (Table 9). Thus, the average annual growth of base money is targeted to rise slightly in 1989-90 to 13-14 percent, but will then decline along with that of broad money.

The authorities intend to continue to focus on base money as the principal intermediate target of monetary policy, reflecting their emphasis on containing inflation in the context of a flexible exchange rate system. However, as under the 1984-86 and 1986-88 stand-by arrangements, the financial program provides for some flexibility to accommodate unanticipated increases in the demand for money that are reflected in increased capital inflows; thus, the base money ceilings may be increased by up to ₱ 3 billion (around 4 percent) to match any overperformance of the targets for net international reserves (NIR) of the monetary authority. Moreover, to ensure that monetary policy remains consistent with the external targets of the program, indicative limits on the net domestic assets (NDA) of the monetary authority will be established.

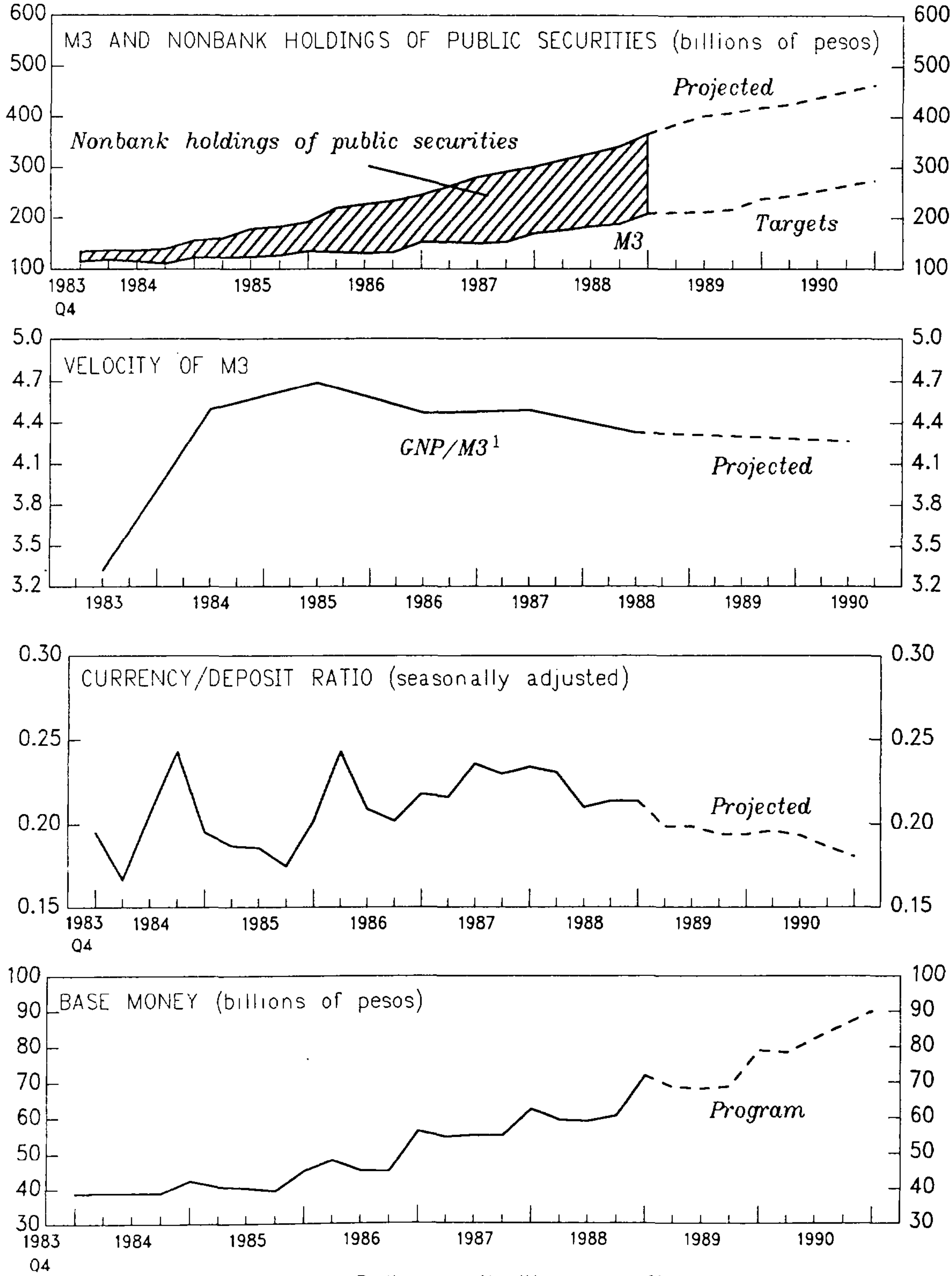
During 1989, the principal open market policy instrument to influence monetary aggregates will continue to be the sale of treasury securities by the National Government, with the excess over its own financing needs deposited at the Central Bank. However, the need for such deposits should decline in later years as the Central Bank deficit is reduced. The Central Bank will continue to rely on open market operations using its own holdings of government securities for day-to-day control of monetary aggregates. An additional important policy instrument, for purposes of both monetary control as well as fiscal transparency, will be the reinstatement of the requirement that the National Government and the major public corporations pay into blocked accounts with the Central Bank the peso equivalent of rescheduled debt service.

Interest rates in the Philippines are market determined. At end-February 1989, one-year time deposit rates were about 15 percent and prime lending rates about 17 percent. Interest spreads are expected to decline as a result of the financial sector reforms (Section III.5.b),

CHART 2

PHILIPPINES

MONETARY DEVELOPMENTS, DECEMBER 1983-DECEMBER 1990



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

[1] GNP divided by the average of the end-of-period money stocks in each of the four quarters of the corresponding year

Table 9. Philippines: Reserve Money Program, 1986-92 1/

(In billions of pesos; end of period)

	1986 Dec. Act.	1987 Dec. Act.	1988 Dec. Act.	1989 June Program	1989 Sept. Program	1989 Dec. Program	1990 March Program	1990 Dec. Program	1991 Dec. Program	1992 Dec. Program
Base money	56.2	62.4	71.7	68.1	68.7	79.0	78.3	90.0	100.7	112.0
(12-month change in percent)	(19.6)	(11.0)	(14.9)	(15.4)	(13.4)	(10.2)	(14.1)	(13.9)	(11.9)	(11.2)
Less: reserve-eligible securities	5.2	4.7	4.4	4.0	3.8	3.7	3.5	3.5	3.1	2.8
Reserve money	51.0	57.7	67.3	64.1	64.9	75.3	74.8	86.5	97.6	109.2
Net international reserves of the monetary authority	-14.3	-10.6	-6.8	-5.9	9.9	21.2	25.2	33.5	52.4	61.0
Medium- and long-term foreign liabilities 2/	-102.6	-103.9	-95.8	-93.4	-104.9	-116.0	-116.2	-116.6	-125.5	-120.7
Net domestic assets	168.0	172.2	169.9	163.4	160.0	170.1	165.8	169.6	170.7	168.9
Credit to the public sector	24.0	-11.8	-30.4	-50.5	-54.7	-44.2	-50.5	-52.5	-54.8	-60.1
Of which: National Government (net)	19.9	-16.1	-35.4	-55.5	-59.7	-49.2	-55.5	-57.5	-59.8	-65.1
Of which: Deposits (-) 3/	-14.9	-38.6	-54.1	-74.2	-78.4	-67.9	-74.2	-76.2	-78.5	-83.8
Assistance to financial institutions	13.7	16.4	15.6	15.6	15.6	15.6	15.6	15.6	15.6	15.6
Regular rediscounting	6.9	7.2	7.2	7.6	7.8	8.0	8.2	8.8	9.6	10.4
Central Bank securities (net)	-29.9	-10.9	-9.9	-8.1	-8.1	-7.6	-7.6	-7.7	-7.1	-7.1
Other items (net)	153.2	171.2	187.4	198.9	199.4	198.3	200.0	205.4	207.4	210.1
Of which: Blocked deposits	-1.5	-5.3	-7.0	-7.0	-13.1	-19.2	-22.8	-33.6	-48.3	-60.0

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

1/ Foreign assets and liabilities converted into pesos at a constant exchange rate of P 18.002 per U.S. dollar. Data include a number of statistical changes made following a recent mission from the Bureau of Statistics.

2/ Includes liabilities assumed under debt restructuring agreements.

3/ Increase in deposits reflects the sale of treasury securities beyond the National Government's own financing needs.

and the programmed fall in domestic public debt in relation to GNP should also contribute to lower rates.

4. External projections and policies

a. Medium-term projections, 1989-92

The projected widening of the current account deficit during the program period reflects a rapid growth of imports even as export performance remains strong (Table 5). Export volume growth averaging 10 percent a year would be concentrated in nontraditional manufactures which already account for two thirds of total exports. The projection of continued gradual gains in market shares is based on (i) increased production capacity and planned additional investment in the manufacturing sector (in particular electronics, textile, furniture, rubber products, and chemicals); (ii) the present underutilization of certain export quotas; (iii) export promotion efforts in several nontraditional markets; (iv) improved institutional support and export credit facilities for exporters, and (v) a competitive exchange rate.

Import volume growth averaging 8 1/2 percent a year is projected, with substantial increases in imports of capital goods to support the planned growth in investment and in certain inputs needed for the production of some manufactured exports (e.g., electronics). Import growth should, however, decelerate over time as the programmed higher level of investment is reached and as the reliance of export industries on domestic inputs rises. The terms of trade are projected to deteriorate by a total of about 4 percentage points during the program period.

The deficit in the services account is projected to increase substantially over the program period. The bulk of the increase is due to larger interest payments, initially as a result of higher international interest rates and, over time, because of some increase in the stock of debt (assuming that the financing gaps will be filled through rescheduling and/or new lending). Service receipts are expected to continue their strong growth, mainly on account of tourism, investment income (as gross international reserves increase), and personal income. Nonfactor service payments will grow in line with imports, as expenditures for freight and insurance rise. Transfer inflows are projected to rise substantially, mainly as a result of increasing workers' remittances.

The envisaged increase in investment will be accompanied by a significant rise in capital inflows. Disbursements of medium- and long-term loans are projected to jump to US$1.3 billion in 1989, 40 percent higher than in 1988, and to average US$1.7 billion in subsequent years. The higher loan disbursements would be mainly due to larger assistance from multilateral development institutions, bilateral sources, in particular Japan, and a growing number of other countries that have not traditionally been involved in the Philippines. However, taking into account scheduled amortization payments (including outflows as a result of debt conversions), the medium- and long-term capital account before rescheduling would remain highly negative. Total net inflows of direct investment are projected to remain at around US$900 million a year (see next section).

Net international reserves of the banking system are targeted to improve substantially over the program period and to turn positive by the end of 1989. Gross official reserves are programmed to rise by US$1.4 billion in 1989, to reach a level equivalent to three months of imports and to be maintained at that level in future years.

Rescheduling of debt service obligations due to commercial banks and Paris Club creditors is expected to provide substantial cash relief over the program period. The multiyear rescheduling arrangement with commercial banks, signed in December 1987, reschedules the public and publicly guaranteed debt through 1992; certain maturities due under the 1985 rescheduling are restructured through 1994. 1/ The Philippine authorities expect that debt service obligations that have fallen due to Paris Club creditors since September 1988 and that will be falling due during the program period will be rescheduled on terms comparable to the last rescheduling agreement. Consequently, the authorities have paid only 30 percent of the interest due on reschedulable debt and have made no amortization payments on such debt. The arrears thus accumulated since September 1988 amounted to US$243 million at end-1988.

Based on the above projections, the Philippine debt indicators show significant improvements over the medium term (Table 10) (outstanding debt is shown in Appendix Table 16). Total external debt is projected to increase only slightly in U.S. dollar terms and to fall substantially in terms of GNP. After rescheduling, the debt service ratio (including Fund obligations) would decline from 34 percent in 1988 to 29 percent in 1992. Repurchases, charges, and interest due to the Fund would be equivalent to 1.1 percent of exports of goods and services in 1992 and 0.9 percent in 1995. Outstanding repurchase obligations would represent about one fourth of gross international reserves of the Central Bank at the end of the program period in mid-1992; this share would fall to one tenth by end-1995.

b. Foreign investment, debt conversions and capital reflows

Direct foreign investment flows, which had not previously been important in the Philippines, tripled in 1988 to almost $1 billion. The increase was fueled by debt conversions, which financed about $800 mil-

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1/ Details of the debt restructuring arrangements are provided in Annex III to the 1988 Recent Economic Developments paper (SM/88/121, Supplement 1, 6/6/88).

Table 10. Philippines: External Debt Indicators, 1986-95

(In millions of U.S. dollars unless otherwise specified)

	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
Debt service before rescheduling	4,182	4,921	5,991	5,596	5,958	6,229	5,796	6,184	6,865	6,359
Principal (excluding IMF) 1/	1,865	2,501	3,636 2/	2,853	2,953	3,082	2,675	2,984	3,487	2,931
IMF repurchases	271	313	163	190	348	304	157	69	96	152
Interest	2,046	2,107	2,192	2,553	2,657	2,843	2,964	3,131	3,282	3,276
Debt service after rescheduling	2,937	3,273	3,599	4,097	4,294	4,633	4,894	5,416	6,098	6,359
Of which: Principal (excluding IMF)	728	1,028	1,398	1,505	1,419	1,597	1,773	2,216	2,720	2,931
Interest	1,938	1,932	2,038	2,402	2,527	2,732	2,964	3,131	3,282	3,276
Debt service ratio 3/										
Before rescheduling	48	54	56	46	45	42	35	33	33	27
After rescheduling	34	36	34	34	32	31	29	29	29	27
Ratio of actual interest payments to GNP (in percent)	6.4	5.7	5.3	5.5	5.2	5.1	5.0	4.8	4.6	4.1
External debt outstanding at end of period (in percent of GNP)	94	83	72	67	61	56	52	48	44	40

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

1/ Medium- and long-term debt plus maturing monetary liabilities.
2/ Includes $1,071 million amortization of banking system liabilities offset by rescheduling of an equivalent amount with foreign commercial banks.
3/ In percent of exports of goods and services. Includes Fund changes and repurchases.

lion of the total inflow. Since 1986, about 8 percent of total bank debt has been extinguished through debt conversions.

The debt equity swap program 1/ for Central Bank debt was suspended in February 1988 in order to limit its monetary impact, but transactions approved under that program prior to February 1988 continued to be completed throughout the year and a significant amount of non-Central bank debt was also swapped. Other types of debt conversions included debt for asset swaps (involving investment in privatized companies) and prepayment of foreign debt in local currency, which is normally passed on by creditors to prospective foreign investors. Almost half of the transactions under the official debt equity conversion scheme were carried out by Filipinos, which suggests that a significant repatriation of flight capital may have occurred; however, a precise quantification is not possible.

The medium-term projections assume that direct foreign investment will remain close to the high level reached in 1988 as applications received by the Board of Investment have continued to grow. During the coming years, the share of direct investment financed through debt conversions is assumed to decline while the share of traditional foreign investment financed through additional foreign exchange inflows is assumed to increase. The investment incentives arising from structural reforms and continued market determination of the exchange rate and interest rates should stimulate private capital inflows, including the reflow of flight capital.

c. Exchange rate policy

In real effective terms, the peso remained roughly unchanged in comparison with major trading partners during 1988, following a steady depreciation in the three preceding years (Chart 3). However, vis-a-vis a group of major Pacific region competitors, 2/ the peso appreciated by about 6 percent in real effective terms from end-1987 to end-1988. The Philippine authorities are committed to continue with the flexible exchange rate system established in October 1984. Exchange rate policy will continue to be guided by floors for the NIR of the monetary authority. The aim will be to ensure an adequate level of international competitiveness so as to support the projected export and import targets.

5. Structural policies

Achievement of the program's medium-term objectives is predicated

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1/ The debt to equity conversion scheme is described in the latest Recent Economic Developments paper (SM/88/121, Supplement 1, June 6, 1988), Annex IV.
2/ Malaysia, Indonesia, and Thailand.

on the continuation of the strong structural reform efforts of recent years. Policies will focus on: (i) a reform of the government corporate sector; (ii) a strengthening of the commercial banking segment of the financial system; (iii) further trade policy reform; (iv) agrarian reform; and (v) poverty alleviation and improvement in the management of natural resources (Table 11).

a. Public nonfinancial corporations

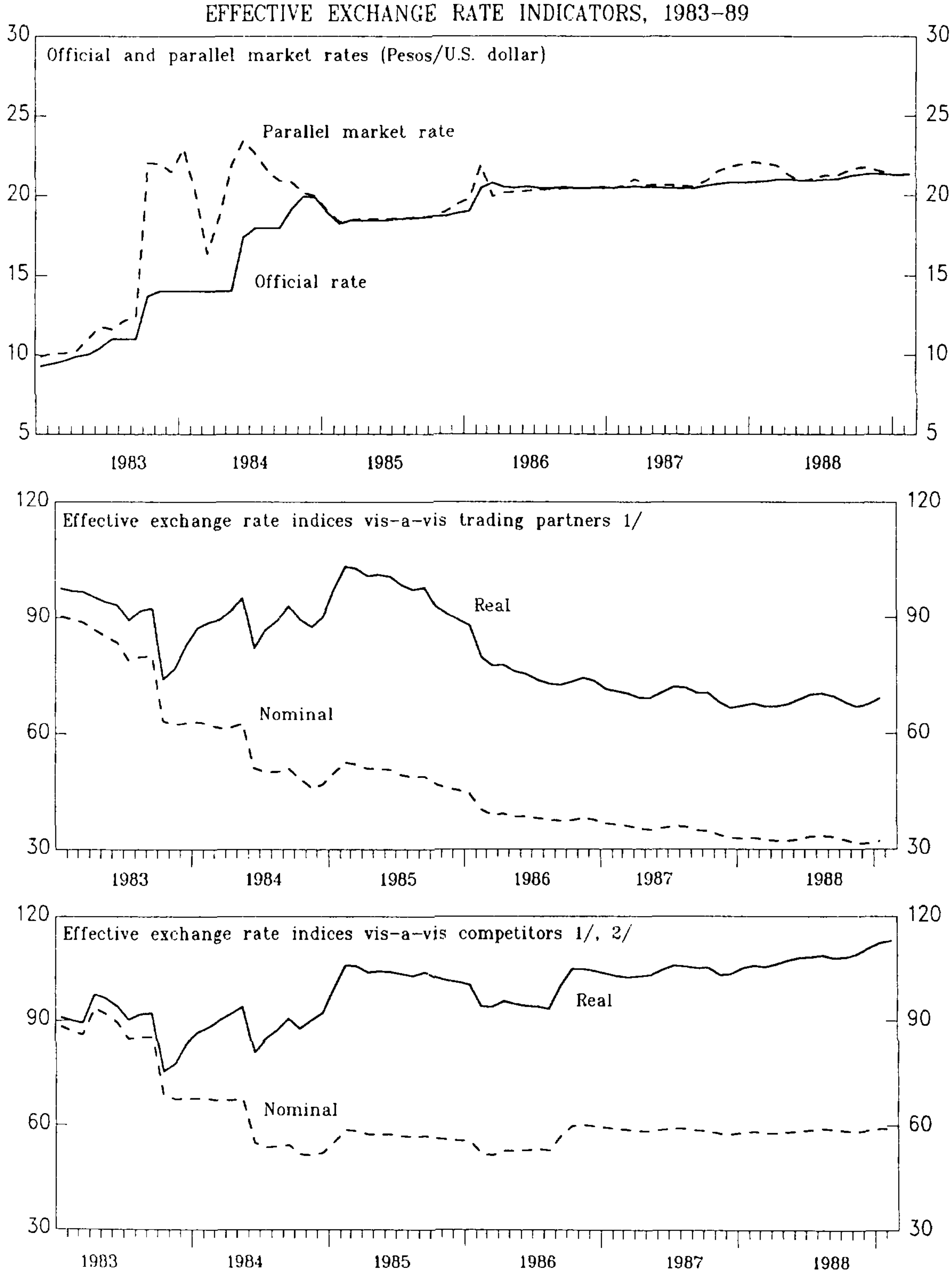
The public corporate sector in the Philippines expanded rapidly in the 1970s and the early 1980s, with the number of corporations rising from 46 in 1970 to 296 in 1985. Although rather small in terms of their share in total nonagricultural employment (less than 1 percent) and output, public corporations contributed substantially to the balance of payments and budgetary crises of the early 1980s. The corporations operated in an environment characterized by inadequate monitoring and control and lax financial discipline. They resorted to heavy external borrowing for projects that were often ill conceived, and their poor financial performance contributed significantly to the public sector deficit. The Government is now implementing a major reform program to address these basic problems, with financial support from the World Bank.

