FOR AGENDA

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May 25, 1988

To: Members of the Executive Board

From: The Secretary

Subject: Philippines - Staff Report for the 1988 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1988 Article IV consultation with the Philippines, which has been tentatively scheduled for discussion on Monday, June 20, 1988.

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

Att: (1)

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INTERNATIONAL MONETARY FUND

PHILIPPINES

Staff Report for the 1988 Article IV Consultation

Prepared by the Asian Department

(In consultation with the Exchange and Trade Relations, Fiscal Affairs, Legal, and Treasurer's Departments)

Approved by P. R. Narvekar and H. B. Junz

May 24, 1988

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I. Introduction 1/

The 1988 Article IV Consultation discussions with the Philippines were held in Manila during the period March 14-27, 1988. 2/ The Philippine representatives included Finance Secretary Jayme, Central Bank Governor Fernandez, Secretaries Monsod (Economic Planning), Caragua (Budget), and Concepcion (Trade and Industry), as well as other senior officials responsible for economic and financial matters.

The Executive Board approved an 18-month stand-by arrangement on October 24, 1986 (EBS/86/222, 9/22/86 and Supplement 1, 10/17/86) in an amount equivalent to SDR 198 million (45 percent of quota, equivalent to 30 percent on an annual basis). The first and second reviews were completed on April 20, 1987 (EBS/87/65, 3/23/87) and November 6, 1987 (EBS/87/204, 9/30/87 and Supplement 1, 10/7/87), respectively. The Philippines has made five purchases totaling SDR 128 million under the arrangement. On March 9, 1988, the Board approved an extension of the arrangement until August 23, 1988 as well as a rephasing of the two remaining purchases, of SDR 35 million each, which were linked, respectively, to observance of new performance criteria for March 1988 and June 1988 (EBS/88/29, 2/12/88). As of March 31, 1988, the Philippines' outstanding use of Fund credit stood at 178.9 percent of quota. With the two remaining purchases, total Fund credit would rise to 184.7 percent of quota at the end of the arrangement (Table 1).

The last Article IV consultation was concluded on October 24, 1986 (EBS/86/222, 9/22/86 and Supplement 1, 10/17/86). 3/ In that meeting, and in the subsequent discussions at the Executive Board on the occasion of the first and second program reviews, Directors stressed the need for firm implementation of structural and financial policies to increase economic efficiency, strengthen domestic resource mobilization, and improve incentives to private sector activity. They welcomed the wide-ranging structural reforms designed to reduce sharply the extent of government intervention in the economy and to re-establish competitive markets. Directors noted that a reduction in public sector deficits would be required over the medium term. They also viewed strong export

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1/ It should be noted that the term "country" used in this paper does not in all cases refer to a territorial entity that is a state as understood by international law and practice. The term also covers some territorial entities that are not states but for which statistical data are maintained and provided internationally on a separate and independent basis.

2/ The staff team comprised Messrs. Baumgartner (head) and Goldsbrough, Mrs. Gurgen (all ASD), Mr. Lorie (FAD), Mr. Ariyoshi (ETR) and Mrs. Mungul (secretary, STA). Mr. Cha, Resident Representative, worked closely with the mission. Mr. Rye, Executive Director for the Philippines, attended some of the discussions as an observer.

3/ The Executive Board was notified of the delay in concluding the present Article IV consultation in EBD/88/29 (1/22/88).

Table 1. Philippines: Fund Position During Remaining Period of Stand-By Arrangement, 1987-88

	Outstanding at Dec. 31,1987	1988 Jan.-March	1988 April-June	1988 July-Sept. 1/
		(In millions of SDRs)		
Transactions under tranche policies (net)	...	-53.9	7.6	18.1
Purchases	...	--	(35.0)	(35.0)
Ordinary resources	(...)	(--)	(11.7)	(11.7)
Borrowed resources	(...)	(--)	(23.3)	(23.3)
Repurchases	...	-53.9	-27.4	-16.9
Ordinary resources	(...)	(-41.4)	(-14.9)	(-5.3)
Borrowed resources	(...)	(-12.5)	(-12.5)	(-11.6)
Transactions under special facilities (net) 2/	...	-23.6	--	--
Purchases	...	--	--	--
Repurchases	...	-23.6	--	--
Total Fund credit outstanding (end of period)	841.6	787.7	795.3	813.4
Under tranche policies	593.9	563.6	571.2	589.3
Special facilities 2/	247.7	224.1	224.1	224.1
		(As percent of quota)		
Total Fund credit outstanding (end of period)	191.1	178.9	180.6	184.7
Under tranche policies	134.9	128.0	129.7	133.8
Special facilities 2/	56.2	50.9	50.9	50.9

Source: Staff estimates.

1/ Although the stand-by arrangement runs to August 23, 1988, data are presented through September 1988.

2/ Compensatory financing facility.

growth as essential and emphasized the importance of maintaining a competitive exchange rate and continuing with trade policy reform.

The Philippines does not maintain exchange restrictions under the transitional arrangements of Article XIV. It maintains an exchange system free of restrictions on payments and transfers for current international transactions, other than the limitation on the remittance of certain dividends in connection with the debt to equity conversion scheme, which constitutes an exchange restriction subject to the approval of the Fund under Article VIII.

II. Background and Developments Under the 1986-88 Stand-By Arrangement

1. Background

A rapid increase in external indebtedness, reflecting foreign financing of large inefficient investments, and a distorted incentive system that discouraged exports and favored inefficient industries pushed the Philippine economy into a serious economic and financial crisis in the early 1980s. The crisis became acute in October 1983, necessitating a standstill on maturing principal payments on most external debt. A severe foreign exchange scarcity ensued, leading to a dramatic compression of imports and a sharp decline in economic activity (Table 2 and Chart 1). The difficulties were aggravated by a lack of investor confidence caused by political uncertainties, long-standing structural weaknesses, and a rapid acceleration of inflation in 1984 owing to a loss of control over monetary aggregates.

Real GNP fell by a total of 11 percent during 1984-85 before beginning to recover in the second half of 1986. The large current account deficit declined in 1984-85 and a sizable surplus (3.3 percent of GNP) was registered in 1986, mainly as a result of import compression. The brunt of the decline in absorption was borne by investment, which fell from 27 percent of GNP in 1983 to 13 percent in 1986. Real private consumption virtually stagnated during 1984-86, implying a cumulative decline of some 6 percent in per capita terms.

Efforts at stabilization during the period from late 1984 to early 1986--supported by a stand-by arrangement with the Fund, fresh money from commercial banks, and a rescheduling of liabilities to Paris Club creditors and banks--succeeded in sharply reducing inflation, eliminating external payments arrears, and terminating exchange controls after the peso was floated in late 1984.