The principal objectives of the reform are to substantially reduce the size of the public corporate sector and to strengthen the economic and financial performance of those corporations that remain. Only 48 corporations will be retained while 130 corporations, accounting for one third of the book value of assets of the public corporate sector, have been earmarked for privatization; the rest will be merged, absorbed as line agencies or departments, converted to private nonprofit bodies, or abolished.

The preparation of detailed privatization plans and schedules is at an advanced stage, and should be completed for all the 130 corporations by June 1989. By end-1988, 23 corporations had already been fully or partially sold and three others were in the process of dissolution. The Government intends to complete the privatization program by the end of 1991. The implementation schedule calls for corporations representing at least one fifth of the total value of assets to be privatized to be offered for sale by December 1989; the corresponding target for December 1990 is one half of all assets to be privatized.

Corporations remaining in the public sector will be given increased operational autonomy but in the context of clearly specified financial and economic targets. The Government Corporate Monitoring and Coordinating Committee will establish and implement corporate planning and performance monitoring systems in five large corporations in 1989 and in 10 more large corporations in 1990. In addition, special privileges and benefits, such as exemptions from tax liabilities and payment of market-related interest on government advances, will be withdrawn; budgetary

Chart 3
PHILIPPINES
EFFECTIVE EXCHANGE RATE INDICATORS, 1983-89



Source: Information Notice System; and Fund staff estimates.
1/ Upward movement indicates appreciation of the Peso; 1980=100.
2/ The competitor countries included in the index are Indonesia, Malaysia, and Thailand. With weights determined by the average value of each country's non-oil merchandise exports during the period of 1983-87.

Table 11. Philippines: Summary of Structural Policies

		Objectives and Targets	Strategies and Measures	Timing of Measures
I.	Fiscal Policies			
	Revenue mobilization	Increase government revenue in relation to GDP. Improve the elasticity of the tax system.	Broadening the tax base by limiting business deductions. Implement initial package of measures to strengthen tax administration, and undertake review to formulate additional administrative measures.	1989
			Implement further administrative measures. Introduce selective new revenue measures.	1990
	Recurrent expenditure	Ensure more efficient use of existing capital stock.	Reorient outlays toward operating and maintenance expenditures.	1989, onward
		Contain growth of personnel expenditure.	Restructure the civil service. Adopt specific limits on the growth in personnel and total personnel expenditure.	1989, onward
	Capital expenditure	Increase public investment in relation to GDP. Improve project implementation.	Give priority to investment in the energy sector, agriculture, rural development, and social services.	1989, onward
			Correct institutional weaknesses and tighten procedures with regard to project preparation, budgeting, supervision, and monitoring at sector level.	1989, onward
II.	Government corporations (GCs)			
		Reduce the size and scope of the public corporate sector.	Put in vendible form and offer for sale GCs accounting for at least 20 percent of gross assets of GCs to be privatized.	1989
			Put in vendible form and offer for sale additional GCs to reach a cumulative total of at least 50 percent of gross assets of GCs to be privatized.	1990
			Complete privatization process.	1991
		Strengthen organization, supervision and control of retained GCs, and improve their efficiency and financial performance.	Amend charters of GCs to give greater operational autonomy.	1989
			Eliminate automatic government guarantees for loans. Phase out subsidies for tax payments and interest on NG advances.	1989-90
			Approve and implement corporate plan and Performance Evaluation System (PES) for 5 pilot GCs.	1989
			Extension of corporate planning to 10 additional GCs.	1990
			Introduction of computerized accounting to 10 GCs.	1990
		Improve cost recovery	Improve billing and collection procedures.	1989-90
			Implement program to reduce technical system losses in the power and water sector.	1989-90
		Enhance the efficiency of tariff structure.	Adjustments in tariffs of power, water, port facilities, and of distribution of rice by the National Food Authority. Gradually adopt long-run marginal cost pricing for power.	1989, onward

Table 11. Philippines: Summary of Structural Policies (concluded)

		Objectives and Targets	Strategies and Measures	Timing of Measures
III.	Poverty Alleviation			
		Land reform	Implement program with specific targets for land redistribution, supplemented by provision of adequate support services.	1989 onward
		Develop human resources	Improve efficiency and effectiveness of primary and secondary education system.	1989-91
			Improve health care system, with emphasis on expanded preventive services.	1989-91
			Increase housing for low-income groups.	1989-91
		Improve natural resources management.	Shift to community-based management, tightening regulations, and stricter enforcement.	1989, onward
IV.	Financial Sector Policy			
		Reduce central bank deficit.	Gradually transfer Central Bank liabilities to the National Government.	1990 onward
		Strengthen government financial institutions	Partially privatize the PNB.	1989
		Strengthen the supervision and regulatory framework for commercial banks.	Strengthen legal framework governing bank supervision. Upgrade commercial banks' reporting requirements, and standardize rules for accounting and loan loss provisions.	1989-90
		Improve institutional arrangement for depositor protection.	Empower PDIC to act as receiver and liquidator of failing banks. Increase capitalization of PDIC, and strengthen management and staff.	1989-90
		Foster competition and reduce costs of financial intermediation.	Encourage mergers/acquisitions of small, high-cost banks. Relax restriction on opening of new bank branches. Review taxation of financial services.	1989-90
		Mobilization and delivery of long-term funds.	Phase out Central Bank role in directed credit programs. Transfer management and responsibility of all industrial sector credit programs to DBP. Charge market-related interest rates on funds on-lent to the private sector.	1989-90
			Reorient the DBP into a wholesale financial institution for raising long-term domestic funds.	1989, onward
V.	External Sector Policy			
	Trade reform	Continue the shift to a system of tariff-based protection.	Lift quantitative restrictions on 90 items.	1989
			Identify 90 additional items for elimination of restrictions during program period.	1989-90
			Review all remaining quantitative restrictions in place, announce a program for their gradual elimination and replacement by tariffs.	1990
	Export promotion	Stimulate growth of non-traditional exports.	Improve access to financing by small- and medium-scale exporters.	1989, onward
	Foreign investment	Encourage greater direct investment inflows	Review debt conversion scheme and have revised scheme in place.	1989

subsidies will be confined only to those corporations which provide important social services or have been specifically directed by the Government to perform noneconomic activities; the extension of government guarantees for loans contracted by the corporations will be curtailed; and greater flexibility will be provided in matters relating to personnel and procurement.

b. Financial sector reforms

The sharp contraction of the economy in 1983-85 highlighted the weakness of the banking system. Several commercial banks and a large number of thrift institutions and rural banks had to be closed while several other commercial banks had to be supported by the Central Bank. While the immediate task of restructuring (including that of the government-owned institutions) is now largely complete, much remains to be done for the financial sector to be in a position to efficiently mobilize and intermediate the volume of savings needed to sustain rapid growth. At present, intermediation costs are high, leading to large spreads between deposit and lending rates; the institutional arrangements for the provision of long-term funds to industry are insufficient; and bank supervision and regulation have been hampered by an inadequate legal framework.

To address these issues, the authorities have begun implementation of a reform program, which will be supported by a sector adjustment loan from the World Bank. Steps have already been initiated to improve and standardize financial reporting, and current banking laws will be amended to permit the Central Bank to take corrective action on problem banks in a more timely fashion. Arrangements for depositor protection will be improved by empowering the Philippine Deposit Insurance Corporation (PDIC) to act as the liquidator of failing banks; the PDIC will be strengthened institutionally and financially. Restrictions on the opening of new branches have already been relaxed in order to promote competition and thereby reduce intermediation costs. In addition, the Government intends to gradually phase out the 5 percent gross receipts tax on financial institutions as well as the 20 percent withholding tax on interest income from interbank deposits; the phaseout will be linked to achievement of the Government's overall revenue targets. Finally, the availability of long-term credit is to be improved by transforming the Development Bank of the Philippines (DBP) into a wholesaler of long-term funds, while the Central Bank's responsibility for the remaining credit allocation programs will be phased out.

c. Trade policy reform

Trade policy in recent years has aimed at rationalizing protection by eliminating prior approval requirements and placing greater reliance on tariffs. From mid-1986 to end-1988, restrictions were lifted on 1,326 import items, reducing the share of total imports subject to restrictions to below 10 percent from 36 percent in 1984. Tariffs were raised on some liberalized items to levels not exceeding 50 percent. At present, 579 items remain subject to restrictions; importation of 102 items (List C) are prohibited for reasons of public health and national security, and importation of the remaining 477 items (List B) including consumer durables, vehicles, spare parts, cement, newsprint, and fertilizer (Appendix Table 17) require prior approval from the Central Bank, the Board of Investment, or other relevant government agency.

The authorities are committed to lifting restrictions on at least 180 items in List B before the end of the program period; 90 items are to be liberalized by end-September 1989, subject to approval by Congress of the appropriate tariffs, and identification of an additional 90 items is expected in two phases by end-June 1990.

Items that will remain restricted at the end of the program period are essentially those for which the authorities are keen to attract new investment or complement a program of expansion, rehabilitation, or modernization. An inherent risk of this strategy of industrial development is that it could result in inefficient industries and thereby frustrate the achievement of an internationally competitive industrial sector over the medium term. This underscores the importance of avoiding the granting of open-ended protection and of accelerating the shift to tariff-based protection. The authorities are committed to lifting quantitative restrictions on most remaining List B items by end-1994. In certain cases where this is not considered feasible, the target date for the lifting of restrictions will be announced by end-June 1990. As the policy reform progresses, the need for given levels of tariff protection will also be reviewed.

d. Agrarian reform

Agrarian reform has been given a boost by the approval of the Comprehensive Agrarian Reform Program (CARP) by the Philippine Congress in June 1988 (see Annex VIII for details). The CARP seeks to distribute 10.3 million hectares of land to an estimated 3.9 million beneficiaries over a ten-year period. The current schedule for implementation projects that 5 million hectares will be distributed to 2 million beneficiaries by end-1992. Most of the land to be distributed during the initial years include public lands and rice and corn lands originally identified for transfer under an earlier land reform program initiated in 1972. The distribution of private agricultural lands acquired under the new law, which account for 22 percent of the total land coverage, is expected to begin in 1992. Under the CARP, land distribution will be supplemented with provision of extension services, credit and other agricultural inputs, and improvements in basic rural infrastructure. To ensure timely and effective implementation of the program steps are being taken to strengthen the various implementing agencies and establish a system for coordinating their different activities.

Progress of the CARP will also be conditional on the availability of adequate financing. The total cash requirement during the ten-year implementation period is estimated at ₱ 225 billion, of which about ₱ 140 billion will be spent on post-land-distribution support activities. The estimated cost for the period 1988-92 is ₱ 73 billion. Approximately ₱ 50 billion over a ten-year period (₱ 39 billion by 1992) is expected from the proceeds of the sale of assets with the Asset Privatization Trust and the Presidential Commission on Good Government, which will be used to finance land acquisition and distribution. The authorities intend to seek concessional external financing for additional infrastructure and agricultural support expenditures amounting to 0.3 percent of GNP in 1990, 0.5 percent in 1991, and 1.0 percent of GNP in 1992. The expenditure targets for these years will be reviewed in the light of the results of a Consultative Group meeting scheduled for mid-1989, which will discuss the CARP and other issues.

e. Poverty alleviation and protection of the environment

According to the latest (1985) official estimates, about 60 percent of all Philippine households had incomes below a poverty line of ₱ 2,882 per month. As the prevalence of poverty is higher in rural areas, the Government has placed emphasis on a rural-based and labor-intensive development strategy, of which agrarian reform is a key element. Rapid economic growth and the absence of major distortions in the price system is expected to be an effective means of reducing poverty over the medium term. In addition, the strategy for poverty alleviation focuses on (i) ensuring a more equitable distribution of the burden of taxation among income groups; (ii) protecting critical expenditures in social sectors that benefit the most disadvantaged groups and targeting such expenditures more directly on the truly needy; and (iii) increasing the effectiveness of delivery of social services through the increased participation of local communities and nongovernment organizations. In line with this strategy, greater emphasis will be placed on providing preventive health care, particularly in rural areas; more resources will be directed toward improving the quality of primary education; high drop out rates among children of poor families will be discouraged by extending free education to the secondary level; and a substantial proportion of newly constructed dwelling units in urban areas will be devoted to housing for low-income groups.

The issue of environmental and natural resources management is closely linked with the population and poverty problems and with ineffective enforcement of regulations. The Government intends to improve resource management by strengthening the authority of user communities and encouraging the active participation of civic organizations. In forested areas, the emphasis will be on improving the welfare of upland dwellers through the Integrated Social Forestry Program. The Government is also reviewing the licensing for timber extraction and is carrying out a reforestation program. In the coastal areas, measures have already been introduced to protect the fish stock from indiscriminate fishing practices and to create coral reef fish sanctuaries.

IV. The Program for 1989-90

1. Macroeconomic targets

The key macroeconomic objectives for 1989-90 are annual real GNP growth of 6 1/2 percent and a decline in the average inflation rate to 8 percent in 1989 and 6-7 percent in 1990. The external current account deficit is projected to widen to 2.2 percent of GNP in 1989 and a peak of 2.5 percent in 1990.

The program provides for continued strong growth in total investment at annual rates of 18-20 percent at constant prices (Table 4). Private investment is expected to continue its recovery in response to the improved policy environment and increasing demand, rising from under 15 percent of GNP in 1988 to 18 percent by 1990. Public investment is also targeted to rise substantially (to 4.2 percent of GNP in 1989 and 4.7 percent in 1990). Two thirds of the increase in total investment between 1988 and 1990 are targeted to be financed from higher domestic savings. The latter will be generated mainly by the public sector, whose savings are targeted to increase from 0.6 percent of GNP in 1988 to 1.4 percent in 1989 and 3 percent in 1990. Thus, despite the large increase in public investment, the consolidated public sector deficit is programmed to remain constant at 3.4 percent of GNP in 1989 and to decline to 2.9 percent in 1990.

2. Fiscal policy

The deficit of the monitored public sector is programmed to decline from 2.4 percent of GNP in 1988 to 2.1 percent of GNP in 1989 and 1.6 percent of GNP in 1990 (Table 6). This improvement will be concentrated in the National Government deficit, which is targeted to fall from over 3 percent of GNP in 1988 to 1.6 percent of GNP in 1989 and 0.9 percent in 1990, despite the assumption of the first tranche of the Central Bank deficit in the latter year.

a. National Government

Total revenue and grants of the National Government are programmed to rise from 13.8 percent of GNP in 1988 to 15.2 percent of GNP in 1989 and 16.7 percent of GNP in 1990. The tax revenue/GNP ratio is targeted to increase steadily from about 11 percent in 1988 to 13.4 percent in 1990.

For 1989, about half of the revenue increase will reflect a jump in nontax receipts and most of the remaining increase will be generated by the first phase of the comprehensive program to strengthen tax administration. The higher nontax revenues will stem from (i) larger foreign grant disbursements (including from the Economic Support Fund of the United States), (ii) additional proceeds from the sale of assets, and (iii) higher interest receipts, including those from the charging of market-related rates on all advances to public corporations and on the National Government's deposits at the Central Bank.

The first set of administrative measures (which are more fully described in Annex V) include: (i) regulations broadening the withholding income tax system (in particular for nonwage incomes) and steps to update and cross-check the list of withholding agents to ensure greater compliance; (ii) ceilings on business allowances for income tax purposes, 1/ (iii) a broadening of the share of imports covered by lists of "fair market values" to reduce the scope for undervaluation; (iv) actions to strengthen collections from special investigations and past-due accounts; and (v) steps to improve VAT administration in order to ensure both greater compliance and a substantial increase in the number of paying VAT registrants. About 2,800 additional tax personnel well be hired in 1989, with over half allocated to the VAT office. Additional budgetary outlays amounting to some ₱ 300 million in 1989 have been approved and the hiring and training of the new staff is already under way. The progress made in improving tax administration will be monitored through a series of indicative quantitative targets and structural benchmarks (Section V).

Achievement of the 1990 for revenue targets will require: (i) additional tax administration measures, which will be formulated during 1989 on the basis of recommendations made by a technical assistance mission from the Fund; and (ii) implementation with the 1990 budget of new revenue measures to cover any remaining fiscal gap (presently estimated at about 0.8 percent of GNP).

The general policy with respect to pricing of oil products has been to adjust prices in line with import price developments, with short-run differences between domestic and world prices being absorbed by the Oil Price Stabilization Fund (OPSF) 2/ (tax revenue from petroleum is linked to the recovery price paid to refineries, which follows closely import prices). The Government is committed to continue the policy of flexible oil price adjustments. Retail prices of petroleum products were reduced by 18 percent in late 1988. Since then, world oil prices have risen and the OPSF is running a deficit; its funds are expected to be depleted by end-May. The Government intends to implement a phased increase in

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1/ A bill was introduced in Congress in late 1988 to set limits on business deductions for income tax purposes. The Government is seeking to strengthen this bill and is pressing for early approval of the revised bill.