Table 2. Philippines: Economic Indicators, 1980-88

	1980	1981	1982	1983	1984	1985	1986	1987 (Est.)	1988 (Proj.)
Growth, investment, and saving 1/									
Real GNP growth (percent change)	5.0	3.4	1.9	1.1	-6.8	-4.2	2.0	5.7	6
Gross domestic investment (percent of GNP)	30.7	30.7	28.8	27.2	17.4	14.3	13.2	14.6	17.3
Gross national saving (percent of GNP)	25.3	25.3	20.7	19.0	13.4	14.3	16.5	13.0	15.9
Private savings—investment balance (percentage of GNP)	...	-0.4	2.8	4.9	1.0	-2.5	-7.6	-0.2	-2.4
Inflation									
CPI (average percent change)	17.6	12.4	10.2	10.0	50.3	23.1	0.8	3.8	7-8
Public sector (in percent of GNP)									
National Government									
Revenue	13.1	11.8	11.4	12.0	10.8	11.5	12.8	14.6	15.3
Expenditure and net lending	14.4	15.8	15.7	14.0	12.7	13.4	17.8	17.4	18.7
Deficit	-1.3	-4.0	-4.3	-2.0	-1.9	-1.9	-5.1	-2.8	-3.4
Consolidated public sector deficit 2/	...	-5.5	-7.0	-9.0	-8.3	-5.9	-5.4	-3.2	-5.7
External									
Export volume (percent change)	...	-3.7	-9.7	3.1	7.8	-27.7	16.6	6.5	8.4
Import volume (percent change)	...	-58.4	6.5	-4.1	-23.4	-16.2	19.7	31.0	8.6
Current account balance (percent of GNP)	-5.4	-5.4	-8.1	-8.1	-4.0	-0.1	3.3	-1.6	-1.4
External debt									
Billions of U.S. dollars	17.1	20.9	24.2	24.8	25.4	26.3	28.3	28.1	28.2
Percent of GNP	48.5	54.4	61.6	72.7	80.6	81.7	92.9	81.7	75.7
Debt service ratio 3/	20.9	25.2	38.1	38.9	44.6	32.7	34.0	35.3	31.1
Gross official reserves (billions of U.S. dollars; end of period)	3.1	2.6	1.7	0.9	0.9	1.1	2.5	2.0	1.9
Real effective exchange rate (end of period) 4/	0.5	1.1	0.4	-18.7	8.6	-0.9	-17.8	-9.1	...
Wages and consumption (percent change)									
Real Wages									
Agriculture 5/	...	...	...	-2.9	-10.5	0.7	-0.8	-1.6	13.6
Private industry 5/	...	...	...	-2.3	-5.8	-4.3	-0.8	-1.6	10.2
National Government 6/	...	...	...	17.0	-20.0	9.2	6.7	9.4	28.2
Real private consumption	4.4	3.9	3.4	2.8	1.1	-0.1	0.9	5.5	4.1

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

1/ Data on savings and investment are subject to significant inaccuracies.

2/ Includes the National Government, financial and nonfinancial public enterprises, and the Central Bank. Data before 1983 are incomplete.

3/ In percent of current earnings; after debt rescheduling for the period 1985-88. Assumes Paris Club reschedulings for the second half of 1988 on terms comparable to those obtained in 1987 and the first half of 1988.

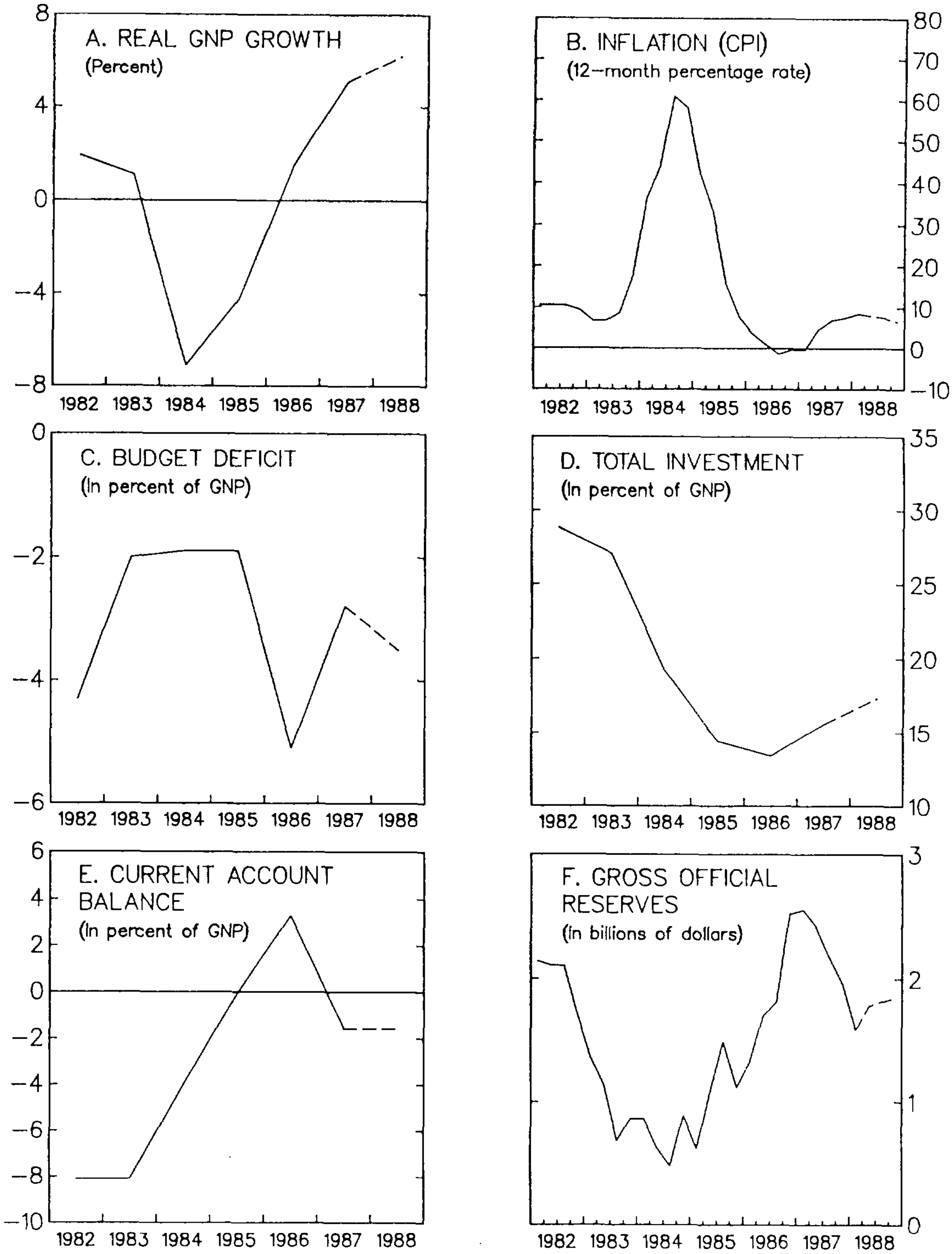
4/ Trade weighted REER vis-a-vis major trading partners; annual percentage change, with an increase indicating an appreciation.

5/ Total average compensation at minimum wage level.

6/ Average national government compensation per employee.

CHART 1
PHILIPPINES
TRENDS IN KEY MACROECONOMIC VARIABLES, 1982-88

——— *Actual* - - - *Program*



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

2. The 1986-88 stand-by arrangement

a. Objectives and policies

Following the change in government in early 1986, a new program was formulated that aimed at achieving a recovery of growth and a fundamental reform of the economic system. The principal macroeconomic objectives are summarized in Table 3. The program provided for an initial fiscal stimulus through expanded investment and operations and maintenance expenditures in 1986, to be followed by a lasting reduction in the public sector deficit. At the core of the economic strategy, however, were comprehensive structural reforms designed to increase efficiency and stimulate private sector activity. These included a tax reform; a reform of the government financial institutions (GFIs); and steps to privatize many nonfinancial public enterprises and to reduce government intervention in and support for the operations of those enterprises remaining in the public sector. Furthermore, public expenditure was to be reoriented toward rural and labor-intensive projects with lower capital and import intensity than earlier investment programs. Trade policy reform was also an important part of the renewed emphasis on a competitive and outward-looking strategy. Major reforms in the agricultural sector were aimed at dismantling monopolies, enhancing the role of the private sector, and improving incentives, particularly in the foodgrain, sugar, and coconut sectors. These structural measures included many elements that had been identified during the 1984-86 stand-by arrangement but had remained unimplemented.

b. Developments under the program

Output and price developments were closely in line with the program, while the balance of payments in 1987 turned out weaker than expected, in part because of speculation following a coup attempt in August 1987. Structural reforms were implemented broadly as envisaged.