2/ The OPSF is not part of the consolidated public sector.

prices of petroleum products so that they fully reflect the world market prices; this adjustment is to be completed before the end of December 1989. In addition, the Government will take measures, including additional asset sales and privatization, to eliminate any negative net balance incurred by the OPSF. In this context, the Government is also considering proposing to Congress an increase in excise duties on tobacco and alcohol products already in 1989. The implementation of the oil price adjustment and the associated measures will be part of the first program review.

The growth in current expenditure will be about 21 percent in 1989 but will be limited to about 7 percent in 1990. As a result, current expenditure as a share of GNP will increase temporarily to 14.5 percent in 1989 but will then fall back to 13.6 percent in 1990. The temporary rise in 1989 reflects: (i) a 17 percent increase in the wage bill; (ii) a 28 percent increase in key maintenance and operating expenditure necessary to restore these expenditures in real terms to a more appropriate level; (iii) a one-time increase in subsidies reflecting the government decision to achieve greater transparency by replacing implicit interest subsidies on government advances by explicit outlays (with a corresponding increase in nontax revenue); and (iv) higher interest payments. The increase in personnel expenditures is due to both the temporary impact of the early retirement scheme and the implementation of the Compensation Standardization Bill (which will cost almost ₱ 6 billion on a full-year basis). The Government has requested Congress for a further deferment in implementation of the Bill from July to October 1989, which would save about ₱ 1.1 billion. They intend to take alternative measures, including the postponement of the filling of new or vacant positions (other than those associated with the tax administration effort), if this deferment is not possible.

The reduction in current expenditure as a share of GNP in 1990 will be achieved by limiting the growth in personnel services to at most 10 percent and by containing the increases in both maintenance and operating expenditures and subsidies to about the level of nominal GNP growth. Most of the projected increase in the wage bill in 1990 will reflect the full-year impact of the implementation of the Compensation Standardization Bill. No additional general salary increase is planned.

Capital expenditures of the National Government will reach ₱ 20.6 billion (2.2 percent of GNP) in 1989, and ₱ 27.1 billion (2.5 percent of GNP) in 1990. These targets include the capital transfers to the Local Government Units (LGUs) which will assume an increasing role in the implementation of rural infrastructural projects. Foreign project financing amounting to ₱ 4.1 billion in 1989 and ₱ 5.9 billion in 1990 has been identified for these expenditures.

b. The monitored corporations

The overall deficit of the monitored corporations is projected to rise to 0.8 percent of GNP in 1989 and 1.0 percent of GNP in 1990, reflecting the targeted increase in capital expenditures. The total internal cash generation is to remain above 1 percent of GNP in both years as a result of (i) the privatization of several subsidiaries of the National Development Corporation (NDC) and other asset sales that will yield receipts of over ₱ 1 billion a year; (ii) a phased increase in NPC's electricity tariffs starting in mid-1989 to achieve a rate of return on the revalued capital base of 8 percent by 1990 (based on the schedule adopted by the Government, power tariffs are to rise by 13 percent by December 1989); and (iii) increases in water tariffs and in the distribution price for rice in 1990. In addition, a program is being implemented to improve the collection efficiency of the National Irrigation Authority (NIA) (by some 10-20 percent), and the billing efficiency of MWSS (by about 20 percent) before the end of 1990.

Capital expenditures of the monitored corporations are targeted to more than double in 1989 to reach ₱ 19.1 billion (2.0 percent of GNP) and to increase further to ₱ 23.2 billion (2.2 percent of GNP) in 1990. About two thirds of the increase will reflect the investments in power generation and transmission at NPC, and most of the remainder water supply projects at MWSS. Foreign project financing of ₱ 10.1 billion and ₱ 13.2 billion, respectively, has been firmly identified for 1989 and 1990.

3. Monetary policy

Broad money is targeted to grow at an average annual rate of 16 1/2 percent in 1989 and 15 percent in 1990. After taking account of the projected improvement in the balance of payments, the decline in net credit outstanding to the public sector, and a projected rise in other items (net) that largely reflects the deficit of the Central Bank, private sector credit is programmed to grow at about 14 percent a year (Table 8). The currency-deposit ratio is projected to continue to decline from an average of 22 percent in 1988 to about 20 percent in 1989 and 19 percent in 1990. Reflecting this return to more normal currency-deposit relationships, base money is targeted to grow at an average annual rate of 13 percent in 1989 and 14 percent in 1990. On an end-period basis, the growth in base money will be significantly lower in 1989 (around 10 percent), reflecting temporary excess liquidity in late 1988, most of which appears to have already been eliminated. At present, the entire expansion in base money is projected to stem from an improvement in the net foreign assets (NFA) of the monetary authority, while NDA remains broadly constant. 1/

4. External policy

The current account deficit is targeted to widen to US$1 billion in 1989 and US$1.2 billion in 1990, reflecting a 9 1/2 percent annual growth in export volume, an average 10 percent rise in import volume, and a terms of trade deterioration of 1 1/2 percent per year. The deficit on the services account is projected to widen, mainly on account of rising interest rates during 1988, the effect of which will only become fully visible in 1989. However, the net surplus on account of transfers is expected to increase further as workers' remittances continue their strong growth.

The trade and current account targets require an appropriate degree of external competitiveness. Exchange rate policy will be guided by NIR floors, which will be performance criteria for September 1989 and March 1990 and indicative benchmarks for June and December 1989. The NIR targets incorporate, inter alia, a substantial increase in medium- and long-term capital inflows and assume that the identified financing gaps will be filled by a rescheduling with Paris Club creditors and by new financing provided by commercial banks. (Deviations in these financing elements from the projected values will be assessed to make appropriate adjustments in the NIR targets.)

To improve the maturity profile of the external debt, limits have been placed on the approval of nonconcessional external loans with 1-12 and 1-5 years maturities and on the outstanding stock of short-term external debt. These limits have been formulated so as to accommodate a reasonable increase in short-term trade related and medium-term project related financing flows, which began to expand in 1988 as the economic climate and relations with foreign commercial creditors improved.

V. Performance Criteria and Program Reviews

Six-monthly quantitative performance criteria for end-September 1989 and end-March 1990 include: (a) a ceiling on the borrowing requirement of the monitored public sector (PSBR); (b) a ceiling on base money; (c) a floor on the net international reserves (NIR) of the monetary authority; (d) limits on external nonconcessional borrowing in

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1/ The composition of base money will be strongly influenced by the effect on the Central Bank's foreign liabilities of filling the residual financing gap in the balance of payments. The present projections assume that the Central Bank's medium- and long-term foreign liabilities increase by the amount of the financing gap (i.e., the entire gap is filled by loans to the Central Bank).

the 1-12 year and 1-5 year maturity ranges; and (e) a ceiling on total short-term external debt outstanding (Table 12). Additional performance criteria for end-September 1989 are: (1) the selection of the first 90 import items to be liberalized, referred to in paragraph 29a of the Memorandum on Economic Policy; (2) the submission to Congress of any proposed new tariffs on those items; and (3) a Monetary Board decision (a) to remove restrictions on those items not requiring tariff adjustments by end-September 1989, and (b) to remove restrictions on the remaining items with effect from the date that the new tariffs are enacted. The performance criteria for NIR of the monetary authority and for external nonconcessional borrowing in the 1-12 year maturity ranges may be adjusted, after consultation with the Fund, to take account of debt operations. The arrangement also contains the usual performance criterion on the exchange and trade system.

Benchmarks for items (a) to (d) above have also been established for end-June and end-December 1989 to guide the monitoring of shorter-term developments under the program. Quarterly indicative targets for net domestic assets of the monetary authority, total tax revenues of the National Government, and capital expenditure by the monitored public sector have also been set. A set of indicative targets has been established to assist the monitoring of progress in the strengthening of tax administration and public sector corporate reform (Table 13).

Five reviews will be conducted. The first, to be completed by December 31, 1989, will review the performance criteria for end-March 1990 and set the benchmarks and indicative targets for end-June 1990 and end-December 1990 as well as the performance criteria and indicative targets for end-September 1990. In addition, during that review, understandings will be reached on (i) the size and composition of new revenue measures for 1990 and (ii) the schedule for the transfer of Central Bank assets and liabilities to the National Government. Understandings on the economic and financial programs for 1990-91 and 1991-92, including on the appropriate performance criteria, benchmarks, and indicative targets, will be reached during the second and fourth reviews, to be completed by June 30, 1990 and June 30, 1991, respectively. In addition, two mid-term reviews of the programs for 1990-91 and 1991-92 will be completed by December 31, 1990 and December 31, 1991, respectively. All the reviews will entail an assessment of exchange rate policy and the progress made in the structural reforms.

Table 12. Philippines: Quantitative Targets for Domestic and External Financial Policies, 1988-90

	1988	1989			1990
	Dec. 31 Actual	June 30 Indicative benchmarks	Sept. 30 Performance criteria	Dec. 31 Indicative benchmarks	Mar. 31 Performance criteria
Targets subject to performance criteria					
		(In millions of U.S. dollars)			
External sector floors/ceilings					
Net international reserves (NIR) of the monetary authority (floor) 1/	-505	-455	420	1,052	1,273
Short-term external debt outstanding	3,621	4,000	4,150	4,250	4,250
Approvals of external borrowing with maturities of 1-12 years 2/	...	1,400	1,400	1,400	1,400
Approvals of external borrowing with maturities of 1-5 years 2/	...	150	150	150	150
		(In billions of pesos)			
Domestic sector ceilings					
Monetary base 3/	71.7	68.1	68.7	79.0	78.3
Public sector borrowing requirement 4/ (cumulative from January 1, 1989)	...	15.6	16.4	20.0	25.6
	1988	1989			1990
	Dec. 31	June 30	Sept. 30	Dec. 31	Mar. 31
		(In billions of pesos)			
Indicative targets					
Net domestic assets of the monetary authority	169.9	163.4	160.0	170.1	166.5
Tax revenues of the National Government	90.3	56.1	85.2	116.2	34.8
Capital expenditure of the monitored public sector	27.4	19.9	28.5	39.7	12.6

Source: Memorandum on Economic Policy.

1/ The floors for the respective test dates will be adjusted upward (downward) for (i) upward (downward) deviations in the cumulative total of new money disbursements from foreign commercial banks and official sources; (ii) downward (upward) deviations in the amount of the level of Central Bank-assumed liabilities under Circular 1091/1171; (iii) upward (downward) deviations in the amounts of rescheduling by Paris Club creditors and commercial banks.

2/ Cumulative approvals from January 1, 1989 onward of all public and private sector foreign borrowing in the specified maturities, excluding reserve liabilities of the banking system and concessional loans (i.e., with a grant element of 25 percent or more).

3/ The ceilings will be adjusted downwards (upwards) to reflect any reduction (increase) in the reserve requirement on deposit money banks. In addition, the limits will be adjusted upward by the amount that NIR exceeds the program floor up to a maximum of ₱ 3.0 billion.

4/ The ceilings for the respective test dates will be adjusted upward (downward) for upward (downward) deviations in the amount of gross external project financing.

Table 13. Philippines: Indicative Structural Targets, 1989-90

I. Strengthening of tax administration

a. Hire and train additional VAT agents and raise the number of paying VAT registrants as follows:

	End-September 1989	End-March 1990
Number of new VAT agents	850	1,700
Number of paying VAT registrants	65,000	75,000

b. Increase the share of imports covered by published "fair market values" as a basis for the C.I.F. valuation of imports for duty and tax purposes as follows:

	1988 Actual	September 1989	December 1989	March 1990
Share of imports covered (in percent)	30	40	50	60

c. Complete the cross checking of income tax withholding agents by June 1989 and register all identified withholding agents with the Bureau of Internal Revenue (BIR) by December 1989.

II. Privatization of public enterprises

a. Offer for sale corporations representing the following share of the 1985 book value of assets to be privatized (P 78 billion 1/):

By December 1989: 20 percent
By December 1990: 50 percent

1/ Excluding Philippine National Bank.

VI. External Contingency Financing 1/

The Philippines has requested that the Fund decide that it will provide, in association with the extended arrangement, contingency financing under the compensatory and contingency financing facility (CCFF), should adverse external contingencies occur during the period of the arrangement. 2/

The proposed contingency mechanism will cover unanticipated deviations from program projections for the following variables: export prices for coconut oil, 3/ copper metal and copper concentrate; partner countries' volume of non-oil imports as it affects Philippine exports of nontraditional manufactures (net of imported inputs); import prices for petroleum and petroleum products; partner countries' non-oil export prices as they affect Philippine non-oil imports (excluding commodity aid and foreign-financed projects); and interest payments on net external debt with variable interest rates. The variables covered represent 56 percent of merchandise exports, and 74 percent of merchandise imports, and 53 percent of total current account transactions. 4/

1/ For a more detailed presentation of the technical parameters and procedures of the contingency mechanism of the CCFF, see Annex XII.

2/ While the letter of March 20, 1989 requests that the Fund "provide external contingency financing" under the CCFF, it is understood that the authorities' request is that the Fund "decide that it will provide external contingency financing" as contemplated in paragraph 17 of the CCFF decision.

3/ As the Philippines is one of the major suppliers of coconut oil to the world market, export prices can be influenced by variations in Philippine export volume. Therefore, if the actual volume of coconut exports in the semester in which a price deviation occurs deviates by more than 10 percent from the projected volume, the applicable actual price used for calculating the deviation will be lowered (raised) by one third of the percentage change by which the volume was higher (lower) than projected in the baseline scenario. The price elasticity of one third reflects the long-term relationship between the Philippine coconut oil export volume and export prices. A threshold of a 10 percent deviation in actual export volume from the projected export volume was chosen to avoid activating this provision for relatively small movements.

4/ Current account transactions that are not subject to external shocks and therefore not covered by the contingency mechanism (i.e., re-exports, imported inputs for the production of manufactured exports, commodity aid, and foreign-financed imports) account for about 10 percent of all current account transactions. Nonfactor service transactions and transfers, which are not covered by the contingency mechanism account for another 19 percent.

The first 12-month baseline period will run from April 1, 1989 to March 31, 1990. The quarterly baseline projections of the variables covered under the contingency mechanism are set out in Table 1 of Annex XII.

The maximum amount of external contingency financing that the Fund would provide in case of unfavorable external deviations during the period of the extended arrangement would be SDR 286.3 million (65 percent of quota), of which a maximum of SDR 110.1 million (25 percent of quota) could be provided with respect to the initial baseline period. The contingency mechanism will be activated during the period of the extended arrangement when the net sum of deviations exceeds the equivalent of 15 percent (SDR 66.06 million) of quota. 1/ In the first six-month period in which the contingency financing would become available, i.e., when the impact on the balance of payments exceeds the minimum threshold, financing equivalent to 50 percent of the applicable net sum of deviations would be made available. Financing in the subsequent semester would be equivalent to 50 percent of the net sum of deviations to the extent that it exceeds the net sum of deviations in the previous semester, but would be reduced to 30 percent of the net sum of deviations to the extent that it is equal to or less than in the previous semester. The effect of the unfinanced portion of the net deviations would be absorbed by additional adjustment measures.

The level of the Philippines' net international reserves (NIR) is currently very low. Thus, in the event that the threshold of 15 percent of quota applying to the sum of deviations is exceeded in a favorable direction, the staff would recommend a build-up of reserves under the program. It is expected that 50 percent of the favorable net sum of deviations (after allowing for the deductible amount of 4 percent of quota) would be added to the program target for the NIR of the monetary authorities during the first six-month period in which these deviations affect the balance of payments. In the subsequent semester, to the extent that the favorable net sum of deviations is equal to or less than that in the first semester, the proportion used to build up the NIR further would be reduced in the same manner as for the financing provided in the case of unfavorable net deviations.

Under this framework, the contingency mechanism would be activated if one of the following deviations from baseline projections 2/ affected the Philippines' balance of payments continuously for at least a six-month period: a deviation in export prices for coconut oil and copper by at least 18.5 percent; a deviation in partner countries' import volume

1/ A lower threshold, for example, 10 percent of quota, was not considered advisable in the case of the Philippines in order to avoid frequent activation of the contingency mechanism on account of relatively small deviations.
2/ Provided that there is no deviation in any other factor.

growth by at least 5 percentage points; a deviation of 15.2 percent in import prices for petroleum and petroleum products; a deviation in partner countries' non-oil export prices by at least 2.9 percentage points; or a deviation in international interest rates by at least 0.81 percentage points.

In the event that the contingency mechanism is triggered, the authorities will consult with the Fund on the necessary policy adjustments to attain the objectives of the program supported by the extended arrangement and on the appropriate adjustments to performance criteria, benchmarks, and indicative targets.

The staff has urged both the Philippine authorities and the commercial banks to include contingency financing from banks in parallel with the Fund in a new financing package. As the negotiations between the Philippine authorities and the banks have so far remained at an exploratory stage, parallel contingency financing has not yet been discussed explicitly. The Philippine authorities have expressed concern that parallel contingency financing could reduce other financing from banks. The staff will continue to press for parallel contingency financing with the understanding that such financing would be additional. It will also indicate to banks that in the event of a contingency the Fund may request additional financing from them. The change in interest rates taken into account in calculating the net sum of deviations for the contingency mechanism will be limited to 2 percentage points during the present baseline period.

VII. Staff Appraisal

The new economic program formulated by the authorities builds on a solid foundation: growth has been strong in the past 2 1/2 years; inflation, though accelerating, has remained within the target range; and balance of payments problems have been avoided notwithstanding the extend debt problem. At the same time, substantial progress has been made in the areas of structural reforms designed to reduce government intervention, remove distortions, and increase efficiency. The Philippine authorities should be commended for these achievements which have brought to a successful conclusion the first phase of stabilization and recovery following the severe economic and financial crisis of the mid-1980s.

The challenges to be faced now are how to sustain strong growth, reduce inflation to a more comfortable level, complete the task of structural reform, tackle the problem of widespread poverty, and seek a lasting resolution of the external debt problem. These issues require a comprehensive approach and a medium-term policy orientation; the proposed program has been designed accordingly. To be successful, the program will also require determined policy implementation as well as strong external support.

The objective of sustained annual growth of 6.5 percent is ambitious but attainable provided that a substantial increase in efficient investment is achieved. Private investment has already begun a strong recovery in response to growing demand and the improved policy environment. However, higher public investment is also needed to provide the infrastructure required for growth. Substantial shortfalls were experienced in public investment in recent years; although many signs point to an improvement and important measures to speed up project implementation have already been introduced, strong efforts will be needed to ensure that the targeted size and efficiency of public investment are achieved. Larger investment will also require larger national savings. Here, a major effort will be required by the public sector, for private consumption can be expected to grow significantly as the recovery in incomes is sustained and the strong population growth continues.