(1) Recovery

The economic situation turned around in the second half of 1986, and real GNP growth in 1986 as a whole was 2.0 percent despite the absence of fiscal stimulus (Chart 2). The recovery gained strength in 1987 and real GNP grew by 5.7 percent despite a severe drought. The main impetus to growth was provided by a strong increase in private consumption (5.7 percent) that resulted from several factors: the release of pent-up demand; wage increases, especially in the public sector; increased employment in industry; and a sharp improvement in farmgate prices in the coconut sector. Gross fixed investment (at constant prices), which had continued to fall in 1986, grew by some 16 percent in 1987, reflecting a recovery in private construction and a strong rebound of equipment investment in response to greater political stability and lower real interest rates.

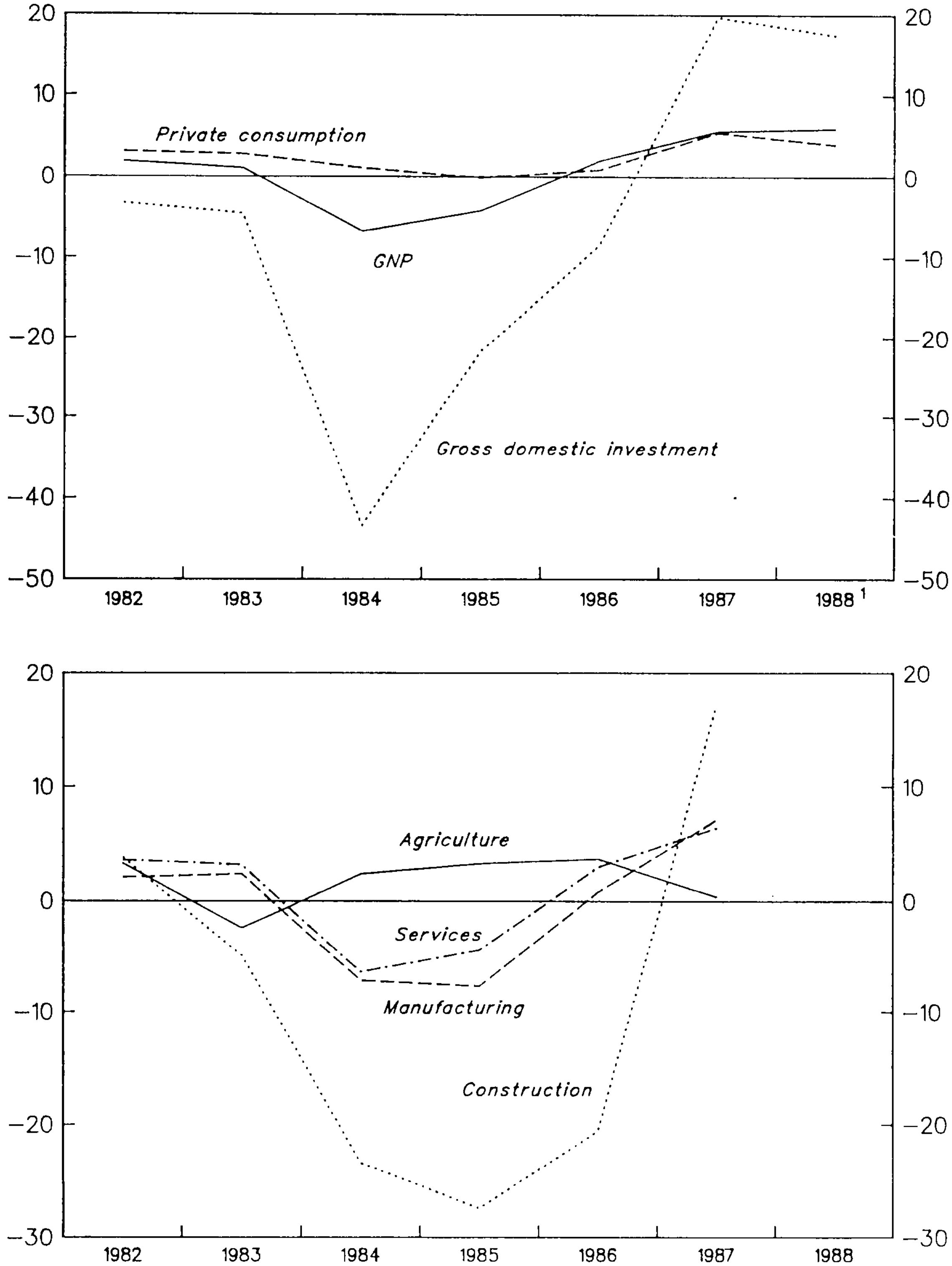
Table 3. Philippines: Principal Objectives of and Performance
Under the Adjustment Program, 1986-88

	1986		1987			1988			
	Program	Actual	Orig. progr.	Second review	Est. actual	Indicative Prog. Orig.	Indicative Prog. Second review	Program	Rev. proj.
GNP and prices (percentage change)									
Real GNP	1.5	2.0	6-7	5.6	5.7	5-6	6.5	6-6.5	6.0
CPI (average)	4	0.8	5-6	4.5	3.8	5	5.5	7.0	7-8
External objectives									
Current account									
Billions of U.S. dollars	0.3	1.0	-0.4	— 1/	-0.5	-0.6	-0.5	-0.5	-0.5
Percent of GNP	0.9	3.3	-1.2	0.1	-1.6	-1.8	-1.5	-1.5	-1.4
Exports (percent change in $ value)	-0.6	4.6	8.1	10.9	18.1	8.0	9.9	11.4	15.2
Imports (percent change in $ value)	0.8	-1.3	12.2	21.2	33.6	10.0	13.5	15.7	13.9
Overall balance (billions of U.S. dollars) 2/	1.2	1.2	0.8	0.8	0.3	...	1.2	0.5	0.3
Gross official reserves									
Billions of U.S. dollars	2.4	2.5	2.7	2.5	2.0	2.8	2.6	1.8	1.9
Months of imports 3/	3.5	3.7	3.5	3.2	2.3	3.3	3.0	1.9	1.9
Debt service ratio (percent, after rescheduling)	35.9	34.0	35.4	33.7	35.3	...	33.2	30.0	31.1
External debt									
Billions of U.S. dollars	26.8	28.3	27.2	28.6	28.1	27.7	28.6	28.8	28.2
Percent of GNP	86.0	92.9	81.0	87.3	81.7	76.0	79.0	79.0	75.7
Public sector (percent of GNP)									
National Government deficit	4.4	5.1	2.4	3.8	2.8	2.0	3.6	3.5	3.4
Monitored public sector borrowing requirement	5.5	4.3	2.9	4.4	1.8	2.6	4.4	4.1	3.8
Consolidated public sector deficit	7.5	5.4	5.2	5.4	3.2	5.1	5.7	5.6	5.7
Public investment expenditure	5.0	3.0	5.0	4.5	3.1	5.0	5.1	4.6	4.0
Money (percent increase)									
Broad money	13	12	15	10	12	15	15	17	14
Base money 4/	15	24	16	11	15	16	15	15	12
Central Bank net domestic assets	9	16	-6	-4	5	...	2	-1	—
Interest rate (percent per annum) 5/	11.0	8.1	...	9-9.5	12.3	...	...	12-13	13

Sources: 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/ Growth rates calculated using the averages of the 10-day test periods.
5/ Ninety-day money market rate; average for last month of year.

CHART 2
PHILIPPINES
DEVELOPMENTS IN REAL GNP AND EXPENDITURE, 1982-88
(Annual real percentage changes)



Sources: Data provided by the Philippine authorities; and staff estimates.
[1] Staff projections.

Output growth in 1987 was strongest in the construction sector (17 percent), but the manufacturing and services sectors also registered substantial growth (6-7 percent). In many industries, capacity utilization, which had fallen precipitously during the recession, improved markedly, but there remained substantial idle capacity, much of which was unusable because of misdirected investment in the 1970s and early 1980s. Inflation, which was very low in 1986, accelerated in 1987, reaching 7 percent at the end of the year, with the drought having been an important factor. Unemployment and underemployment declined markedly in 1987.

(2) Fiscal developments

The consolidated public sector deficit declined from 5.4 percent of GNP in 1986 to 3.2 percent of GNP in 1987 and similar reductions were registered in the (monitored) public sector borrowing requirement (PSBR) and the National Government deficit. 1/ The lower deficits were caused mainly by the impact on revenues of the surge in imports and the introduction of the tax reform. The tax revenue/GNP ratio rose by almost two percentage points, more than outweighing the effect of large increases in personnel expenditure and substantial (though less-than-programmed) growth in maintenance and operating expenditure. Total capital expenditure by the public sector, at slightly over 3 percent of GNP in 1987, was well below the program target of 5 percent because of: (i) implementation delays that were caused partly by efforts to strengthen controls over contracting and operating activities; (ii) management changes in some of the largest public enterprises; and (iii) mandatory 45-day bans on the signing of new contracts prior to the elections in mid-1987 and early 1988. The overall deficit of the 14 major nonfinancial public corporations fell from 1.1 percent of GNP in 1986 to 0.2 percent in 1987, as their internal cash generation improved markedly. However, this reflected mainly temporary factors, such as the collection of arrears and asset sales.

(3) Monetary developments

After a substantial expansion in the Central Bank's net domestic assets (NDA) and in base money during late 1986, monetary policy was tightened in 1987. By December 1987, base money growth declined to 12 percent from 21 percent a year earlier. During the year, the primary instrument for controlling monetary aggregates shifted from sales of the Central Bank's own securities to sales of treasury

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1/ The consolidated public sector comprises the monitored public sector (consisting of the National Government and the 14 major nonfinancial public corporations) as well as the major GFIs, the Central Bank, other (nonmonitored) nonfinancial public corporations, local governments, and the social security system. Financing transactions between the public nonfinancial sector and the public financial sector are not consolidated.

securities in excess of the Government's own financing needs, with the proceeds being deposited at the Central Bank. However, shortfalls in the scheduled sales of treasury securities in late 1987--caused by concern over rising interest costs to the budget--resulted in a temporary acceleration in the growth of Central Bank NDA and base money.

Broad money (M3) rose by 12 percent in 1987, the same rate as in 1986 despite the strengthening economic recovery. The growth in deposits slowed as holdings of alternative financial assets, notably treasury bills, increased substantially (Chart 3). In contrast, currency demand remained high especially in the period leading up to the local government elections in January 1988. After falling markedly during 1984-86, private sector credit recovered strongly in 1987, rising by over 16 percent.

Interest rates fell in the first quarter of 1987, but then rose in response to the tightening of monetary policy and an increase in inflation. By end-year, rates on 90-day money market deposits were over 12 percent, some 4 percentage points higher than at end-1986, while prime lending rates were around 16-17 percent.

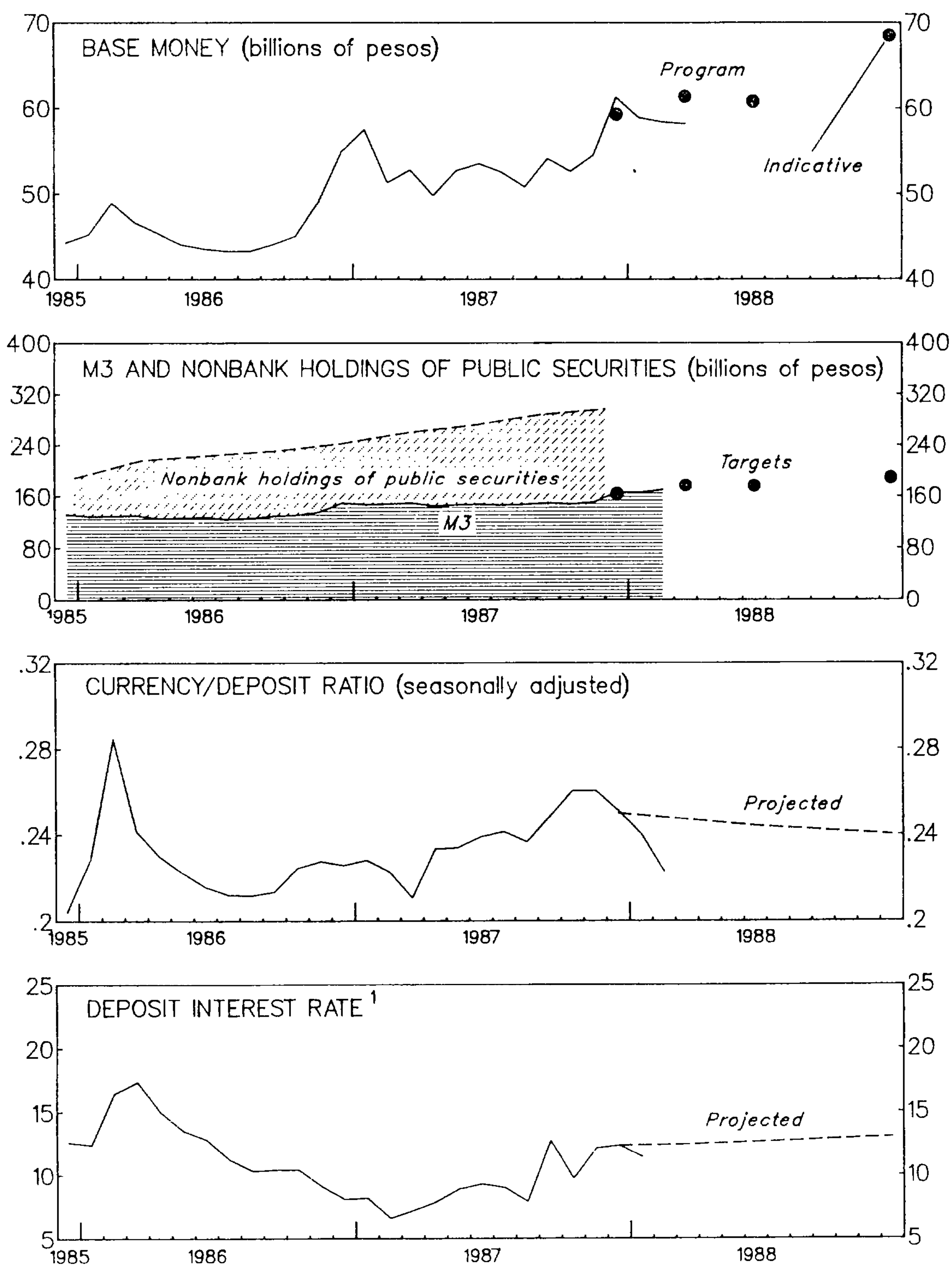
(4) External developments

The resumption of strong growth in 1987 resulted in the re-emergence of a current account deficit, equivalent to 1.6 percent of GNP (Table 4). Export growth was rapid (18 percent in dollar value and an estimated 7 percent in terms of volume), and mainly reflected a strong performance of exports of manufactures. The response of import volume to the recovery--an increase by over 30 percent--was substantially stronger than anticipated. Total inflows of medium- and long-term loans were broadly as envisaged, mainly because of a large unanticipated aid inflow toward the end of the year, which offset shortfalls in project-related loans. New rescheduling arrangements with both Paris Club creditors and commercial banks 1/ became effective and total debt relief amounted to some $1.5 billion in 1987. Total external debt was estimated at $28.1 billion in 1987, equivalent to 82 percent of GNP. The debt service ratio (after rescheduling) stood at 35 percent of exports of goods and services in 1987, slightly higher than in 1986.