The need to increase public savings is reflected in the fiscal targets of the program. Slippage in this area would frustrate public investment, crowd out private investment or add to the pressure on the balance of payments. The increase in public savings will have to come primarily from a better revenue performance at the level of the National Government, supported by an improved internal cash generation of public enterprises through price and tariff adjustments, greater collection efficiency, and privatization. The 1986 tax reform improved the efficiency, equity and revenue elasticity of the tax system. However, there have been longstanding problems with respect to tax administration, and tax compliance has traditionally been poor. Firm implementation of the proposed administrative revenue measures will be a first significant step toward tackling these problems, but will probably not be sufficient. Therefore, the authorities' intention to monitor developments closely and to identify and implement additional administrative measures is an essential element of the program. It is equally important that new revenue measures be adopted in 1990; the tax revenue/GNP ratio is low by international standards and the envisaged increase over the program period is modest. Policy with respect to current expenditure will have to focus primarily on containing personnel costs. After introduction of the Compensation Standardization Bill, an appropriate civil service wage structure will be in place, which should make the lower wage bill growth envisaged for the remainder of the program period both desirable and realistic. Additional efforts will need to focus on containing the size of the establishment and eliminating redundant workers.

Another important aspect of fiscal policy is the initiation in 1990 of a phased transfer to the National Government of the large net interest burden on the Central Bank. The authorities have successfully avoided rapid inflation by not permitting the monetization of this deficit; the final step in resolving this problem requires that the Government assume responsibility for these liabilities, thereby making the true fiscal deficit apparent.

Although the increased rate of inflation in 1988 was due in part to temporary supply shocks, there are some signs of emerging demand pressures. Monetary policy will have to be pursued cautiously in the period ahead if the inflation objectives of the program are to be achieved. The authorities will have to keep the targets for monetary aggregates under close review, taking account of developments in growth and currency-deposit relationships.

Two of the structural reforms contained in the program deserve special mention. First, trade policy reform has been a key element in re-orienting industry toward the world market by removing import restrictions and relying on tariffs for protection. Further significant action in this area will occur during the program period and, with some exceptions, completion of the process of trade policy reform is envisaged by the mid-1990s. While these steps are welcome, the timetable envisaged for completing the liberalization process contains risks. As long as quantitative import protection is still in place for some important industries, investments are likely to be made that are not sufficiently efficient to withstand international competition and, consequently, strong pressures might arise to maintain this protection.

Second, measures to reduce the widespread poverty are an integral part of the program. The quick and forceful implementation of the agrarian reform program, with adequate foreign assistance, is of crucial social importance, for it holds out the promise of substantially improving the living standards of the rural poor. Another important plank of the policy to alleviate poverty is the re-orientation of government expenditure to the benefit of disadvantaged groups. More generally, the growth orientation of the program and the objective of low inflation will be of considerable benefit to the poor.

The objective of sustained strong growth can only be achieved with strong export performance and substantial external support. For exports, the exchange rate is of particular importance. While recent export growth has been strong, developments in the relative competitive position deserve constant attention and flexible responses with respect to the exchange rate. It is important that the recent real effective appreciation of the peso vis-a-vis major competitors be reversed.

The increase in investment and the envisaged build-up of official reserves will require sizable external financing. After allowing for a large increase in foreign official assistance, substantial financing gaps are projected for the program period. Also, on current projections, sizable financing gaps would persist beyond the program period, suggesting that normal market access would not be restored within the next 5-6 years. These projections point to a potential role for debt reduction to help ensure external viability and to reduce the risks to growth.

Several implications flow from this balance of payments scenario. First, within the domestic policy domain, strong efforts must be made to stimulate reflows of flight capital and foreign direct investment. Second, with regard to official creditors, substantial support will be required. And third, foreign commercial banks will have to play a key role through providing appropriate amounts of fresh financing. In addition, the prospects that the Philippines will be able to achieve its objectives of strong investment and growth and a return to more normal financial market access could be facilitated if the authorities and banks were to agree on voluntary, market based debt operations resulting in a significant debt reduction. The remarkable economic success of the past 2-3 years, the adoption of a strong medium-term program, and recent initiatives that give the debt strategy new forward momentum should all permit substantial progress toward a lasting resolution of the debt problem.

The staff believes that this is an appropriate case for official support of debt reduction operations. The Fund's own support could take the form of a set-aside and other methods of financial assistance that might be developed in the forthcoming discussion. As the program was designed before the initiation of the discussion of modalities of the Fund's support for debt reduction operations, the program's financial structure--and the amount of support--might have to be reviewed.

The discussions with commercial banks on a new financing arrangement have so far only been exploratory, in part because of the new elements in the debt strategy. The timing of an agreement remains uncertain and it is possible that the negotiations will be prolonged. In the absence of an agreement with commercial banks the program is not fully financed and debt operations cannot proceed. Nevertheless, there is a need for the Fund to give its support to the program without undue delay. Withholding this support now would delay the envisaged strong response from other official sources and could entail serious cash flow problems. During the period of discussion between the Philippines and its commercial bank creditors, the staff will closely monitor program developments and the progress in the negotiations; it will also respond to requests for assistance in these negotiations. The staff will bring to the attention of the Executive Board any significant new developments in the Philippines' external financing situation during this period.

It is expected that the debt service obligations that have fallen due to Paris Club creditors since September 1988 and that will fall due during the period of the program supported by the extended arrangement will be rescheduled shortly after the approval of the arrangement. Accordingly, the staff recommends approval of the exchange restriction evidenced by the arrears to Paris Club creditors until the completion of the first review under the extended arrangement or December 31, 1989, whichever comes first.

In conclusion, the staff is confident that full implementation of the policies proposed will achieve the program objectives. The access to Fund financing under the contingency element of the CCFF provides a degree of protection against external shocks and gives greater assurance that the program will remain on track. The Philippines' good track record in implementing the 1986-88 program also provides strong indication that the program will be implemented as envisaged. Repurchase obligations have always been timely discharged and the balance of payments outlook does not suggest that the Philippines will have difficulties in meeting future obligations vis-a-vis the Fund. The request for an extended arrangement deserves the support of the Fund.

VIII. Proposed Decision

1. The Philippines has requested:

(a) an extended arrangement for the period of three years from [ ] in an amount equivalent to SDR 660.6 million; and

(b) a decision that, should adverse external contingencies occur during the period of the extended arrangement, the Fund will provide, in association with the extended arrangement, external contingency financing under the Compensatory and Contingency Financing Facility (Decision No. 8955-(88/126), adopted August 23, 1988), up to a maximum amount equivalent to SDR 286.3 million.

2. (a) The Fund approves the extended arrangement set forth in EBS/89/59, Supplement 1.

(b) The Fund decides that:

(i) should adverse external contingencies occur during the period of the extended arrangement, the Fund will provide, in association with the extended arrangement, external contingency financing under Decision No. 8955-(88/126), up to a maximum amount equivalent to SDR 286.3 million, in accordance with the factors set out in the Annex to this decision, and

(ii) should favorable external contingencies occur during the period of the extended arrangement, adjustments of up to SDR 286.3 million will be made by the Fund at the time under paragraph 27 of Decision No. 8955-(88/126), in accordance with the factors set out in the same Annex.

3. Should the Philippines notify the Fund after the date of this decision that it no longer wishes to avail itself of the benefit under paragraph 2(b)(i) above in association with the extended arrangement, the provision of paragraph 27 of Decision No. 8955-(88/126) shall continue to apply for the remainder of the baseline period during which such notice was received by the Fund.

4. The Fund waives the limitation in Article V, Section 3(b)(iii).

5. The Fund approves the retention by the Philippines of the exchange restriction evidenced by arrears to Paris Club creditors until the completion of the first review contemplated in paragraph 4(c) of the extended arrangement or December 31, 1989, whichever comes first.

External Contingency Financing

I. For duration of extended arrangement

1. External contingencies to be taken into account:	(i) the effects of changes in export prices of coconut oil (ii) the effects of changes in export prices of copper concentrate and copper metal (iii) the effects of changes in non-oil import volume of major trading partners on the export volume of nontraditional manufactured products net of imported inputs (iv) the effects of changes in prices of petroleum and petroleum products (v) the effects of changes in partner countries' non-oil export prices on prices of non-oil imports, net of imported inputs for manufactured exports and imports for foreign-financed projects. (vi) the effects of changes in interest payments on net external debt at variable interest rates, provided that changes resulting from increases in interest rates over 2 percentage points will not be taken into account.
2. Maximum amount of external contingency financing in case of unfavorable external contingent deviations:	SDR 286.3 million 1/
3. Minimum threshold to be exceeded by net sum of deviations before financing is provided:	SDR 66.06 million (15 percent of present quota)
4. Proportion of financing of net sum of deviations:	In first semester in which threshold is exceeded: 50 percent of net sum of deviations; and

	In next semester: 30 percent of the part of the net sum of deviations that does not exceed the net sum of deviations in the previous semester and 50 percent of the remainder.
5. Maximum amount of adjustment in case of favorable external contingent deviations:	SDR 286.3 million

II. For duration of initial baseline period

1. Duration of baseline period:	April 1, 1989-March 31, 1990
2. Maximum amount of external contingency financing:	SDR 110.1 million
3. Maximum amount of adjustment in case of favorable external deviations:	SDR 110.1 million

1/ Fund financing with respect to deviations in net interest costs is limited to SDR 66.06 million.

Table 14. Philippines: National Government Revenues, 1986-92

(In billions of pesos)

	1986	1987 1/	1988 Prelim. Actual	1989 Program	1990 Program	1991 Program	1992 Program
Total revenue and grants 2/	79.2	101.2	112.9	149.9	180.0	204.5	227.9
Tax revenue 2/	65.4	85.4	90.3	116.2	144.8	169.1	198.3
Taxes on net income and profits	19.1	21.6	27.9	35.9	41.4	47.9	55.5
Companies, corporations, individuals	13.9	16.1	20.8	27.1	32.5	38.4	45.3
Others	5.2	5.5	7.1	8.8	8.9	9.5	10.2
Taxes on domestic production and consumption	26.7	35.9	33.0	40.4	46.6	53.3	61.2
Sales and business taxes	10.3	13.3	12.8	18.6	23.5	28.7	34.8
Other than VAT	9.3	12.2	5.8	5.5	6.7	8.0	9.6
VAT (domestic) (including the 2 percent tax)	...	...	5.7	11.5	15.1	18.6	22.7
Of which: Administrative measures	...	...	—	0.8	1.8	2.2	2.6
Motor vehicle tax	1.0	1.1	1.3	1.5	1.8	2.1	2.5
Excises	16.4	22.6	20.2	21.9	23.1	24.6	26.4
Taxes on international trade and transactions	17.8	26.0	25.6	35.2	42.4	48.9	57.7
Import duties and taxes	16.8	25.7	25.0	34.5	41.6	47.9	56.5
Other than VAT	(16.8)	(25.7)	(18.6)	(26.0)	(31.6)	(36.3)	(42.9)
VAT (imports)	(...)	(...)	(6.4)	(8.5)	(10.0)	(11.6)	(13.6)
Export duties	0.6	—	—	—	—	—	—
Travel tax	0.4	0.3	0.6	0.7	0.8	1.0	1.2
Other tax revenue	1.8	2.0	3.9	4.7	5.6	6.7	8.0
Other domestic taxes	(1.8)	(1.7)	(3.5)	(4.3)	(5.2)	(6.2)	(7.5)
Real property tax	(...)	(0.2)	(0.3)	(0.3)	(0.4)	(0.4)	(0.5)
Miscellaneous	(...)	(0.1)	(0.1)	(0.1)	(0.1)	(0.1)	(0.1)
Additional measures needed to close the fiscal gap	...	...	...	...	8.7	12.2	15.9
Nontax revenue	13.8	15.8	22.5	33.7	35.2	35.4	29.5
Collection from other offices and other	7.4	11.3	20.9	27.9	30.0	29.8	26.3
Other offices	(7.4)	(6.7)	(10.0)	(12.3)	(13.2)	(14.6)	(15.8)
PCGG sequestered assets	(—)	(0.2)	(0.8)	(0.4)	(0.4)	(0.4)	(0.4)
Sales of assets	(—)	(1.0)	(5.2)	(6.6)	(6.6)	(5.0)	(—)
Interest on Central Bank deposits 3/	(—)	(1.8)	(4.7)	(5.7)	(6.4)	(5.9)	(5.7)
Interest from NFGCs	(—)	(1.5)	(0.3)	(2.9)	(3.5)	(3.9)	(4.4)
ESF proceeds	6.2	3.1	0.2	3.8	4.0	4.5	2.1
Other foreign grants	0.2	1.4	1.4	2.0	1.2	1.1	1.1
Memorandum items:			(In percent of GNP)				
Total revenue and grants	12.9	14.4	13.8	15.8	16.7	16.6	16.2
Tax revenue (including measures not yet identified)	10.7	12.2	11.1	12.3	13.4	13.7	14.1
Nontax revenue (including ESF)	2.3	2.3	2.8	3.6	3.3	2.9	2.1

1/ Data for 1987 have been adjusted to be consistent with PSBR reconciliation.
2/ Including measures to cover fiscal gap, tentatively identified in tax revenue.
3/ From Central Bank records.

Table 15. Philippines: Summary Cash Flow of the 14 Major Nonfinancial Government Corporations, 1986-92

	1986	1987 1/	1988 Prel. Actual 1/	1989 Program	1990 Program	1991 Program	1992 Program
			(In billions of pesos)				
Internal cash generation	0.3	5.1 2/	11.6 2/	11.3 2/	12.1	19.1	19.6
Of which: Current subsidies from National Government	0.1	0.8	1.7	5.0	5.9	6.4	6.1
Tax payments to National Government	-0.3	-0.4	-0.7	-1.2	-2.1	-2.5	-2.7
Interest on National Government advances	—	-1.4	-0.2	-2.9	-3.5	-3.9	-4.4
Impact of measures				2.0	3.0	8.9	8.3
Capital expenditures	5.9	9.7	9.5	19.1	23.2	33.6	32.0
NPC transfer to National Government	1.2	-1.4	—	—	—	—	—
Deficit (-)	-6.8	-3.2	2.1	-7.8	-11.1	-14.5	-12.4
Financing	6.8	3.2	-2.1	7.8	11.1	14.5	12.4
Foreign (net)	-5.3	-1.2 2/	-3.6 2/	1.5 2/	7.7	11.8	5.6
Domestic (net)	12.1	4.4	1.5	6.3	3.4	2.7	6.8
Equity and net lending from National Government 3/	(10.5)	(9.8)	(5.4)	(4.1)	(3.6)	(3.8)	(4.8)
Domestic bank (net)	(0.9)	(-0.2)	(-3.4)	(-1.5)	(-0.1)	(1.6)	(6.0)
Domestic nonbank (net)	(0.7)	(-5.2)	(-0.5)	(3.7)	(-0.1)	(-2.7)	(-4.0)
Memorandum items:			(In percent of GNP)				
Internal cash generation	—	0.7	1.4	1.2	1.1	1.6	1.4
Capital expenditure	1.0	1.4	1.2	2.0	2.2	2.7	2.3
Deficit (-)	-1.1	-0.5	0.3	-0.8	-1.0	-1.2	-0.9
			(In billions of pesos)				
Internal cash generation	0.3	5.1	11.6	11.3	12.1	19.1	19.6
National Power Corporation	1.4	5.0 2/	6.5 2/	6.2 2/	7.3	9.8	13.0
Philippine National Oil Corporation	—	1.8	3.2	3.3	1.8	2.2	2.5
Metropolitan Water and Sewerage System	0.4	0.4	0.4	0.4	0.4	0.5	1.1
National Irrigation Administration	-0.6	-0.8	-0.8	0.4	-0.2	-0.2	-0.2
National Development Company	0.2	0.1	1.5	1.3	0.7	3.9	0.2
Other corporations	-1.1	-1.4	0.8	-0.3	2.1	2.9	3.0
Capital expenditures	5.9	9.7	9.5	19.1	23.2	33.6	32.0
National Power Corporation	3.0	3.7	2.0	8.3	8.2	17.4	18.4
Philippine National Oil Corporation	-0.7	1.7	0.5	1.9	2.5	3.3	2.4
Metropolitan Water and Sewerage System	0.6	0.6	0.6	2.1	3.9	3.5	2.9
National Irrigation Administration	1.6	1.9	2.2	2.6	2.9	3.5	2.4
National Development Company	—	-0.3	0.4	0.1	—	—	—
Other corporations	1.4	2.1	3.8	4.1	5.7	5.9	5.9

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

1/ Data for 1987 and 1988 have been adjusted to be consistent with Central Bank figures on financing of the PSBR.
2/ After adjustments to include external interest or amortization for which the National Power Corporation is not required to make payments due in blocked accounts.
3/ Reconciled with National Government sources.

Table 16. Philippines: Total External Debt by Creditor, 1986-88

(In millions of U.S. dollars at end-period) 1/

	1986	1987	1988
Commercial banks	15,356	14,824	13,245
of which: short-term	3,771	3,140	3,120
Other financial institutions	828	390	396
Multilateral	4,688	5,033	5,069
of which:			
World Bank	2,409	2,454	2,526
IMF	1,266	1,260	1,094
Suppliers' credit	3,085	2,355	2,111
Bilateral	3,925	5,203	6,509
Other	374	844	585
Total	28,256	28,649	27,915

Source: Data provided by the Philippine authorities.

1/ Valued at end-period exchange rates.

Table 17. Philippines: Items Subject to Import Restrictions 1/

a. List B (477 items)

Animal and meat products	31
Coffee	9
Fish and fish preparation	36
Sugar	3
Fertilizers	19
Potatoes/onions/garlic	4
Cement and cement products	5
Antibiotics	23
Vessels and appurtenances	14
Radiation emitting apparatus	21
Spare parts, machinery and equipment for iron and steel, cement, textile, and coconut industries	37
Consumer durables/electrical goods	33
Raw materials, parts, components for consumer electronic products	73
Trucks and buses	10
Motor-cycles	2
Cars, jeeps	10
Used tires	2
Cigarette paper	1
Newsprint	1
Spare parts for cars, trucks, etc.	73
Diesel/gasoline engines	33
Refined petroleum products	15
Coal and derivatives	5
Rice and corn	12
Other items, not elsewhere classified	5
Total	477

b. List C: (102 items)

Used tires	6
Dangerous drugs	... 2/
Chemicals for manufacturing of explosives	10
Other chemicals	3
Color reproduction machines	3
Used vessels	5
Ammunition and firearms	28
Animals and animal effects	40
Pesticides	7
Total	102

Source: Data provided by the Philippine authorities.
1/ As of December 1988.
2/ No specific classification is indicated since items under this category are normally declared under generic names.