A weakening of confidence in the wake of the August 1987 coup attempt contributed to the worsening of the external position in 1987. This was reflected mainly in a decline in tourist receipts, increases in other service outflows, and efforts by the domestic commercial banks to strengthen their foreign exchange positions. While the available balance of payments data do not suggest large short-term capital outflows, speculative activity was strong in the second half of the year. This is indicated by the re-emergence in late-1987 of a

1/ These arrangements are reported in detail in a supplement to the forthcoming paper on recent economic developments.

CHART 3
PHILIPPINES
MONETARY DEVELOPMENTS, DECEMBER 1985–DECEMBER 1988



Sources: Data provided by the Philippine authorities; and staff estimates, and EBS/88/29.
[1] Rate on 90-day money market deposits.

Table 4. Philippines: Balance of Payments, 1985-88 1/

(In billions of U.S. dollars)

	1985	1986	1987 Program 1/	1987 Actual	1988 Jan. 1988 Program	1988 Revised
Trade balance	-482	-202	-741	-1,017	-1,016	-1,085
Exports, f.o.b.	4,629	4,842	5,372	5,720	6,385	6,590
Imports, f.o.b.	-5,111	-5,044	-6,113	-6,737	-7,401	-7,675
Oil	-1,277	-728	-938	-1,062	-1,090	-1,110
Non-oil	-3,834	-4,316	-5,175	-5,675	-6,311	-6,565
Services	85	757	245	-76	-24	-102
Receipts	3,288	3,791	3,529	3,497	3,702	3,712
Of which:						
Economic Support Fund (ESF)	(62)	(300)	(180)	(152)	(120)	(174)
Payments	-3,203	-3,034	-3,284	-3,573	-3,726	-3,814
Of which: interest	(-2,208)	(-2,046)	(-2,131)	(-2,226)	(-2,311)	(-2,299)
Transfers	379	441	528	554	511	648 2/
Current account	-18	996	32	-539	-529	-539
(As percent of GNP)	(-0.1)	(3.3)	(0.1)	(-1.6)	(-1.5)	(-1.4)
Capital account (net)	1,009	246	781	803	764	871
Direct investment (net)	17	140	131	205	207	167
Medium- and long-term loans (net)	890	815	351	242	-190	171
Inflows	2,344	2,545	2,366	2,437	1,857	2,319
Pipeline	317	664	506	415	377	350
New commitments	314	246 3/	404 3/	566 3/	416 3/	567 3/
Concerted lending	400	525	--	--	--	--
Rescheduling 4/	1,313	1,110	1,456	1,456	1,064	1,155
Outflows	-1,454	-1,730	-2,015	-2,195	-2,047	-2,148
Short-term capital (net)	-849	-916	2	141	347	133
Trade facility	-721	-136	361	390	517	335
Other short-term (including errors and omissions)	-128	-780	-359	-249	-170	-202
Other financing (net) 5/	818	--	--	--	--	--
Monetization of gold, and valuation adjustments	133	207	297	215	400	400
Change in net international reserves of the banking system (- increase) 6/	-991	-1,242	-813	-264	-505	-332
Central bank (net)	26	-922	-614	-188	-468	-301
Assets (- increase)	-175	-1,398	-48	500	159	109
Use of Fund credit (net)	178	4	-104	-156	-64	-67
Purchases	340	275	207	161	92	97
Repurchases	-162	-271	-311	-317	-156	-164
Other liabilities 7/	23	472	-462	-532	-563	-343
Commercial banks (net)	-1,017	-320	-199	-76	-37	-31
Financing gap	--	--	--	--	270 8/	296 8/
Memorandum items:						
Gross official reserves	1,061	2,459	2,507	1,959	1,800	1,850
(months of current year's imports of goods and services)	1.5	3.7	3.2	2.3	1.9	1.9
Exceptional finance	3,954	1,770	1,514	1,514	2,135	2,268
Rescheduling	3,554	1,245	1,514	1,514	2,135	2,268
Paris Club	660	379	599	599	269	300
Commercial banks 9/	2,853	866	915	915	1,866	1,968
Suppliers	41	--	--	--	--	--
Concerted bank lending	400	525	--	--	--	--

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

1/ Adopted at the time of the second review.

2/ Includes $49 million interest rebate on rescheduled debt paid in 1987 at pre-rescheduling interest rates.

3/ Commitments made after December 31, 1985.

4/ Excludes rescheduling of monetary liabilities.

5/ Includes unremittable arrears and rollover of nonmonetary trade arrears in 1985.

6/ Excludes rescheduled maturing monetary liabilities.

7/ Includes utilization of the trade facility.

8/ Assumed to be financed by rescheduling of debt service obligations due to Paris Club creditors during the second half of 1988 on terms comparable to those granted for 1987 and the first half of 1988.

9/ Includes rescheduling of maturing monetary liabilities.

significant discount (up to 6 percent) of the peso in the parallel market, which persisted during January-February 1988 but virtually disappeared thereafter (Chart 4). At the same time, the peso came under strong pressure in the official market and the Central Bank provided support through large sales of foreign exchange. As a result, gross official reserves declined steeply in the last four months of the year. Almost all of the loss of official reserves ($0.5 billion) was reflected in an increase of foreign exchange holdings of commercial banks. Gross reserves amounted to about $2 billion at end-1987, equivalent to slightly over two months of imports of goods and services, compared with over three months at the end of 1986.

The peso's exchange rate vis-à-vis the U.S. dollar has remained virtually unchanged since early 1986. During 1987, the peso depreciated by about 9 percent, in real effective terms, vis-a-vis trading partners, but remained broadly unchanged against a weighted basket of the Philippines' main Pacific area competitors.

Developments in the areas of structural policies are described in Section III.6.