Philippines

Basic Data

Area:	300,000 sq km
Population (1988):	58.8 million
Annual rate of population growth (1978-86):	2.4 percent
Gross national product (1988):	$38.7 billion
GNP per capita (1988):	$658

	1985	1986	1987	1988 Prel.	1989 Prog.
			(Changes in percent)		
GNP and prices					
Real GNP	-4.2	2.0	5.9	6.7	6.5
Of which: Agriculture	3.3	3.7	-1.0	3.4	...
Manufacturing	-7.7	0.8	6.7	8.7	...
Nominal GNP	13.3	2.4	14.5	16.5	15.9
Implicit GNP deflator	18.3	0.4	8.1	9.2	8.8
Consumer price index (end-period)	5.7	-0.3	7.5	9.1	8.0
Nominal GNP (in billions of pesos)	597.7	612.0	700.5	816.1	945.8
National Government					
Total revenue	21.3	14.9	27.8	11.6	32.8
Total expenditure and net lending	19.7	38.0	9.8	14.2	19.2
Money and credit 1/					
Net domestic assets 2/	13.5	4.5	3.1	7.5	8.4
Domestic credit	-4.5	-8.7	-9.0	8.3	9.9
Public sector credit	19.3	-17.0	...	...	...
Private sector credit	-9.7	-6.6	14.7	13.0	14.2
Total liquidity	8.1	11.3	8.8	21.8	16.8
M3	9.7	13.4	11.4	23.1	13.5
Base money	6.7	19.6	11.0	14.9	10.2
Interest rate (90-day money market rate; end-period)	12.6	8.1	12.3	14.9	...
External sector					
Exports, f.o.b. (in U.S. dollar terms)	-14.1	4.6	18.1	23.7	13.7
Imports, f.o.b. (in U.S. dollar terms)	-15.8	-1.3	33.6	20.6	17.6
Exchange rate (period average)					
Nominal effective	-7.3	-21.2	-9.2	-7.8	-2.0 3/
Real effective	9.5	-22.0	-8.0	-2.7	2.8 3/
P/U.S. dollar (level)	18.6	20.4	20.6	21.1	21.3 4/
			(In millions of U.S. dollars)		
Balance of payments					
Exports, f.o.b.	4,629	4,842	5,720	7,074	8,040
Imports, f.o.b.	-5,111	-5,044	-6,737	-8,128	-9,560
Services and transfers, net	464	1,198	573	677	561
Current account balance	-18	996	-444	-377	-959
Overall balance 5/	991	1,242	264	516	1,583
External debt (end-period)					
Total	26,252	28,256	28,649	27,915	29,117
Medium- and long-term	16,643	21,705	23,662	23,088	24,060
Short-term	8,573	5,378	3,792	3,761	3,921
IMF	1,036	1,173	1,195	1,066	1,136
Debt service (as a ratio to exports of goods and services) 6/	33	34	36	34	34
Gross official reserves (end-period) (In months of imports of following year's imports of goods and services)	1.5	3.7	2.3	2.1	3.0
			(In percent of GNP)		
Gross domestic investment	14.3	13.2	15.4	18.2	20.5
Gross national saving	14.3	16.5	14.1	17.2	18.3
National government revenue	11.5	12.9	14.4	13.8	15.8
National government expenditure and net lending	13.4	18.1	17.3	17.0	17.5
National government deficit	-1.9	-5.1	-2.9	-3.1	-1.6
M3 (end-period) 1/	22.3	24.9	24.3	25.6	25.1
Exports	14.4	15.9	16.8	18.3	18.4
Imports	15.9	16.6	19.8	21.0	21.9
Current account balance (deficit -)	-0.1	3.3	-1.3	-1.0	-2.2
External debt	81.7	92.9	83.4	72.2	66.7

Sources: Data provided by the Philippine authorities; IMF, International Financial Statistics; and staff estimates.

1/ End-period. There is a break in the series in 1986.

2/ Net domestic assets with net foreign assets converted into pesos at a constant exchange rate of P 18 per $1.

3/ January 1989.

4/ As of February 1989.

5/ After rescheduling, concerted lending, and changes in nonmonetary arrears; equivalent to the change in net international reserves of the banking system.

6/ Including IMF; after rescheduling.

Philippines: Social and Demographic Indicators 1/

Area	Population	Density
300 thousand sq. km.	58.8 million (1988) Annual rate of growth: 2.4 percent	196 people per sq. km. 588 people per sq. km. of arable land

Population characteristics		Health	
Life expectancy at birth - male	62 years	Population per physician	6,700
- female	66 years	Population per hospital bed	629
Infant mortality rate (per 1,000 live births)	43		

Income distribution		Education	
Percent of national income		Primary school enrollment rate 2/	97
Highest 20 percent	41	Secondary school enrollment rate 2/	55
Lowest 20 percent	6		

Access to safe water	
Percent of population - urban	65
- rural	43

Nutrition	
Per capita calorie intake (calories per day)	2,214
Per capita protein intake (grams per day)	60

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

1/ Data refer to the most recent estimates between 1982 and 1987 unless otherwise specified.

2/ As percentage of age group.

Philippines: Summary of the Economic Program, 1989-92

1. Principal objectives

Sustaining a real GNP growth of 6.5 percent; containment of inflation within 8 percent in 1989 and a gradual decline thereafter to 5-6 percent; a moderate widening of the external current account deficit from 1 percent of GNP in 1988 to 2 1/2 percent in 1990-91, followed by a gradual decline thereafter; a substantial reduction in debt and debt service ratios with a view of eventual return to normal market access; build up gross official reserves to the equivalent of three months of imports; generation of productive employment opportunities; and alleviation of poverty.

2. Policy strategy

(a) To achieve the growth target, investment is programmed to rise from 18 percent of GNP in 1988 to 24 1/2 percent in 1992. This includes an increase in public investment from about 3 1/2 percent of GNP in 1988 to close to 6 percent in 1992. The program allows for adjustment of the public sector borrowing requirement for any excess or shortfall in capital expenditure financed by external project loans. Public investment would be directed mainly toward the power sector and toward rural and social infrastructure, including transportation and agricultural support facilities.

(b) Given the external current account target, the financing of this investment will require an increase in public savings from under 1 percent of GNP in 1988 to 4 1/2 percent of GNP in 1992 as well as higher private savings. Fiscal policy will be geared towards the achievement of the public savings target. This will be supplemented by prudent monetary policy and continuation of structural reforms.

(c) To finance the higher external current account deficit and to achieve the official gross reserves target, the strategy will focus on securing higher inflows from official and private sources (including private investment); a further rescheduling of debts to Paris Club creditors; and new financing from foreign commercial banks. At the same time, existing and new options for market-based debt reduction will be actively pursued.

3. Financial policies

(a) Fiscal policy. The consolidated public sector deficit (inclusive of the Central Bank and the monitored public corporations) is targeted to remain at 3 1/2 percent of GNP in 1989 and decline gradually to about 2 1/2 percent of GNP by 1992. The National Government deficit will be limited to a range of 1-1 1/2 percent of GNP, while the 14 major nonfinancial corporations will run deficits of about 1 percent of GNP. The principal measures to achieve these targets will be (i) substantial strengthening of tax administration; (ii) new revenue measures in 1990; (iii) containment of the growth in personnel expenditures to 17 percent in 1989 and 10 percent in subsequent years; and (iv) a strengthening of internal cash generation of public enterprises through price and tariff adjustments, improved cost recovery and collection efficiency, and privatization. The fiscal adjustment measures implemented in 1989 are equivalent to 1 percent of GNP. The size of the fiscal gap to be closed through revenue and expenditure measures is estimated at about ₱ 9 billion (0.8 percent of GNP) in 1990, with only small gaps (₱ 2-3 billion) remaining in 1991-92 if sufficient measures are taken in 1990.

A phased transfer to the National Government will be initiated in 1990 of the large debt service burden of the Central Bank that was caused by quasifiscal activities (mainly foreign exchange swaps and guarantees) carried out in the early 1980s.

(b) Monetary policy. Consistent with the growth and inflation objectives, target ranges of 13-16.5 percent for the average annual growth of broad money and of 11-14 percent for base money have been established. The program incorporates a band for limited additional reserve money expansion linked to NIR overperformance. Interest rates will continue to be market determined.

(c) External sector policies

External policies will support a continuation of the export performance, particularly of nontraditional items; annual export volume growth of 10 percent is projected over the program period. Accordingly, the aim of exchange rate policy will be to ensure a competitive exchange rate; trade reform will continue; and access to financing by exporters will be improved. Foreign investments will continue to be encouraged by streamlining of procedures for processing investment applications. The debt-to-equity conversion scheme is also being reviewed with the aim of attracting additional foreign investment, encouraging the repatriation of flight capital, and reducing the stock of external debt.

4. Structural policies

(a) Public nonfinancial corporations. The main elements of reform are: (i) the privatization of 130 out of 296 corporations and, of the remainder, retaining only 48 in their present form; (ii) introduction of corporate planning and performance monitoring and evaluation systems in 15 large government corporations; (iii) the restriction of budgetary subsidies only to those corporations providing social services or performing noneconomic activities mandated by the Government; (iv) limiting the extension of government guarantees on loans;

(v) greater flexibility in matters relating to personnel and procurement; (vi) a phased introduction of marginal cost pricing in the power sector; and (vii) private sector participation in power generation.

(b) Financial sector reform. Key elements of the program include: (i) strengthening the supervisory and regulatory framework of commercial banks; (ii) improving arrangements for depositor protection; (iii) reducing the costs of financial intermediation; and (iv) improving the institutional framework for the mobilization and delivery of long-term credit.

(c) Trade reform. The aim will be to support the export drive and build an internationally competitive industrial sector mainly through the phased replacement of import restrictions by tariffs and gradual reduction of tariffs over the longer term. During the program period, quantitative restrictions will be lifted for at least 180 items out of the 477 restricted items in List B.

(d) Agrarian reform. The Comprehensive Agrarian Reform Program will be implemented over a ten-year period. By end-1992, five million hectares will be distributed to 2 million beneficiaries. Land distribution will be supplemented with provision of extension services, credit and other agricultural inputs, and improvements in basic rural infrastructure. External assistance will be sought to finance support activities.

(e) Poverty alleviation. Steps will be taken to direct expenditures in health, education and housing sectors more directly to the truly needy. Delivery of social services will be made more effective through increased participation of local communities and nongovernment organizations. Management of natural resources will be improved mainly through a tightening of regulations and more effective enforcement.

5. Performance criteria

Quantitative performance criteria have been set for end-September 1989 and end-March 1990 for base money, the public sector borrowing requirement (PSBR), net international reserves (NIR) of the monetary authority, short-term external debt outstanding; and new approvals of nonconcessional external borrowing in the 1-12 year and 1-5 year maturity ranges. An additional performance criterion for end-September 1989 is the removal of restrictions on 90 import items.

Quarterly benchmarks have been established to guide the monitoring of shorter-term developments under the program. In addition, quarterly indicative targets have been set for net domestic assets of the monetary authority, total tax revenues of the National Government, and capital expenditures by the monitored public sector. Also, progress in the strengthening of tax administration and privatization of government corporations will be monitored.

Review of Developments under the 1986-88 Stand-by Arrangement

1. Objectives and principal policies

The stand-by arrangement was approved on October 24, 1986 for an 18-month period. On March 9, 1988 the Executive Board approved an extension of the arrangement by 4 months. The focus of the Government's economic program was to revive economic activity and to correct long-standing structural weaknesses. The strategy of the program was two-fold: wide-ranging structural reforms would be implemented to increase efficiency and stimulate private sector activity, but in the interim fiscal stimulus would be provided through expanded public investment and maintenance expenditures for an early initiation of the recovery. The structural measures included a major reform of the tax system, a reform of government financial institutions, trade policy reforms, and reforms in the agricultural sector.

2. The outturn

Growth performance under the program was in line with expectations. The balance of payments outturn was weaker than expected in 1987, in part because of speculation following a coup attempt in August 1987, but in 1988 developments were more favorable than anticipated (Table 1). Structural reforms were implemented broadly as envisaged.

(a) Output and price developments

The economic recovery that began in the second half of 1986 gained momentum during 1987-88. The major sources of output growth were the manufacturing, construction, and services sectors. Investment growth averaged 27 percent during this period, and was accompanied by strong growth in consumption. Inflation rose during the period, largely reflecting domestic demand pressures as well as supply shocks arising from drought and typhoons.

The bulk of the investment in 1987-88 took place in the private sector. Initially, there was a surge in construction activity, but in 1988 investment was concentrated more in equipment investment, signaling the attainment of capacity limits in many industries and buoyant expectations. Although there was some progress in the implementation of decentralized public infrastructural projects, public investment expenditure fell short of the program targets in both years. The shortfalls arose because of a reappraisal of projects, a tightening of administrative procedures, and management changes in some government departments and public enterprises.

Table 1. Philippines. Principal Objectives of and Performance Under the Adjustment Program, 1986-88

	1986		1987			1988	
	Program	Actual	Original Program	Second Review	Actual	Program	Actual
GNP and prices (percentage change)							
Real GNP	1.5	2.0	6-7	5.6	5.9	6-6.5	6.7
CPI (average)	4	0.8	5-6	4.5	3.8	7.0	8.8
External objectives							
Current account							
Billions of U.S. dollars	0.3	1.0	-0.4	-- 1/	-0.4	-0.5	-0.4
Percent of GNP	0.9	3.3	-1.2	0.1	-1.3	-1.5	-1.0
Exports (percent change in $ value)	-0.6	4.6	8.1	10.9	18.1	11.4	23.7
Imports (percent change in $ value)	0.8	-1.3	12.2	21.2	33.6	15.7	20.6
Overall balance							
(Billions of US dollars) 2/	1.2	1.2	0.8	0.8	0.3	0.5	0.5
Gross official reserves							
Billions of U.S. dollars	2.4	2.5	2.7	2.5	2.0	1.8	2.1
Months of imports 3/	3.5	3.7	3.5	3.2	2.3	1.9	2.1
Debt service ratio (percent, after rescheduling)	35.9	34.0	35.7	33.7	35.4	30.0	33.7
External debt							
Billions of U.S. dollars	26.8	28.3	27.2	28.6	28.6	28.8	27.9
Percent of GNP	86.0	92.9	81.0	87.3	83.4	79.0	72.2
Public sector (percent of GNP)							
National Government deficit	4.4	5.1	2.4	3.8	2.9	3.5	3.1
Monitored public sector borrowing requirement	5.5	4.3	2.9	4.4	2.1	4.1	2.4
Consolidated public sector deficit 4/	6.8	4.8	4.5	4.7	2.7	4.9	3.4
Public investment expenditure	5.0	3.1	5.0	4.5	3.6	4.6	3.4
Money (percent increase; end of period)							
Broad money	13	12	15	10	12	17	23
Base money 5/	15	24	16	11	15	15	15
Central Bank net domestic assets	9	16	-6	-4	5	-1	--
Interest rate (percent per annum) 6/	11.0	8.1	--	9-9.5	12.3	12-13	14.9

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

1/ Less than $50 million.
2/ After rescheduling and concerted lending.
3/ Months of imports of goods and services of the current year.
4/ Program targets for 1986-88 differ from those shown in earlier reports, as they have been adjusted to reflect change in definition of the public sector.
5/ Growth rate calculated using the averages of the 10-day test periods.
6/ Ninety-day money market rate; average for last week of December.

(b) Fiscal developments

The overall public sector deficit was smaller than targeted in both 1987 and 1988, mainly because of lower than expected capital expenditures. The tax reform initiated in 1986, aided by the economic recovery and surge in imports, had a sizeable positive impact on revenue in 1987. However, these gains were not sustained in 1988, in part because of weak tax administration, and revenues declined as a ratio of GNP. Personnel expenditure increased rapidly during the program period owing to wage increases designed to offset earlier large real wage losses, restructuring of the compensation system, and new hirings to relieve the chronic shortages in special occupational categories such as teachers and social workers.

(c) Monetary developments

Following the coup attempt in August 1987, increased emphasis was placed on the use of monetary policy to contain balance of payments outflows, and interest rates rose. Concern over rising interest rates caused some cutbacks in the planned sales of open market instruments, and the program target for base money was exceeded. However, monetary developments returned to their programmed path in early 1988 and the performance criteria for end-March and end-June were met. The improvement in the political climate and return of confidence in the financial system resulted in a decline in the currency-deposit ratio. This contributed to a 23 percent increase in broad money (M3), compared with 12 percent growth in 1987. Notwithstanding the faster expansion of broad money, interest rates rose in real terms in 1988.

(d) External sector developments

The external current account returned to a deficit in 1987. However, the deficit was substantially smaller than targeted in 1988. Exports, particularly of nontraditional items, rose at an increasingly rapid pace and surpassed program expectations in both years. With the recovery of economic growth and investment and the strong growth in manufactured exports, imports also grew rapidly.

The availability of multilateral and bilateral financing increased during the program period. New rescheduling arrangements with both Paris Club creditors and commercial banks became effective in 1987. However, after August 1988 arrears were accumulated with respect to debt service to Paris Club creditors in anticipation of a new rescheduling arrangement following approval of the extended arrangement. Substantial use was made of the debt to equity conversion scheme and this was reflected in a marked increase in direct investment and a reduction in bank debt by 8.5 percent.

The net international reserves position of the banking system improved slightly during 1987-88. However, gross official reserves declined in 1987, as the Central Bank intervened to support the peso in the face of heavy speculative purchases by the commercial banks toward the end of the year. The Central Bank continued to be a net seller of foreign exchange in the first two months of 1988. However, over the year as a whole gross reserves rose slightly to $2.1 billion, equivalent to 2 months of imports, helped by large purchases in December from the commercial banks.

During 1987-88, the peso remained broadly unchanged against the U.S. dollar. The peso depreciated slightly in real effective terms vis-a-vis trading partners, but there was some erosion of competitiveness vis-a-vis major export competitors in the region.

(c) Structural measures

Structural reforms were implemented broadly as envisaged. Tax reform, which was implemented in stages, included a reduction in the marginal income tax rates, withdrawal of many exemptions, rationalization and widening of the sales tax base, restructuring of the excise and import duties, and introduction of a value added tax. Reform of the government financial institutions involved major organizational and financial restructuring of the Philippine National Bank and the Development Bank of the Philippines. Major cost reductions involving sizable staff reductions were implemented by both banks. In addition, in 1987 most nonperforming assets were transferred to a newly established Asset Privatization Trust with roughly similar amount of specified liabilities being transferred to the National Government. Trade policy reform involved the removal in stages since mid-1986 of restrictions on 1,326 import items, accounting for about 25 percent of total imports. In some of these cases, restrictions were replaced by tariffs of up to 50 percent. Agricultural sector reforms included dismantling of export monopolies in the sugar and coconut sectors, withdrawal of the ban on copra exports, removal of export taxes on coconut products, and lifting of restrictions on new investments in coconut milling.

Measures to Strengthen Tax Administration

The relatively low tax revenue/GNP ratio in the Philippines, which averaged only 11.3 percent during 1986-88, has tended to reflect not so much statutory rates that are especially low, 1/ but rather low effective rates resulting from a narrow tax base and a low level of compliance on that base. Thus, tax evasion and avoidance have severely hampered the mobilization of public sector resources needed to pay for productive government expenditures and social services and have also caused regressivity and inequity in the effective burden of taxation. For instance, available data suggest that only a small proportion of professionals and the self-employed file for income tax returns, and that those who file pay on average only about 1 percent of their gross income in taxes even when they belong to the highest income tax bracket. 2/ Evasion and avoidance have also severely affected the collection of indirect taxes, including sales taxes and import duties.