(5) Performance criteria

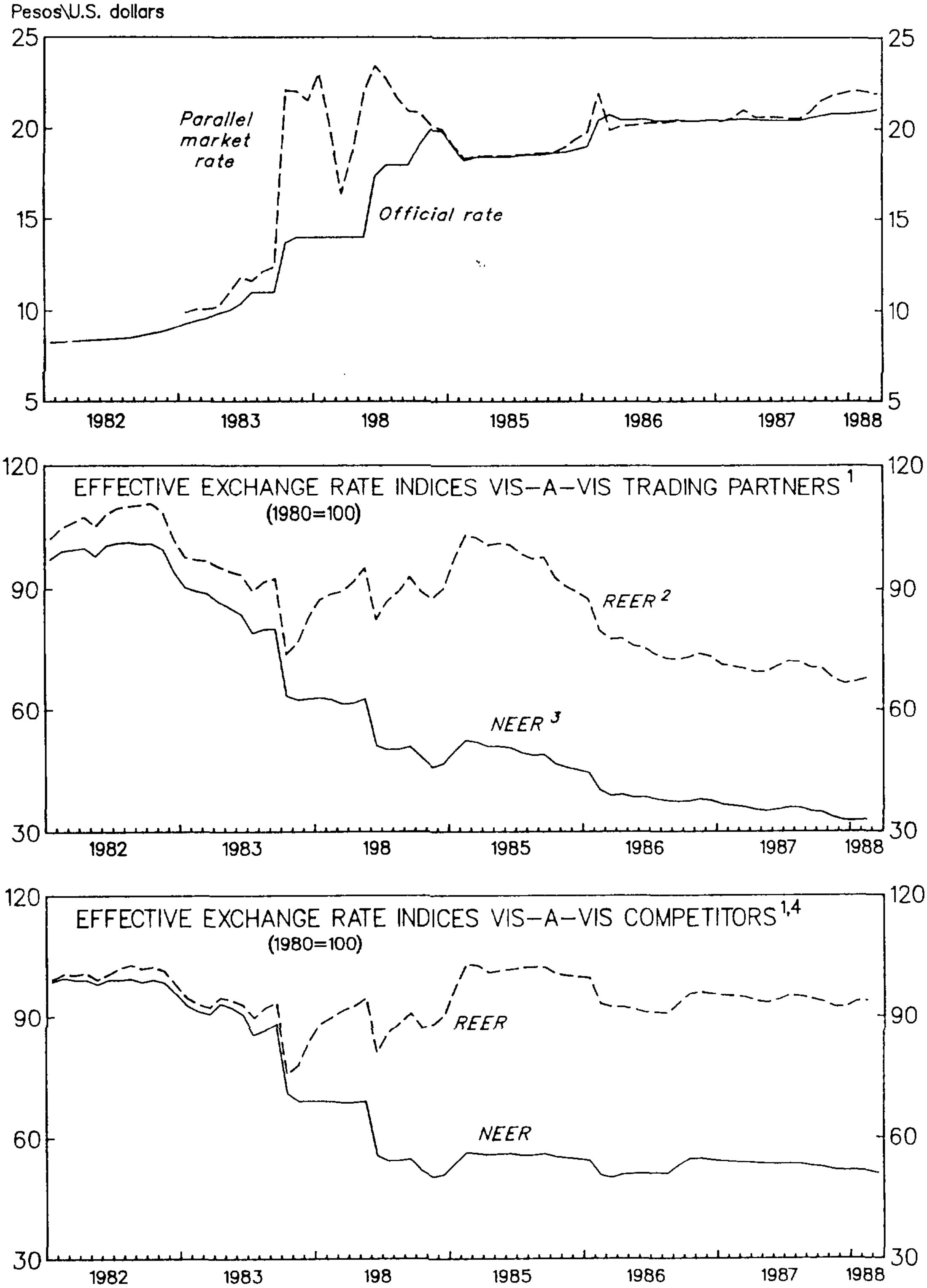
The quantitative performance criteria for base money and NIR of the monetary authority for end-March 1988 were met (Table 5). It is expected that the limits on external debt and borrowing were also observed. Information on the observance of the limit on the PSBR will not be available before early June.

III. Policy Discussions

1. Objectives and policies for 1988

The original program for 1988 was presented in detail in EBS/88/29 (2/12/88). The immediate aim of economic policy was to strengthen confidence and to prevent a further weakening of the external position; in addition to this immediate concern, policies were designed to achieve continuation of the economic recovery. (The principal macroeconomic objectives for 1988 are shown in Table 3.) Thus, the key elements of economic policies were (a) a mopping-up of excess liquidity; (b) a reversal of Central Bank intervention from large sales to sizable purchases of foreign exchange; (c) a substantial increase in public investment; and (d) continuation of the structural reforms. At the Executive Board meeting to discuss the extension of the stand-by arrangement, there was a consensus on the need for immediate policy action, though Directors differed on the relative emphasis to be placed on interest rate and exchange rate policies. A number of Directors expressed concern about the envisaged increase in the public sector deficits and the potential for inflationary pressures.

CHART 4
PHILIPPINES
EXCHANGE RATE INDICATORS, 1982–88



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

[1] Upward movement indicates appreciation of the peso.

[2] Trade–weighted index of nominal exchange rates deflated by seasonally adjusted relative prices.

[3] Trade–weighted index of nominal exchange rates.

[4] The competitors included in the index are Hong Kong, Indonesia, Korea, Malaysia, Singapore, and Thailand. With weights determined by the value of each country's non–oil merchandise exports.

Table 5. Philippines: Quantitative Performance Criteria, 1987-88

	Dec. 31, 1987		March 31, 1988		June 30, 1988
	Ceiling	Actual	Ceiling	Actual	Ceiling
			(In billions of pesos)		
Monetary base 1/	59.3	61.7	61.4 2/	58.7	60.8 2/
Public sector borrowing requirement (cumulative from Jan. 1, 1988)	29.7	18.0	10.5	...	15.0
			(In millions of U.S. dollars)		
Floor on net international reserves of the monetary authority 3/	70 4/ (-300)	-820	-933 4/ (-770)	-792 5/	-565
Short-term external debt outstanding	7,600	6,744	7,600	...	7,600
Approvals of external borrowing with maturities of					
1-12 years	1,000 6/	140	1,000 6/	...	1,000 6/
1-5 years	200 6/	4	200 6/	...	200 6/

Source: Based on discussions with the Philippine authorities.

1/ The ceilings will be adjusted downward (upward) to reflect any reduction (increase) in the reserve requirement of deposit money banks.

2/ In addition, the ceilings will be adjusted upward by the amount that NIR exceeds the program floor up to a maximum of ₱ 2.0 billion. The excess of NIR over the floor will be converted into pesos at ₱ 18.002/US$1.

3/ Floors for the respective test dates will be adjusted: (1) upward (downward) by the amount by which the cumulative total of new money disbursements after January 1, 1988 on external debt contracted after December 31, 1985 from foreign commercial banks and official sources exceeds (falls short of) $73 million at end-March 1988, and $231 million at end-June 1988; (2) upward (downward) by the amount that the level of deposit liabilities of the Central Bank to foreign commercial banks under the trade facility falls shorts of (exceeds) $709 million at end-March 1988, and $586 million at end-June 1988; and (3) upward (downward) by the amount that the level of Central Bank-assumed liabilities under Circular 1091 falls short of (exceeds) $374 million at end-March 1988, and $391 million at end-June 1988. In addition, the floor will be adjusted upward (downward) by the amount that actual rescheduling falls short of (exceeds) the following amounts: (i) the floors for end-March 1988, and end-June 1988 assume a rescheduling from commercial banks between January 1, 1988 and March 31, 1988 of $198 million, and June 30, 1988 of $397 million; (ii) the floors for end-March 1988, and end-June 1988 assume a rescheduling of principal and interest by Paris Club creditors between January 1, 1988 and March 31, 1988 of $134 million, and June 30, 1988 of $269 million.

4/ Adjusted floor; the unadjusted floor is shown in parentheses.

5/ Preliminary.

6/ Cumulative approvals from January 1, 1987 onward on 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.)

Compared with the policy strategy discussed at the beginning of the year, the authorities have put more emphasis on monetary restraint and less on exchange rate policy to ease the pressure on reserves. In the area of fiscal policy, there has been an unfavorable shift in the composition of expenditure--larger personnel outlays and lower capital expenditure--compared with the earlier estimates while the projected fiscal deficits have remained virtually unchanged. With speculative activities having now largely died down, the main policy issues for 1988 are: (a) to contain the pressure on the balance of payments and prices resulting from rapidly rising private and public sector demand, mainly consumption; (b) to forestall a deterioration in competitiveness in the face of rising inflation and large wage increases in the public sector; and (c) to press ahead with structural reforms.

The macroeconomic objectives for 1988 have remained virtually unchanged from those established at the beginning of the year. Growth is still expected to amount to about 6 percent in 1988 and inflation is forecast at about 7-8 percent. The consolidated public sector deficit and the PSBR are projected to increase by about 2 1/2 percent of GNP in 1988, owing to strong expenditure growth. However, the excess of private sector saving over investment is projected to increase by about 2 1/2 percent of GNP in 1988, because of a recovery of private savings from its unusually low level in 1987. As a result, the external current account deficit would remain broadly unchanged in 1988 (1.4 percent of GNP).

Both exports and imports are projected to grow by about 8 percent in volume terms, with a small improvement in the terms of trade. Export volume growth will be concentrated in the nontraditional sector, although traditional exports are expected to rebound from the 1987 drought. Inflows of medium- and long-term capital are expected to be somewhat lower than in 1987 (mainly because of the large disbursements at the end of 1987). 1/ Similarly, short-term capital inflows are now forecast to be smaller than projected in January 1988, because of substantially lower utilization of the trade facility. Official reserves at the end of 1988 are projected at $1.85 billion, broadly unchanged from the end-March 1988 level and the earlier program target.

2. Exchange rate policy

In early February 1988, the Central Bank ceased to provide support for the peso through large sales of foreign exchange. Subsequently, net

1/ The current rescheduling arrangement for Paris Club debts covers only debt service in the first half of 1988, and the authorities intend to approach the Paris Club shortly for a rescheduling of future debt service. Exceptional financing from banks is projected at over $1.9 billion in 1988, reflecting the rescheduling of medium- and long-term debt ($850 million) and of short-term monetary liabilities (close to $1.1 billion).

purchases were resumed, which reached some $120 million by early May. 1/ However, because of a preceding tightening of monetary conditions, this reversal of intervention did not lead to a significant exchange rate movement. The authorities stated that they had relied mainly on monetary policy to stem speculation because of concern that an exchange rate movement could encourage rather than curb speculative activity. However, they emphasized that exchange rate policy would be used if there were to be indications of a more fundamental worsening of the balance of payments. While the healthy growth of exports suggests that competitiveness is adequate at present, the authorities acknowledged that exchange rate policy would need to take account of the inflation differential in favor of trading partners and competitors if competitiveness is to be maintained.

The staff team stressed the need for exchange rate flexibility to avoid an overburdening of monetary policy with potentially conflicting external and internal objectives. While the correction of the balance of payments pressures that emerged in the latter part of 1987 and the containment of domestic demand required a tightening of monetary conditions, sole reliance on monetary policy in the period ahead entailed the risk of seriously weakening the recovery. Furthermore, an active exchange rate policy and a strong competitive position were required to ensure the rapid growth of the traded goods sector needed for external viability.

3. Monetary policy

Policy in the first part of 1988 has been to tighten bank liquidity through sustained sales of treasury securities. As a result, commercial banks' reserve positions were squeezed and interest rates rose. Although nominal interest rates in the first months of 1988 were some 3 percentage points above the level in early 1987 and are expected to remain broadly unchanged, the authorities did not consider the present level a deterrent to investment, because real rates had not increased. They emphasized that in formulating interest rate policy, consideration must also be given to maintaining a significant positive differential with respect to interest rates in major overseas financial markets.

The authorities indicated that they intended to maintain a cautious monetary policy stance for the remainder of the year. While they regarded the present rate of inflation as within acceptable bounds, they were concerned about its recent acceleration--the 12-month inflation rates in February-April 1988 were about 9 percent--and intended to use monetary policy flexibly to contain inflationary pressures. Thus, they

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1/ The Central Bank has traditionally been a large net buyer of foreign exchange in the market, not only to acquire official reserves but also to finance the large official debt service obligations and other payments it makes on behalf of the public sector.

had lowered the target for base money growth to 12 percent (from the 15 percent target established at the time of the extension of the stand-by arrangement) (Table 6). Given the NIR projections, the new target for base money growth implies no increase in Central Bank NDA during the year. As currency deposit ratios are expected to decline moderately from their historically high levels, the projected base money growth is consistent with a 14 percent increase in broad money, compared with a program target of 17 percent (Table 7). Private sector credit is projected to increase by about 19 percent during 1988.

In implementing monetary policy, the Central Bank has been hampered by the legacy of quasi-fiscal operations during 1982-84, 1/ which continue to give rise to large interest payments and a strongly negative income position. As a first step toward the longer-run objective of shifting to the Treasury the burden of servicing the liabilities arising from these operations, the Central Bank ceased to issue its own bills in 1987, while the sales of treasury securities were increased (and the receipts in excess of the Government's financing needs were deposited with the Central Bank). The shortfalls in treasury bill issues in late 1987 illustrated the potential constraints on relying primarily on this method of conducting open market operations. However, the authorities are confident that the sales of treasury securities programmed for 1988 will be achieved, and the financial program for 1988 also allows for the Central Bank to build up its own holdings of treasury securities (through purchases in the secondary market), thereby expanding its scope for conducting open market operations independently of the Treasury. Because of the complex and sensitive issues involved, there are no plans at present to take further steps toward transferring to the Treasury the debt service burden weighing on the Central Bank.

4. Fiscal policy

The consolidated public sector deficit for 1988 is now projected at 5.7 percent of GNP, with the monitored PSBR and the national government deficit amounting to 3.8 percent and 3.4 percent of GNP, respectively (Tables 8 and 9). These deficits, which are substantially larger than in 1987, are virtually identical to those presented in the January 1988 program. However, recurrent expenditures (mainly wages and interest expenditure) have been revised upward while capital expenditures have been scaled down. Public investment is now expected to amount to 4.0 percent of GNP, well short of the target of 4.6 percent in the 1988 program.

The staff noted that the shift in expenditure composition was detrimental to both growth and adjustment and stressed that every effort should be made to step up efficient public investment, while containing the growth of personnel expenditure. The persistent shortfall of public investment from the target of 5 percent of GNP--which is incorporated in

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1/ These operations, which resulted in large losses, comprised mainly the provision of forward cover and swap operations.

Table 6. Philippines: Reserve Money Program, 1986-88 1/

(In billions of pesos; end of period)

	1986 Dec.	Dec. 1987 Prog. 2/	Dec. 1987 Est. Actual	1988 March Prog. 3/	1988 March Est. Actual	1988 June Prog. 3/	1988 December Indic. 3/	1988 December Proj.
Base money	54.9	59.3	61.3	61.4	58.7	60.8	70.2	68.5
(12-month change in percent) 4/	24	8	12	16	11	14	15	12
Less: reserve-eligible securities	4.9	4.5	4.4	4.3	4.3	4.3	4.3	4.3
Less: reserve-deficiency	--	--	--	--	0.6	--	--	--
Reserve money	50.0	54.8	56.9	57.1	53.8	56.5	65.9	64.2
Net international reserves of the monetary authority	-16.4	-5.4	-13.1	-13.8	-13.2	-10.1	-4.6	-7.6
Medium- and long-term foreign liabilities 5/	-70.5	-71.6	-73.2	-72.7	-69.6	-72.2	-71.2	-71.7
Net domestic assets	136.9	131.8	143.2	143.6	136.6	138.8	141.7	143.5
Credit to the public sector	12.9	-40.7	-20.4	-29.1	-37.1	-35.4	-37.6	-36.3
Of which: National Government (net) 6/	(8.7)	(-44.3)	(-24.8)	(-33.5)	(-41.6)	(-39.8)	(-42.0)	(-40.7)
Of which: Deposits (-) 7/	(-14.9)	(-58.7)	(-38.4)	(-52.7)	(-54.4)	(-67.0)	(-70.9)	(-60.9)
Assistance to financial institutions	13.7	16.5	16.4	16.5	16.3	16.5	16.5	16.5
Regular rediscounting	6.9	7.7	7.2	7.2	7.2	7.2	7.2	7.2
Central Bank securities (net)	-29.9	-0.4	-10.8	-0.4	-2.5	-0.4	-0.4	-0.4
Other items (net) 8/	133.3	148.7	150.8	149.4	152.7	150.9	156.0	156.3
Of which: Accumulated central bank interest payments	(51.5)	(65.7)	(68.2)	(73.2)	(...)	(78.7)	(88.4)	(84.7)

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.

2/ Program established at the second review.

3/ Program established at the extension of the stand-by arangement in March 1988.

4/ Growth rates refer to end-of-period data; therefore they may differ from program targets given in Table 3, which refer to the ten-day test period.

5/ Includes liabilities assumed under debt restructuring agreements.

6/ Includes Central Bank holdings of treasury bills obtained through secondary transactions.