The authorities are determined to address these issues in the context of the economic program and are already implementing a first set of measures, detailed below, whose estimated financial impact for 1989-90 is shown in Table 1.

1. Income tax

a. The withholding tax system, which applies not only to wages but also to other incomes such as rental, interest, and consultancy fees, will be broadened to include professional fees of doctors and incomes from partnership shares (affecting mostly lawyers). Regulations instituting (i) a 15 percent withholding tax for members of general professional partnerships (or a final 30 percent withholding tax in the case of nonresidents), and (ii) a 10 percent withholding tax on professional fees paid to medical practitioners by hospitals and clinics have been issued, effective January 1, 1989. Furthermore, a program is underway to update and cross-check the list of registered withholding agents using (i) the list of employers registered with the Social Security System; (ii) the list of banks, according to records of the Central Bank and local government offices; (iii) the list of corporations registered with the Security and Exchange Commission (SEC); and (iv) the list of registered single proprietorships and partnerships from the Department of Trade and Industry. This task is expected to be

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1/ Although lower than in Japan and Korea, statutory rates are comparable with those prevailing in Thailand and Indonesia.

2/ In comparison, wage and salary earners in the highest income tax bracket pay on average 10 percent of their incomes in taxes.

Table 1. Philippines: Tax Administration Measures, 1989-90

(In millions of pesos)

	Projections 1989	1990
1. Income Tax		
a. Broadening of withholding tax system	500	930
b. Ceilings on business deductions	600	1,200
c. Special investigations, delinquent accounts, back taxes from copper mining companies, etc.	1,020	890
2. Excises		
a. Back taxes, and effective payment of excises on minerals, mineral products, quarry resources, and nonessential goods	760	390
b. Strengthening of collections of excises on cars	380	380
3. Value-Added Tax (VAT)		
a. Raising the number of paying registrants and reducing underdeclaration	800	1,800
4. Customs Duties		
a. Broadening of use of "fair market values" of imports for duty calculation	1,160	2,850
b. Collections of back duties from copper mining companies and from scheme to settle duties on illegally imported cars	560	480
Total	5,780	8,920

completed by June 1989, and a number of investigations and prosecutions are expected to be undertaken soon thereafter.

b. Legislation to revise the system of business deductions will be introduced in an effort to prevent erosion of the tax base in the case of corporate incomes and incomes of professionals and the self-employed. In particular, in the case of itemized deductions, limits for representation, travel and advertising expenses will be implemented.

c. Additional income tax collections are to result from new special investigations, from concerted efforts to collect from delinquent accounts (which amounted to almost P 14 billion at end-December 1988), from the implementation of an agreement reached between the Bureau of Internal Revenue (BIR) and the copper mining corporations to settle back taxes, and from the externalities associated with the strengthening of the value-added tax system.

d. Regulations have been issued to upgrade significantly the zonal property values used for application of transfer taxes, in particular the capital gains tax and the estate and donor tax.

2. Excises

a. Steps are being taken to enforce the effective payment of excises on minerals, mineral products, quarry resources, and nonessential goods, previously subject to a minimum sales tax. This will include back tax payments and new collections from formerly distressed copper mining companies as a result of the lifting of the suspension on payment of taxes.

b. Regulations have been issued to ensure full payment, at properly applicable rates, of the excise taxes on cars and other vehicles. It will no longer be possible to obtain or renew vehicle registrations without evidence of full payment of the excise tax.

3. Value-added tax (VAT)

On a full-year basis, collections of the VAT on domestic production would have amounted to about P 7.6 billion in 1988 (actual collections, which started on April 1, were P 5.7 billion). This outcome represented a shortfall of about P 1 billion from projections. 1/ The authorities estimated that, in view of the administrative difficulties encountered and the excessive use made of transitory administrative arrangements, collections in 1988 were only about 45 percent of the maximum theoretical collections. The authorities aim to reduce the leakage rate from

1/ Collections of the VAT on imports turned out to be on target, reaching P 6.4 billion in the 12-month period through the end of December 1988.

55 percent to 25 percent by 1992, with an intermediary target of 40 percent for 1989. An action plan is currently being implemented focusing on (i) enrolling registrable persons and businesses, and raising the number of paying VAT registrants (currently only about 59,000); and (ii) preventing the underdeclaration of sales and purchases as well as inflated input tax credits. To reach these objectives, 1,700 new VAT agents will be recruited, reducing the number of VAT accounts per revenue officer from 345 to about 100.

4. Customs duties

a. Survey data suggest that the undervaluation of imports for calculation of customs duties is a widespread practice that has resulted in an estimated 10-20 percent narrowing of the dutiable base. To correct the situation, and without departing from the general policy of basing import duties on c.i.f. values, the authorities have taken steps to broaden the use of published "fair market values" as guidelines for the valuation of imports for the purpose of duty calculation. These guidelines would also reduce the need for discretionary assessment and the scope for corruption. A system to generate efficiently, and on a continuous basis, value information for the purpose of devising a uniform valuation and classification of imports has been introduced. Publication of "fair market values" will be accelerated with the aim of increasing the share of imports covered from 30 to 50 percent by the end of 1989 and 80 percent by 1992.

b. Additional import duty revenues are also to result from the lifting of the suspension on payment of taxes granted previously to copper mining companies. In addition, a voluntary payment scheme has been offered for the settlement of import duties on illegally imported cars. Regulations have been issued to prevent registration (or its renewal) unless evidence of full payment of import duties is provided.

The Public Investment Program 1/

An adequate level of public investment is essential to ensure the continued growth of the Philippine economy and the achievement of the objectives of the Medium-Term Development Plan. Since 1986, the Government has reexamined its investment priorities, dropping a number of marginal projects and increasing the emphasis of the Medium-Term Public Investment Program (MTPIP) on poverty alleviation and regional development. The most recent revision of the MTPIP (in June, 1988) eliminated ₱ 26.5 billion of projects, mostly in the energy development area.

The initial target in the June 1988 MTPIP for the level of investment during the 1989-92 period was 5.6 percent of GNP. This has been scaled back under the present program to 5.1 percent, in recognition of potential slippages in implementation. The total investment for this period will be about ₱ 195 billion (in 1988 prices) of which around two fifths represent foreign exchange cost. The planned expenditures have been reviewed by World Bank staff and are considered appropriate both in terms of level and content.

Table 1. Planned Public Investment, 1989-92

(In billions of pesos, 1988 prices)

		(Percent)
Agriculture	23.8	12.2
Communications	10.0	5.1
Power and energy	39.2	20.1
Flood control and drainage	5.1	2.6
Industry and utilities	2.0	1.0
Social services	22.1	11.3
Transportation	47.5	24.3
Urban infrastructure	3.3	1.7
Water supply, sewerage	19.3	9.9
Other projects	23.1	11.8
Total	195.4	100.0
Percent of GNP	5.1	

Sources: National Economic Development Authority (NEDA); and staff estimates.

1/ Prepared by the World Bank staff.

The bulk of investment will go into the traditionally capital intensive sectors of power and transportation (Table 1). These two sectors will account for 44 percent of planned expenditures, although significant shifts in priorities within both sectors are occurring.

A major increase in investment in the power sector is needed to ease the rapidly emerging capacity constraints. In the short term, NPC has had to invest in oil-fired gas turbines in order to meet the rapid growth in demand occasioned by the recovery of the economy and to replace the power originally planned to come from the nuclear power plant. Beyond this, increased emphasis is being given to power generation from geothermal sources rather than through the development of marginal coal deposits. A limited amount of funds will be invested in rural electrification, in order to extend electricity service to additional areas. These investments, however, are conditional on a reform of the rural electric cooperative system, much of which is not financially viable. In transportation, the primary emphasis will be on the construction of rural and farm-to-market roads as well as on the improvement and rehabilitation of existing roads in order to avoid larger outlays in the future for reconstruction.

In the social services sector, investments are intended to decentralize services and increase access to basic facilities, especially water supply and education. The Metropolitan Waterworks and Sewerage System (MWSS) is currently implementing major water rehabilitation projects. The Government's objective is to expand the system of secondary schools in order to fulfill the Constitution mandate of access to free secondary education for all students. In agriculture, increased emphasis is being placed on forestry projects and the conservation of natural resources, as well as on projects designed to increase agricultural productivity, support agrarian reform, and improve the delivery system for farm inputs and services. This will include the rehabilitation of irrigation networks by the National Irrigation Administration (NIA).

Implementation. Actual implementation of the MTPIP during the past few years has been disappointing, as expenditure levels have fallen considerably short of objectives. Thus, public investment as a share of GNP was about 3.6 percent in 1987 and 3.4 percent in 1988 (Table 2), and the disbursement on foreign loans used to finance the investment program has lagged behind expectations. These shortfalls in implementation reflect a number of factors, including changes in department and agency heads during the period, and a tightening of administrative procedures since 1986. Because of past abuses, review agencies such as the Commission on Audit (COA) and the National Economic Development Authority (NEDA) became increasingly diligent in the review and approval of new projects. In early 1988, the Government established the Project Facilitation Committee (PFC) in order to expedite project implementation and project identification. As a result, a number of changes in project

Table 2. Philippines: Public Investment, 1987-89

(In millions of pesos)

	1987	1988	1989
National Government			
Total	12,900	13,759	18,920
Infrastructure	7,300	7,819	10,720
Other capital	5,600	5,940	8,200
Public corporations	8,300	8,019	19,119
Of which: National Power Corporation (NPC)	3,679	2,027	8,293
Philippine National Oil Company (PNOC)	1,653	528	1,898
National Iriigation Authority (NIA)	1,937	2,199	2,639
Metropolitan Water or Sewage System (MWSS)	587	609	2,416
Philippine Ports Authority (PPA)	229	565	1,103
Local Government	1,500	1,200	2,000
Total	22,700	22,978	40,039
PSBR adjustments 1/	2,800	4,900	
Total	25,500	27,878	40,039
(In percent of GNP)	(3.6)	(3.4)	(4.2)

Sources: Data provided by the Philippine authorities.

1/ PSBR adjustment covers capital expenditures from foreign loans not reported by individual agencies and corporations, but included in the calculation of the public sector borrowing requirement.

administration have been introduced, which are expected to affect involvement in 1989. These include:

- the limiting of COA's preauditing to the final 15 percent of project expenditures;
- the elimination of COA's prior approval of project contracts;
- the raising of the limits on projects that can be approved by regional Department of Public Works and Housing (DPWH) directors from P 1 million to P 5 million; this ceiling may be raised further to P 10 million in 1989;
- increased funding through the PFC of project feasibility studies;
- the improvement in bid review and award procedures, including the beginning of bidding procedures prior to budget allocations;
- increased training of project management officers, and increased salaries for those officers handling foreign assisted projects.

In addition, the Government intends to establish a Contract Review Panel, composed of the Undersecretaries of Budget, Finance, and NEDA, and the head of the PFC, in order to expedite the approval of large contracts by the Office of the President.

These and other improvements are expected to result in a substantial increase in the face of investment in 1989. The planned allocation totals 4.2 percent of GNP and represents a real increase of over 30 percent, but would still be below the Plan target.

Balance of Payments Sensitivity Analysis

The medium-term balance of payments projections presented in the report are based (i) on a macroeconomic framework that includes real GNP growth of 6.5 percent per year and (ii) on projections of external parameters derived from the latest World Economic Outlook. This annex indicates the sensitivity of the balance of payments projections to deviations in the external environment and to shortfalls in investment and real GNP growth.

1. Changes in external parameters

Deviations in key assumptions on the external environment would have a significant impact on the overall balance of payments. A 1 percentage point shortfall in average annual export volume growth during 1989-92 (i.e., a cumulative shortfall of 4 percentage points) would increase the current account deficit by over $0.5 billion (0.9 percent of GNP) by 1992 (Table 1). The financing gaps during the entire 1989-92 period would be raised by a cumulative $1.1 billion. Prices for non-oil imports that were 1 percentage point higher than projected in 1989 (with the higher level being maintained subsequently) would raise the current account deficit by $87 million (0.2 percent of GNP) in 1989, with the impact growing over time as the resulting larger financing gaps are assumed to be financed on commercial terms. Similarly, a one dollar per barrel higher world oil price would lead to a $87 million higher current account deficit in the first year.

A worldwide increase in interest rates by one percentage point would, with a time lag of almost half a year, raise net interest payments by $118 million (0.3 percent of GNP) a year (taking into account increased earnings on reserves and given that slightly more than 50 percent of total external debt was contracted at variable rates). If the higher interest rates were sustained, the current account deterioration would grow to $129 million in the second full year as a result of financing the larger deficit.

2. Investment and growth

The balance of payments projections presented in the report indicate that, if the residual financing gaps expected in 1989-92 are filled by new money contracted on broadly commercial terms, then substantial financing gaps would persist into the mid-1990s. Although these later gaps could be filled by concerted new lending and further rescheduling and while debt and debt service ratios would continue to decline, based on present projections a return to normal market access may not be achieved by the mid-1990s. Associated with these

Table 1. Philippines: Balance of Payments Sensitivity
Analysis for External Parameters, 1989-92

(In millions of U.S. dollars)

	1989	1990	1991	1992
I. Impact of one percent per annum lower export volume growth on				
(i) trade balance	-81	-180	-304	-462
(ii) current account deficit 1/	-85	-197	-345	-514
II. Impact of one percent higher non-oil import price level during the program period on				
(i) trade balance	-83	-94	-106	-118
(ii) current account deficit 1/	-87	-108	-131	-146
III. Impact of $1 per barrel higher world oil prices during the program period on				
(i) trade balance	-83	-87	-91	-95
(ii) current account deficit 1/	-87	-100	-115	-130
IV. Impact of one percentage point higher world interest rates during the program period on				
(i) current account deficit 1/	-118	-129	-140	-151

Source: Staff estimates.

1/ Includes changes in interest payments resulting from higher or lower residual financing gap.

circumstances, Philippine debt could continue to trade at a substantial discount on the secondary market. 1/ The persistence of a significant discount could, in turn, make it more difficult to arrange new financing packages. Such a set of circumstances could undercut the Government's efforts to create the environment for strong investment and growth and could have a dampening effect on both foreign and domestically financed investment. Voluntary debt reduction could help reduce the risks to growth by accelerating the return to normal market access and improving investment incentives.

A lower rate of investment and hence lower output growth would cause some initial reduction in the current account deficit and the size of the residual financing gaps. However, this would not represent a viable longer-term solution since lower investment would affect the economy's ability to generate resources for future debt service payments, while the resulting lower growth rates would also tend to undermine the strength of adjustment efforts.

An attempt has been made to quantify the impact of lower investment on growth and the external current account. This impact largely depends upon the marginal efficiency of investment and the response of the overall savings rate to changes in growth. Rough estimates indicate that a shortfall in investment of about 2 percent of GNP would reduce GNP growth by 1 percentage point per year and would be associated with smaller current account deficits of about 1/2 percentage point of GNP per year during 1989-90, about one percentage point during 1991-93, and somewhat less in subsequent years. (The smaller impact in later years reflects the cumulative effect of a smaller productive base on export growth). The lower current account deficits would reduce the average annual financing gaps by about $200 million per year during the projection period. The debt service ratios would be about 3/4 of 1 percentage point lower by 1995. However, these effects would gradually diminish over time because of lower export growth. In sum, a decline in investment could have a significant effect on growth while only moderately reducing the external financing gap.

1/ As of mid-April 1989, the secondary market price for Philippine commercial bank debt was about 40 cents per dollar of face value.

Comprehensive Agrarian Reform Program

The principal aims of the Comprehensive Agrarian Reform Program (CARP), approved by the Philippine Congress in June 1988, are to increase agricultural productivity and to improve the standard of living of small farmers. The CARP takes a broad approach to agrarian reform as it goes beyond redistribution of land ownership and also emphasizes the provision of support services such as production credit, extension services, and infrastructure facilities.

The CARP seeks to distribute 10.3 million hectares to an estimated 3.9 million beneficiaries over a ten-year period. Public lands account for almost one-half of the program's coverage; private lands acquired under the new law for only one-fifth; and rice and corn lands carried over from the Operation Land Transfer program launched in October 1972 for about 7 percent. The rest includes voluntarily surrendered lands, idle and abandoned lands, and integrated social forestry areas. Under the new law, the land retention limit for private agricultural lands is five hectares for landowners, plus three hectares for each child who is at least 15 years old and is actually tilling the land or managing the farm. The acquisition of private agricultural lands devoted to commercial livestock, poultry and pig raising, acqua-culture, fruit farms, vegetables and cutflower farms, cocoa, coffee and rubber plantations has been deferred for ten years beginning from the first year of commercial production.

The land distribution program will be implemented almost evenly over a ten-year period in three overlapping phases. Phase I (1.05 million hectares; and covering mainly rice and corn lands, and idle and abandoned lands) is expected to be virtually completed by 1992. Initially, the CARP Act called for the implementation of Phase II (7.66 million hectares; and covering public lands, private lands in excess of 50 hectares, and forestry areas) within the first four years of the program. However, taking into account the capabilities of the implementation agencies a more gradual time table for annual distribution has now been adopted. Nearly one-half of the public lands are slated for distribution in the form of 25-year leaseholds. The implementation of Phase III (1.58 million hectares; consisting of private lands below 50 hectares) will mainly begin in 1992. Award limits for beneficiaries have been set at 1.4 hectares for rice and corn lands, 1.67 hectares in the case of public lands, and 3 hectares for private agricultural lands. Pending the final land transfer, private landowners are expected to share a portion of gross production with their farm workers.

Drawing on the lessons from earlier unsuccessful attempts at agrarian reform in the Philippines, the CARP places considerable emphasis on post-land distribution support activities and the creation of appropriate implementation mechanisms. Under the CARP, an extension program will be developed to provide technical training, facilitate access to inputs and credit, and give assistance with marketing. Although these services will be geared primarily toward the beneficiaries of the agrarian reform, assistance will also be extended to affected landowners to set up industries in rural area. The implementation of CARP will also involve substantial improvement of farm-related infrastructure facilities, including communal irrigation systems, small water impounding dams, rural roads, access trails, agro-forestry nurseries, and agro-industrial prototype equipment. To ensure timely implementation of land acquisition and distribution and an effective provision of extension services it will be necessary for the various implementing agencies--such as the Department of Agrarian Reform, Department of Environment and Natural Resources, Department of Agriculture--to recruit additional staff and provide them with the necessary training. It is estimated that a total of about 69,000 persons will have to be recruited, many of whom will be hired on a contractual basis for a limited time period. To coordinate the activities of the various implementing agencies, coordinating bodies have been established at the national, provincial, and barangay levels.

The provision of credit support is a vital element of the CARP, as the beneficiaries are unlikely to qualify for bank credit on their own; beneficiaries who were previously tenant cultivators will also no longer have access to production loans from landowners. The CARP will not contribute much to collatarization in the short run; titles received will be mortgaged to the Land Bank of the Philippines (LBP) for 30 years and will not otherwise be transferable by the beneficiaries, except to heirs, for ten years. To encourage bank lending to semi-bankable beneficiaries, i.e. those who have viable projects but are collateral deficient, the Government intends to set up a loan guarantee fund. For the more disadvantaged beneficiaries, funds will be made available for onlending. For agricultural loans, the LBP will be the principal lending institution either directly or through Rural Banks acting as conduits. To enable LBP to handle this role effectively, steps are being taken to build its institutional capabilities. For agro-processing loans the Development Bank of the Philippines will be the principal lending institution. In order to meet the agro-industrial credit requirements under the CARP, especially by former landowners who want to shift to non-farm activities, the establishment of a Rural Industrialization Loan Fund has been proposed.

The total cash requirement for implementing the CARP over a ten-year period is estimated on a preliminary basis at ₱ 225 billion. Of this amount, outlays on land acquisition and distribution account for about 37 percent (₱ 84 billion); the rest is to be spent on post-land distribution support activities. Under the CARP, landowners will be paid only 25-35 percent of the value of their land in cash, depending on the size of their holdings, and the rest will be paid through Land Bank bonds. These bonds will carry market interest rates aligned with the

91-day treasury bill rates, and will have a ten-year maturity period with 10 percent of the face value of the bonds maturing every year. The landowners may use these bonds at their full face value to obtain assets under the Asset Privatization Program, acquire shares in government corporations, or to offset various taxes and fees. The cash compensation to landowners, payment for maturing bonds, and the interest payments on bonds during the 10-year implementation period are estimated to amount to P 80 billion, i.e. about 95 percent of cash outlays on land acquisition and distribution. The net financing requirement for providing credit support (i.e. net of loan repayments) is estimated at P 81 billion, including administrative costs (P 4 billion) and the cost of setting up the loan guarantee fund (P 13.6 billion). This is based on the premise that beneficiaries will receive production loans of P 5,000 per hectare subject to a maximum of four renewals, and that the loan recovery rate will gradually rise from 50-70 percent in the first year of the program to 73-93 percent.

Sufficient availability of external assistance will be critical for timely implementation of CARP, particularly beyond 1990. The Government expects to raise P 50.1 billion from the sale of assets with the Asset Privatization Trust and the Presidential Commission on Good Government, which will be used to finance land acquisition and distribution. Support activities will be financed from external sources. At present, only P 2.4 billion of external assistance has been identified. The Government will seek the remaining requirements from bilateral and multilateral donors during the forthcoming Consultative Group Meeting.

Philippines - Fund Relations
(As of March 31, 1989)

I. Membership status

(a) Date of Membership: December 27, 1945
(b) Status: Article XIV

A. Financial Relations

(Amounts in millions of SDRs, unless otherwise specified)

II. General Department (General Resources Account)

	Amount	As percent of quota
(a) Quota:	440.4	100.0
(b) Total Fund holdings of pesos:	1,156.4	262.6
(c) Fund credit:	754.8	171.4
Of which: Credit tranches	215.3	48.9
EAR	315.4	71.6
CFF	224.1	50.9
(d) Reserve tranche position:	38.8	8.8

III. Stand-By and Extended Arrangements

(a) Previous stand-by and extended arrangements.

Type of Arrangement	Date of Approval	Duration	Amount	Utilization
SBA	05/16/73	1 year	45.00	--
SBA	07/16/74	1 year	38.75	38.75
SBA	05/31/75	1 year	29.06	29.06
EFA	04/02/76	3 years	217.00	217.00
SBA	06/11/79	1 year	105.00	91.25
SBA	02/27/80	2 years	410.00	410.00
SBA	02/25/83	1 year	315.00	100.00
SBA	12/14/84	1 1/2 years	615.00	403.00
SBA	10/24/86	1 year 10 months	198.00	198.00

Philippines--Fund Relations (continued)

(b) Special facilities

Type of special facility	Date of Approval	Amount
CFF	02/25/83	188.55
CFF	10/24/86	224.10

IV. SDR Department

(a) Net cumulative allocation:	116.60
(b) Holdings:	0.82
(As percent of net cumulative allocation)	0.70

V. Administered accounts

(a) Trust Fund loans	
(i) Disbursed	151.47
(ii) Outstanding	14.91
(b) SFF Subsidy Account	
(i) Donations to Fund	None
(ii) Loans to Fund	None
(iii) Payments by Fund	49.14

VI. Financial obligations due to the Fund

	Overdue Financial Obligations (3/31/89)	Principal and Interest Due 1989 (4/1-12/31)	1990	1991	1992
(a) Principal	--	110.4	254.4	215.6	109.9
(i) Repurchases	--	100.8	249.7	215.0	109.9
(ii) Trust Fund	--	9.6	4.7	0.6	--
(b) Charges and interest	--	45.9	56.3	37.0	23.2
Total	--	156.3	310.6	252.6	133.1

B. Nonfinancial Relations

VII. Exchange rate arrangement: Since October 15, 1984, the exchange rate for the Philippine peso has been determined freely by market forces. On that date, the rate was determined at ₱ 19.95 = US$1 representing a depreciation of about 8.1 percent from the rate of ₱ 18.33 = US$1 on October 12, 1984. Between mid-December 1984 until mid-1985, the peso broadly appreciated in real effective terms against the U.S. dollar. Since October 15, 1985, the peso depreciated against the U.S. dollar and stabilized at about ₱ 20.4 = US$1 from February 1986 to August 1987. Since then, there has been a depreciation to ₱ 21.35 = US$1.

VIII. Last Article IV Consultation: The 1988 Article IV consultation report(SM/88/113) was discussed by the Executive Board on June 20, 1988.

Philippines--Fund Relations (concluded)

IX. Consultation cycle: The Philippines is on the standard 12-month cycle.

X. Technical Assistance: A technical assistance mission from the Bureau of Statistics on money and banking visited Manila in October 1988, and a mission on general statistics (production, employment, wages) visited Manila in February 1987. Missions from the Fiscal Affairs Department visited Manila during October-November 1986 and February 1987 to advise on the introduction of the value-added tax. A mission to give technical assistance on tax administration visited Manila in March-April 1989.

XI. Resident Representative: A Resident Representative has been stationed in Manila since January 1984. Mr. Chungsuk Cha assumed the post in 1987.

World Bank Activity in the Philippines 1/

1. World Bank lending in 1987-88

Between January 1, 1987 and December 31, 1988, the Bank approved seven loans to the Philippines, totaling $847 million in new commitments (Table 1). Included in this total is $300 million for an Economic Recovery Loan approved in March 1987. This loan supports important reforms of the government financial institutions, the public investment program, trade liberalization, and tax reform; two tranches of $100 million each have been disbursed. Loans approved in 1988 include a Public Corporation Reform Project, which supports a program of divestiture and other reforms for nonfinancial government corporations; a loan for irrigation operations support which helps define a realistic program for rehabilitation and maintenance of the irrigation system; a housing sector loan which supports reforms of various housing finance entities and provides support for mortgage lending; and a power sector development project, which finances the expansion of geothermal based power.

Table 1. Loan Approvals in 1987

(In millions of U.S. dollars)

		Amount	Date
1.	Economic Recovery Loan	300	3/17/87
2.	Economic Recovery Technical Assistance Project	10	3/17/87
3.	Provincial Ports Projects	32	5/26/87
4.	Irrigation Operations Support	45	6/02/88
5.	Program for Government Corporations	200	6/15/88
6.	Bacon-Manito Geothermal Power	100	6/23/88
7.	Housing sector	160	6/24/88
	Total	847	

1/ Prepared by World Bank staff.

As of September 30, 1988, there were 33 bank-assisted projects undergoing implementation in the Philippines. Disbursements totaled $262 million in 1988. The Bank estimates a level of disbursements of $403 million during 1989.

The Bank has a number of projects under development for possible approval in 1989. These include a financial sector loan, which will support a series of reforms aimed at improving the operation of the private commercial banks and their regulation. Other operations being considered include a loan for small- and medium-scale industry and an energy sector loan.

The 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. Recent reports have focused on important issues such as poverty/unemployment, transportation, the financial sector, energy/power and public sector resource management. A new Country Economic Memorandum was issued in January, 1989. This report will serve as background documentation for the next meeting of the Consultative Group.

Estimated disbursements on World Bank loans outstanding as of end-December 1988 are summarized in Table 2.

Table 2. IBRD/IDA Disbursements, 1987-89

(In millions of U.S. dollars)

	1987	1988	1989 Est.
Disbursements on projects, pipeline 10/83	246	63	41
Disbursements on new loans made after 10/83	24	199	362
Total	270	262	403

2. Financial relations

(a) IBRD/IDA lending operations
as of September 30, 1988)

Table 3. IBRD/IDA Lending Operations

(In millions of U.S. dollars)

	Commitments		Undisbursed
	IBRD	IDA	
Seventy three loans and five credits disbursed	2,762.7	73.0	
Present commitments	1,861	34.4 1/	1,087.4
Total	4,623.8	107.4	1,087.4
Repayments	1,031.8	1.9	
Debt outstanding	3,501.8	105.3	

(b) IFC investments
(as of September 30, 1988)

Total gross commitments	222.5
Less: repaid, sold, or cancelled	129.7
Total commitments held by IFC	92.8

3. Recent economic and sector reports

Philippines: Toward Sustaining the Economic Recovery, January 30, 1989, No. 7438-PH.

The Philippines: The Challenge of Poverty, October 17, 1988, No. 7144-PH.

Philippines: Transport Sector Review, March 31, 1988, No. 7098-PH.

1/ Net of cancellations.

Philippines: Selected Issues in Public Sector Resource Management, April 15, 1988, No. 6887-PH.

Philippines: Financial Sector Study, August 23, 1988, Report No. 7177-PH.

Philippines: Forestry, Fisheries and Agricultural Resource Management Study (ffARM Study), January 17, 1989, No. 7388-PH.

The Philippines: Education Sector Study, December, 1988, No. 7473-PH.

4. Technical Assistance:

The IBRD has provided technical assistance to the Philippines through its standard lending operations in such sectors as agriculture, transportation, and public utilities.

5. Aid Consultative Group:

The Consultative Group, under the chairmanship of the Bank, met in January 1987 in Paris. A country Economic Memorandum on the Philippines, prepared by the World Bank, was distributed and discussed at this meeting. The next meeting of the Consultative Group is tentatively scheduled for June 1989.

Asian Development Bank Activity in the Philippines 1/

Asian Development Bank lending to the Philippines rose sharply from $43.5 million for one project (Second Manila Port) in 1987 to $357.96 million ($180.0 million from OCR and $177.96 million from ADF) for six projects in 1988 (Table 1). The loan program covered several subsectors including forestry, secondary and tertiary (agricultural technology) education, power, microcredit, and integrated area development. The Bank also approved a private sector loan, co-financed by the International Finance Corporation, in the amount of $24 million, to the Philippine Long Distance Telephone Company. The 1988 lending program included $120 million for the Forestry Sector Program approved in June 1988. This loan involves policy and institutional reforms; loan proceeds will provide balance-of-payments support to the Government and ensure the availability of resources to expand and accelerate the Government's reforestation program. A first tranche of $60 million was disbursed in September 1988. A second disbursement is expected to be made in 1990 after the completion of the ongoing Bank-assisted Forestry Sector Master Plan (financed by the Finnish International Development Agency). The Overseas Economic Cooperation Fund (OECF) of Japan has provided $120 million in co-financing for this loan.

As of 31 January 1989, there were 38 Bank-assisted projects under implementation in the Philippines. Disbursements totaled $157.4 million in 1988. Total loan service payments to the Bank in 1988 were $202.6 million, resulting in negative net resource transfer of $45.2 million. The Bank estimates a level of disbursements of about $145 million during 1989.

Table 1. Project Approvals in 1988

(In millions of U.S. dollars)

		Amount	Date
1.	Agricultural Technology Education	15.86 (ADF)	8 March 1988
2.	Forestry Sector Program	60.00 (ADF)	28 June 1988
	Forestry Sector Program	60.00 (OCR)	28 June 1988
3.	Secondary Education	70.00 (ADF)	11 Aug. 1988
4.	Fourteenth Power loan	120.00 (OCR)	27 Oct. 1988
5.	Sorsogon Integrated Area	24.1 (ADF)	3 Nov. 1988
6.	NGO Microcredit	8.0 (ADF)	22 Dec. 1988
	Total	$ 357.96	

1/ Prepared by Asian Development Bank staff.

The Bank has a number of projects under consideration for possible financing in 1989. These include program loans for the fisheries and the road and road transport sectors, a power loan, urban water supply, and a poverty alleviation-oriented project for the integrated development of low income upland communities.

In 1988 the Bank approved 23 technical assistance projects amounting to $11.9 million, compared with eight projects totaling $1.8 million in 1987. Eleven projects were in the agriculture sector, four in industry and development banks, two each in social infrastructure and energy, and one each in the ports, telecommunications, water supply, environment, and financial sectors. As of the end of 1988 the Bank has provided technical assistance amounting to $32 million for 109 projects.

The economic and sector studies proposed to be undertaken during 1989-1990 include: a study on the transfer pricing of power, a review of small and medium industries sector policies, and an analysis of regional development issues. Policy research will also be undertaken in support of proposed Bank operations in transport, fisheries, the financial sector and various aspects of social development.

Actual (1988) and estimated (1989-1990) disbursement figures for Bank loans as of end-December 1988 are summarized in Table 2.

Table 2. ADB Disbursements, 1988-1990

(In millions of U.S. dollars)

	1988	1989	1990
Disbursements	157	145	270

Between the commencement of Bank operations in the Philippines in 1969 and the end of 1988, the Bank had approved 90 loans totaling $2.83 billion for 81 projects and two special assistance loans. Of these, 76 loans amounting to $2.52 billion were from OCR and 14 loans amounting to $307 million were from ADF. In addition, the Bank's Private Sector Division has provided one loan to PLDT for $24 million and two equity investments totaling about $3 million. Of these total commitments, $762.3 million was undisbursed at the end of 1988. Principal repayments as of 31 January 1989 amounted to $308.7 million, with debt outstanding totaling $2.52 billion.

Recent Bank Economic Reports: Country Strategy Study for the Philippines, July 1988
Economic Survey on the Philippines, November 1988, PHI-Ec-5s-4

External Contingency Financing

This annex sets out the technical parameters and procedures governing use of the contingency mechanism of the Compensatory and Contingency Financing Facility (CCFF) referred to in the Annex of the letter dated March 20, 1989.

1. Coverage

The contingency mechanism will cover unanticipated deviations resulting from external contingencies in export earnings from coconut oil, copper concentrate, copper metal, and nontraditional manufactured exports; in the cost of imported petroleum, petroleum products and other imports; and in net interest payments on variable rate external debt. The contingencies to be covered are variations in the export prices of coconut oil and copper and in the import prices of petroleum; variations in partner countries' import demand to the extent that they affect nontraditional manufactured exports; variations in partner countries' export prices to the extent that they affect certain imports as defined in Section 2.d; and changes in international interest rates. All projections and calculations of prices and values are calculated in terms of U.S. dollars.

2. Baseline projections and calculation of deviations

For the purpose of the calculations, the projected monthly values and volumes will be one third of the quarterly projections shown in the attached Table 1, and the projected quarterly prices, where applicable, apply to each month of the quarter.

a. Coconut oil, copper concentrate, and copper metal

The projected export prices and volumes for coconut oil, copper concentrate, and copper metal incorporated in the underlying program are set out in the attached Table 1. The price projections for copper concentrate are based on the price projections for copper metal but include fixed refining and smelting charges and assume a fixed copper metal content per unit of copper concentrate.

For exports of coconut oil, copper concentrate, and copper metal, the deviation in export earnings from the baseline projection will be calculated as the deviation in export prices from the baseline projection multiplied by the export volumes (net of volumes covered by forward contracts that had fixed export prices before the time the baseline scenario was established) 1/ specified in the attached Table 1. The deviation in export prices will be calculated as follows: for coconut oil, as the difference in U.S. dollars terms between the prices in the baseline projection and the actual quarterly export unit values as recorded by the National Statistical Office (NSO). For copper metal, as the difference in U.S. dollar terms between the prices in the baseline projections and the spot prices for copper as monitored by the Fund's Research Department. For copper concentrate, as the difference in U.S. dollar terms between the prices in the baseline projection and the adjusted spot prices for copper (as monitored by the Fund's Research Department); for the adjustment from copper metal to copper concentrate prices, the same formula that was used to derive copper concentrate prices from copper metal prices for establishing the baseline scenario would be applied.

If the actual volume of coconut exports in the semester in which a price deviation occurs deviates by more than 10 percent from the projected volume, the applicable actual price used for calculating the deviation will be raised (lowered) by one third of the percentage change by which the volume was higher (lower) than projected in the baseline scenario.

b. Nontraditional manufactured exports

The projected values of nontraditional manufactured exports, imported inputs and covered net exports are set out in Table 1. Deviations in export earnings from the baseline projection will be calculated as the deviation in partner countries' non-oil import volume from the baseline projection (in percentage points) multiplied by the projected value of covered net exports. The deviation in partner countries' non-oil import volume will be calculated as the difference between the projected changes and the actual changes in partner countries' non-oil import volume as calculated by the Fund's Research Department.

c. Petroleum imports

The projected import prices and volumes for crude petroleum and petroleum products are set out in Table 1. The deviation in import costs from the baseline projection will be calculated as the deviation in import prices from the baseline projection multiplied by the import volumes specified in the attached Table 1. The deviation in import prices will be calculated as the difference in U.S. dollar terms between the prices in the baseline projection and the average crude oil spot prices as monitored by the Fund's Research Department reduced by 0.14 percent (the same percentage that was used to derive the prices for

1/ At the time the baseline scenario was established, there were no forward contracts for exports after April 1, 1989.

the baseline projection from the projections provided by the Fund's Research Department).

d. Other imports

The projected values of other imports are shown in the attached Table. Other imports are defined as total imports minus (i) imported inputs (for the production of nontraditional manufactured exports), (ii) imports of crude petroleum and petroleum products, and (iii) imports for foreign-financed projects; imports for foreign-financed projects are estimated to be 80 percent of the value of project loans as projected in the balance of payments.

Deviations in import costs from the baseline projection will be calculated as the deviation in partner countries' non-oil export unit values from the baseline projection (in percentage points) multiplied by the projected value of other imports. The deviation in partner countries' non-oil export unit values will be calculated as the difference between the projected changes and the actual changes in partner countries' non-oil export unit values as calculated by the Fund's Research Department.

e. Net interest payments on external debt

For the purpose of the contingency mechanism, interest payments on the Philippines' net external debt will be defined as interest payments on total external debt at variable rates less earnings on the gross foreign assets of the banking system. In calculating the net sum of deviations, it is assumed that the projected net monthly interest payments are one third of the quarterly projections set out in Table 1, and that the projected quarterly interest rates apply to each month of the quarter.

For gross interest payments, the deviation will be calculated as the difference (in terms of percentage points) between the projected and actual average international reference interest rate, as it affects the Philippines' balance of payments, applied to the amount of variable interest rate debt outstanding at the beginning of each quarter as projected under the program. The average international reference interest rate shall be the weighted average of the six-month LIBORs for eurodollar, euro-yen, euro-french franc, euro-deutsche mark, euro-swiss franc, euro-pound sterling and ECU deposits (as published in the monthly edition of the Fund's International Financial Statistics) and charges to the Fund of 7.38 percent. The weights for calculating the average international reference interest rate are derived from the currency composition of the debt stock at end-1988.

For investment income of the banking system, the deviation will be calculated as the difference (in terms of percentage points) between the projected and actual average international interest rate, applied to the amount of gross foreign assets of the banking system outstanding at the beginning of each quarter. The average international interest rate shall be the weighted average of the six-month LIBORs for deposits of relevant currencies, with the weights derived from the currency composition of the banking systems' gross foreign assets.

Deviations in net interest payments will be calculated as the difference between deviations in gross interest payments and deviations in investment income of the banking system.

The change in interest rates that would be taken into account in calculating the net sum of deviations for the contingency mechanism would be limited to 2 percentage points during this baseline period.

3. Applicable sum of net deviations

The contingency mechanism will be triggered during the period of the extended arrangement when the cumulative net sum of deviations exceeds 15 percent of the Philippines quota in the Fund, i.e., SDR 66.06 million. 1/ For this purpose, the net sum of deviations will be calculated as the net sum of deviations in all variables covered. The applicable net sum of deviations for purposes of calculating the financing that would be made available from the Fund (or before applying symmetry procedures--see section 7 below) will be calculated by deducting 4 percent of quota (i.e., SDR 17.6 million) from the net sum of deviations. This deductible will be applied once during any baseline period, on the first occasion when the contingency mechanism is triggered

4. Proportion to be financed

In the semester in which the contingency mechanism is first triggered, total financing in an amount equivalent to 50 percent of the applicable net sum of deviations would be provided. In the subsequent semester, when financing is provided, the financing of the calculated net sum of deviations will be reduced by 20 percentage points to the extent that deviation is equal to or less than in the previous semester when financing was provided; it will remain 50 percent of the net sum of deviations to the extent that the net sum of deviations is greater than in the previous semester.

The maximum financing to be provided by the Fund under the contingency element during the period of the Extended Fund Facility is 65 percent of quota (SDR 286.3 million), of which a maximum of 25 percent of quota (SDR 110.1 million) could be provided during the initial baseline period (April 1, 1989-March 31, 1990).

1/ All references to the Philippines' quota in this Annex are to the present quota of SDR 440.4 million.

5. Calculation of Fund financing

The financing specified in section 4 above will be calculated by multiplying the applicable net sum of deviations by the proportion to be financed, as explained in section 4 above. As an example, consider the threshold of 15 percent of quota and 50 percent financing of the applicable net sum of deviations. A cumulative net deviation equivalent to 25 percent of the Philippines' Fund quota (SDR 110.1 million) would trigger the contingency element of the CCFF and provide financing of 10.5 percent of quota (SDR 46.25 million) in the first semester when financing is made available after applying the deductible of 4 percent of quota (SDR 17.6 million).

6. Activation of the Contingency Mechanism

Once it becomes evident that the minimum threshold will be exceeded, a Fund mission would visit Manila to establish understandings with the authorities on necessary policy adjustments and revised quarterly and semi-annual targets/ceilings for the underlying program. Purchases under the contingency mechanism would be available at the same time as the purchases under the associated arrangement after a review of the impact on the program of the external contingency has been completed by the Executive Board of the Fund; the quantitative performance criteria of the arrangement would need to be met after they have been adjusted to take account of the effect of the contingencies. Subsequent purchases under the contingency mechanism will be made available upon observance of the adjusted performance criteria, as approved by the Executive Board.

7. Symmetry provisions

The crossing of the 15 percent of quota threshold in a favorable direction would also trigger a special review by a Fund mission to discuss with the authorities adjustments to the underlying program with a view to conserving a substantial part of the favorable net deviation. In such an event, given the Philippines' low level of gross international reserves, it is expected that 50 percent of the net favorable deviation (after allowing the deductible amount of 4 percent of quota), would be added to official international reserves during the six-month period in which the benefit of the favorable net deviation affects the balance of payments. In subsequent semesters, the proportion used to build up the net international reserves further would be reduced in the same manner as the financing provided in the case of net unfavorable deviations (see section 4 above).

8. Lagged effect on the balance of payments

In calculating the effect of an external contingency on the balance of payments, it is recognized that there is a lag between the changes in the exogenous variables (partner countries' export prices and import demand, petroleum prices and interest rates) that would trigger the contingency mechanism and the impact of the contingency on the balance of payments. These lags are as follows:

(1) changes in partner countries' export prices and changes in the price of crude oil affect the balance of payments with a one-month lag;

(2) changes in partner countries' non-oil import volume and changes in copper prices affect the balance of payments with a two-month lag;

(3) changes in the reference interest rates affect (i) the investment income in the balance of payments three months after the change takes place and (ii) the gross interest cost five months after the change takes place.

If the Philippines enters into longer term contracts at fixed prices for sale of export products covered under the contingency mechanism, or if variable rate loans are converted to fixed rate, the projected baseline will be adjusted accordingly.

9. Adjustment of performance criteria

In the case of a favorable net sum of deviations, it is expected that the program target for the net international reserves of the Central Bank of the Philippines would be adjusted upward as outlined in section 7 above. In the case of an unfavorable net sum of deviations, the floor on net international reserves of the monetary authority, the ceiling on the borrowing requirement of the monitored public sector, and the limit on external nonconcessional borrowing will be adjusted by appropriate amounts in light of the magnitude of the contingency and the contingency financing available from commercial banks.

10. Ex-post review

In the event that the contingency mechanism is activated and Fund financing is provided, an ex post review will be conducted to determine whether, on the basis of actual prices, partner countries' import volume and actual variable interest rates, the amount of contingent financing provided by the Fund on the basis of estimated data was appropriate. In the event that purchases under the contingency element were larger than would have been calculated on the basis of actual developments the Philippines will be expected, unless the Fund decides otherwise, to make a prompt repurchase of the excess.

11. Parallel contingency financing

As the negotiations between the Philippine authorities and foreign commercial banks have so far only been exploratory, parallel contingency financing from banks has not yet been discussed explicitly.

Table 1. Philippines: Contingency Mechanism, Baseline Scenario, 1989-90

	1988 Q4 Actuals	1989 Q1	1989 Q2	1989 Q3	1989 Q4	1990 Q1
1. Coconut oil exports						
Volume (in '000 m.t.) 1/	181	176	197	202	220	238
Under forward contracts 2/	181	141	3			
Spot transactions	--	35	194			
Price (c.i.f., in US$/m.t.)*	536	523	500	495	489	483
Under forward contracts	536	526	500			
Spot transactions	521	500	500			
Price change (per quarter, in percent)	-2.7	-2.4	-4.4	-1.0	-1.2	-1.2
Under forward contracts	...	-1.9	-4.9			
Spot transactions 1/	-4.6	-4.0	--			
2. Copper concentrate exports						
Volume (in '000 m.t.)	116	134	115	120	126	135
Price (in US$/m.t.)*	765	739	645	598	570	479
Price change (per quarter, in percent)	22.2	-3.4	-12.7	-7.3	-4.7	-16.0
3. Copper metal exports						
Volume (in '000 m.t.)	28	31	34	34	29	31
Price (in US$/m.t.)*	3,245	3,151	2,807	2,639	2,536	2,206
Price change (per quarter, in percent)	42.2	-2.9	-10.9	-6.0	-3.9	-13.0
4. Nontraditional manufactured exports						
Total value (US$ mns.)	1,335	1,239	1,340	1,409	1,356	1,413
Minus imported inputs						
Garments	206	188	193	215	224	210
Electronics	262	223	249	269	238	253
Machinery and transport equipment	9	7	6	8	8	7
Covered net exports	858	821	892	917	886	943
Partner countries' non-oil import volume (change from preceding quarter in percent)*	1.9	1.8	1.7	1.5	1.8	1.6
5. Petroleum imports						
a. Crude petroleum						
Volume (in mns. barrels)	21.40	20.68	16.60	16.15	16.62	20.01
Under forward contracts 2/	9.07	4.93				
Spot transactions	12.33	15.75				
Price (in US$ per barrel)*	11.41	15.67	15.23	14.73	15.23	15.78
Under forward contracts	11.80	15.33				
Spot transactions	11.12	1.573				
Price change (per quarter, in percent)	-19.9	37.4	-2.8	-3.3	3.4	3.6
Under forward contracts		29.9				
Spot transactions		41.5	-3.2			
b. Other petroleum products						
Volume (in mns. of barrels)	1.80	1.86	2.85	2.52	2.50	1.90
Of which: already contracted 2/	--	--	--	--	--	--
Price (in US$ per barrel)*	14.44	16.74	16.20	15.67	16.20	16.78
Price change (per quarter, in percent)	9.2	15.9	-3.2	-3.3	3.4	3.6

Table 1. Philippines: Contingency Mechanism, Baseline Scenario, 1989-90 (concluded)

	1988 Q4 Actuals	1989 Q1	1989 Q2	1989 Q3	1989 Q4	1990 Q1
6. Other imports (US$ mns.)						
All imports	2,078	2,265	2,397	2,519	2,378	2,557
Petroleum and petroleum products	270	355	299	277	294	348
Imported inputs for manufactured exports	477	418	448	492	470	470
Commodity aid 3/	17	9	9	19	9	2
Project loans 4/	51	60	74	208	235	70
Covered imports	1,263	1,423	1,568	1,523	1,370	1,667
Partner countries' non-oil export unit values (change from preceding quarter in percent)*	1.6	1.9	1.2	0.9	1.0	0.8
7. Net interest cost on floating rate debt						
a. Gross interest cost (excl. spread)	...	1,321	1,302	1,221	1,262	1,317
Debt stock at beginning of period	...	15,094	14,884	14,621	15,117	15,767
Average interest rate 5/*	...	8.75	8.75	8.35	8.35	8.35
b. Investment income of banking system	...	355	318	299	355	436
Claims at beginning of period	...	4,025	3,600	3,559	4,237	5.198
Average interest rate 6/*	...	8.82	8.82	8.39	8.39	8.39
Memorandum items:						
Six-month LIBOR						
$US	9.04	9.5	9.5	9	9	9
Yen	4.61	4.5	4.5	4.5	4.5	4.5
French franc	8.39	8.75	8.75	8.5	8.5	8.5
Deutsche mark	5.20	5.5	5.5	5.5	5.5	5.5
Swiss franc	4.38	5	5	5	5	5
Pound sterling	12.5	13	13	12.5	12.5	12.5
ECU	7.7	7.5	7.5	7	7	7
Fund charges (in percent)	7.38	7.38	7.38	7.38	7.38	7.38

Source: *Date provided by the Central Bank of the Philippines; and IMF Research Department.*

*Deviations would be calculated in case these operational variables turn out to be different from their projected values.

1/ If volume differs significantly from projections, price changes would be adjusted before any deviation is calculated.
2/ Only if contracted at a fixed price before March 1, 1989.
3/ Commodity grants from bilateral sources.
4/ Eighty percent of project loans (as projected in the balance of payments).
5/ Weighted average of interest rates shown below (i.e., excluding any spreads) and Fund charges; weights are determined by the currency distribution of external debt at end-1988 and liabilities to the Fund.
6/ Weighted average of interest rates shown below; weights are determined by the currency distribution of relevant claims at end-1988.

EXTENDED ARRANGEMENT

A letter, with annexed memorandum, dated March 20, 1989 from the Governor of the Central Bank of the Philippines and the Secretary of Finance (EBS/89/..) requests

(a) an extended arrangement and sets forth:

(i) the objectives and policies that the authorities of the Philippines intend to pursue for the period of this extended arrangement;

(ii) the policies and measures that the authorities of the Philippines intend to pursue for the first year of this extended arrangement; and

(iii) understandings of the Philippines with the Fund regarding reviews that will be made of progress in realizing the objectives of the program and of the policies and measures that the authorities of the Philippines will pursue for the second and third years of this extended arrangement; and

(b) a decision that, should adverse external contingencies occur during the period of this extended arrangement, the Fund will provide in association with this extended arrangement, external contingency financing up to a maximum amount equivalent to SDR 286.3 million under the Compensatory and Contingency Financing Facility (Decision No. 8955-(88/126), adopted August 23, 1988) and in accordance with the factors set out in the Annex to the above-mentioned decision, with the understanding that, under that facility, should favorable external contingencies occur during the period of the requested arrangement, adjustments of up to SDR 286.3 million will be made by the Fund (under paragraph 27 of that decision) at that time in accordance with the factors set out in the Annex to the above-mentioned decision.

To support these objectives and policies, the International Monetary Fund grants this extended arrangement, subject to any decision adopted pursuant to paragraph 27 of Decision No. 8955-(88/126), in accordance with the following provisions:

1. For a period of three years from ___, 1989, the Philippines will have the right to make purchases from the Fund in an amount equivalent to SDR 660.6 million, subject to paragraphs 2, 3, 4, 5, and 6 below, without further review by the Fund.

2. Purchases under this arrangement shall not exceed, without the consent of the Fund, the equivalent of SDR 94.37 million until December 15, 1990, the equivalent of SDR 188.74 million until June 15,

1990, the equivalent of SDR 283.11 million until December 15, 1990, the equivalent of SDR 377.48 million until June 15, 1991, the equivalent of SDR 471.85 million until December 15, 1991, and the equivalent of SDR 566.22 million until April 30, 1992.

3. Purchases under this extended arrangement shall be made from ordinary resources until the outstanding use of ordinary resources in the upper credit tranches and under the Extended Facility equals 140 percent of the Philippines' quota in the Fund of SDR 440.4 million. Thereafter, purchases shall be made from borrowed resources, provided that any modification by the Fund of the proportions of ordinary and borrowed resources shall apply to amounts that may be purchased after the date of modification.

4. The Philippines will not make purchases under this extended arrangement

(a) during any period in which the data at the end of the preceding period indicate that

(i) the ceiling on the borrowing requirement of the monitored public sector referred to in paragraph 40 and Table 2 of the Memorandum annexed to the authorities' letter;

(ii) the ceiling on base money referred to in paragraph 41 and Table 2 of the same Memorandum;

(iii) the floor on net international reserves of the monetary authority referred to in paragraph 45 and Table 2 of the same Memorandum;

(iv) the limits on the approval of nonconcessional external loans with 1-12 year maturities, including the sublimit on the approval of nonconcessional loans with 1-5 year maturities, referred to in paragraph 44 and Table 2 or the same Memorandum; or

(v) the limit on outstanding short-term external debt referred to in paragraph 44 and Table 2 of the same Memorandum.,

is not observed; or

(b) after September 30, 1989 until the intentions referred to in paragraphs 29(a) and 45(1) and (2), and the intention referred to in paragraph 45(3) of the same Memorandum have been carried out; or

(c) after December 14, 1989, June 14, 1990, December 14, 1990, June 14, 1991 and December 14, 1991 respectively, until the reviews contemplated in paragraph 47 of the same Memorandum have been completed and suitable performance criteria have been established or, after such performance criteria have been established, while they are not being observed; or

(d) if the Philippines
  (i) imposes or intensifies restrictions on payments and transfers for current international transactions, or

  (ii) introduces or modifies multiple currency practices, or

  (iii) concludes bilateral payments agreements that are inconsistent with Article VIII, or

  (iv) imposes or intensifies restrictions on imports for balance of payments reasons.

When the Philippines is prevented from purchasing under this extended arrangement because of this Paragraph 4, purchases will be resumed only after consultation has taken place between the Fund and the Philippines and understandings have been reached regarding the circumstances in which such purchases can be resumed.

5. The Philippines will not make purchases under this extended arrangement during any period in which the member has an overdue financial obligation to the Fund or is failing to meet a repurchase expectation pursuant to the Guidelines on Corrective Action with respect to a noncomplying purchase.

6. The Philippines' right to engage in the transactions covered by this extended arrangement can be suspended only with respect to requests received by the Fund after (a) a formal ineligibility, or (b) a decision of the Executive Board to suspend transactions, either generally or in order to consider a proposal, made by an Executive Director or the Managing Director, formally to suppress or to limit the eligibility of the Philippines. When notice of a decision of formal ineligibility or of a decision to consider a proposal is given pursuant to this Paragraph 6, purchases under this arrangement will be resumed only after consultation has taken place between the Fund and the Philippines and understandings have been reached regarding the circumstances in which purchases can be resumed.

7. Purchases under this extended arrangement shall be made in the currencies of other members selected in accordance with the policies and procedures of the Fund, and may be made in SDRs if, on the request of the Philippines, the Fund agrees to provide them at the time of the purchase.

8. The value date for purchases under this extended arrangement involving borrowed resources will be determined in accordance with Rule G-4(b) of the Fund's Rules and Regulations. The Philippines will

consult the Fund on the timing of purchases involving borrowed resources in accordance with Rule G-4(d).

9. The Philippines shall pay a charge for this extended arrangement in accordance with the decision of the Fund.

10. (a) The Philippines shall repurchase the outstanding amount of its currency that results from a purchase under this extended arrangement in accordance with the provisions of the Articles of Agreement and decisions of the Fund, including those relating to repurchases as the Philippines' balance of payments and reserve position improves.

(b) Any reductions in the Philippines currency held by the Fund shall reduce the amounts subject to repurchase under (a) above in accordance with the principles applied by the Fund for this purpose at the time of the reduction.

(c) The value date of a repurchase in respect of a purchase financed with borrowed resources under this extended arrangement will be normally either the 6th day or the 22nd day of the month, or the next business day if the selected day is not a business day, provided that the repurchase will be completed not later than seven years from the date of purchase.

11. During the period of the extended arrangement the Philippines shall remain in close consultation with the Fund. These consultations may include correspondence and visits of officials of the Fund to the Philippines or of representatives of the Philippines to the Fund. The Philippines shall provide the Fund, through reports at intervals or dates requested by the Fund, with such information as the Fund requests in connection with the progress of the Philippines in achieving the objectives and policies set forth in the attached letter and its annexed memorandum.

12. In accordance with the last paragraph of the attached letter, the Philippines will consult the Fund on the adoption of any measures that may be appropriate at the initiative of the Government or whenever the Managing Director requests consultations because any of the performance criteria in Paragraph 4 above have not been observed or because he considers that consultation on the program is desirable. In addition, after the period of the arrangement and while the Philippines has outstanding purchases in the upper credit tranches, the Government will consult with the Fund from time to time, at the initiative of the Government or at the request of the Managing Director, concerning the Philippines' balance of payments policies.