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

8/ Includes peso counterpart deposits related to the Central Bank's assumption of foreign liabilities under debt restructuring agreements.

Table 7. Philippines: Monetary Survey, 1986-88 1/

(In billions of pesos; end of period)

	1986	Dec. 1987		1988			
	Dec.	Prog. 2/	Est. Actual	March Prog. 3/	June Prog. 3/	December Indic.3/	December Proj.
Total liquidity	167.5	174.9	181.4	194.5	193.7	214.7	208.3
M3 4/	149.3	163.7	166.5	176.9	176.3	195.5	189.4
(12-month change in percent)	12	10	12	18	20	17	14
Currency	29.3	33.7	35.4	34.3	33.7	40.8	39.4
Deposits and deposit substitutes	120.0	130.0	131.1	142.6	142.6	154.7	150.0
Other liabilities	18.2	11.2	14.9	17.6	17.4	19.2	18.9
Net foreign assets	-110.2	-98.9	-107.1	-102.9	-98.1	-95.5	-98.4
Net international reserves	-37.3	-22.7	-32.6	-28.9	-24.6	-23.0	-26.1
Other foreign liabilities	-72.9	-76.2	-74.5	-74.0	-73.5	-72.5	-72.3
Net domestic assets	277.7	273.8	288.5	297.4	291.8	310.2	306.7
Public sector credit	29.2	-27.2	-7.1	-12.9	-18.0	-19.3	-18.2
Credit to National Government (net)	14.0	-40.3	-21.9	-27.6	-32.7	-34.0	-32.9
Monitored corporations	2.4	1.4	2.9	3.3	3.3	3.3	2.8
Other government entities	12.8	11.7	11.9	11.4	11.4	11.4	11.9
Private sector credit	114.4	134.5	132.8	147.2	146.0	162.3	157.5
Other items (net)	134.1	166.5	162.8	163.1	163.8	167.2	167.4
Of which: Central Bank security issues outside the banking system	(-18.8)	(--)	(-0.4)	(--)	(--)	(--)	(-0.4)
Memorandum items:							
Currency/deposit ratio	0.244	0.259	0.270	0.241	0.236	0.264	0.263
Base money multiplier	2.719	2.721	2.716	2.881	2.900	2.785	2.765

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.

2/ Program established at the second review.

3/ Established at the extension of the stand-by arrangement in March 1988.

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

Table 8. Philippines: Consolidated Public Sector Deficit, 1985-88

	1985	1986	1987 Jan. 1988 Estimate	1987 Actual	1988 Jan. 1988 Program	1988 Revised Proj.
			(In billions of pesos)			
National government deficit	-11.2	-31.3	-23.5	-19.6	-27.1	-27.3
Monitored corporations' deficit	-8.0	-6.8	-3.9	-1.6	-11.2	-9.9
National government transfers to monitored corporations	3.4	10.5	10.3	9.8	6.4	6.5
NPC transfer to the National Government	--	1.2	-0.9	-1.4	--	--
Monitored public sector borrowing requirement (PSBR)	-15.8	-26.4	-18.0	-12.8	-31.9	-30.7
Deficit of government financial institutions (GFIs) 1/	-18.5	-12.4	0.7	1.2	1.0	0.2
Net income of Central Bank	-15.5	-18.2	-10.1	-10.9	-14.7	-15.4
Other 2/	1.8	1.5	0.9	-0.9	0.2	-2.1
National government transfers to GFIs and other corporations	12.6	21.4 3/	1.9	1.7	2.3	2.0
Of which: GFIs (all)	(11.3)	(20.4) 3/	(1.3)	(1.0)	(1.2)	(1.0)
PNB transfer to the National Government	...	0.7	-0.7	-0.7	--	--
Consolidated public sector deficit	-35.4	-33.4	-25.3	-22.4	-43.1	-46.0
Memorandum items:						
Financing of PSBR	15.8	26.4	18.0	12.8	31.9	30.7
Net external	-2.6	-1.7	8.5	6.4	-0.5	-6.2
Net domestic	18.4	28.1	9.5	6.4	32.4	36.9
Bank	-0.1	-4.9	-34.9	-35.6	-12.4	-11.0
Nonbank	18.5	33.0	44.4	42.0	44.8	47.9
			(As percent of GNP)			
National government deficit	-1.9	-5.1	-3.4	-2.8	-3.5	-3.4
Cash deficit of monitored corporations	-1.3	-1.1	-0.6	-0.2	-1.4	-1.2
PSBR	-2.6	-4.3	-2.6	-1.8	-4.1	-3.8
Consolidated public sector deficit	-5.9	-5.4	-3.7	-3.2	-5.6	-5.7

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

1/ Philippine National Bank (PNB), Development Bank of the Philippines (DBP), and the Philippine Export and Foreign Loan Guarantee Corporation (Philguarantee).
2/ Includes other nonfinancial public corporations, local governments, and the social security systems.
3/ Includes ₱ 4.4 billion in the form of write-off of government deposits, identified as equity contribution in the Treasury accounts.

Table 9. Philippines: National Government Budget, 1985-88

	1985	1986	1987 Jan. 1988 Estimate	1987 Actual	1988 Jan. 1988 Program	1988 Revised Proj.
			(In billions of pesos)			
Revenues and grants	68.9	79.2	102.0	103.1	117.9	123.0
Domestic-based taxes	42.8	47.6	60.2	59.6	65.6	66.4
International trade taxes	18.4	17.8	25.6	26.2	27.4	29.3
Nontax revenue	7.7	13.8	16.2	17.3	24.9	27.3
Expenditures and net lending	80.1	110.5	125.5	122.7	145.0	150.3
Current operating expenditure 1/	53.6	65.7	96.8	97.2	113.6	123.2
Of which: Personnel	(22.9)	(25.0)	(33.7)	(32.9)	(38.6)	(45.5)
Maintenance and operating	(13.2)	(15.0)	(21.7)	(21.6)	(26.1)	(23.9)
Interest payments	(14.7)	(21.6)	(35.5)	(36.8)	(39.3)	(46.2)
Subsidies	(1.0)	(1.7)	(3.3)	(3.1)	(6.5)	(4.4)
Of which: Tax expenditures	[--]	[--]	[1.0]	[0.9]	[4.2]	[2.1]
Capital expenditure 1/	10.5	12.9	14.0	14.1	21.4	18.6
Equity and net lending	16.0	31.9 2/	14.7	11.4	10.0	8.5
Of which: Assistance to GFIs	(11.1)	(20.4) 2/	(1.3)	(1.0)	(1.0)	(1.0)
Deficit (-)	-11.2	-31.3	-23.5	-19.6	-27.1	-27.3
Financing	11.2	31.3	23.5	19.6	27.1	27.3
Foreign (net)	-0.3	3.6	8.2	6.1	0.1	-8.0
Gross borrowings	(3.7)	(9.8)	(15.0)	(14.9)	(9.7)	(10.9)
Amortization	(-4.0)	(-6.2)	(-6.8)	(-8.8)	(-9.6)	(-18.9)
Domestic (net)	11.5	27.7	15.3	13.5	27.0	35.3
Bank 3/	(0.2)	(-5.8)	(-35.8)	(-36.0)	(4.5)	(-11.0)
Nonbank 3/	(11.3)	(33.5)	(51.1)	(49.5)	(22.5)	(46.3)
			(In percent of GNP)			
Memorandum items:						
Revenue and grants	11.5	12.8	14.8	14.6	15.2	15.3
Tax revenue	10.2	10.6	12.5	12.2	12.0	11.9
Expenditure and net lending	13.4	17.8	18.2	17.4	18.7	18.7
Of which:						
Maintenance and operating expenditure	(2.2)	(2.4)	(3.2)	(3.1)	(3.4)	(3.0)
Capital expenditure 4/	(1.5)	(1.9)	(1.8)	(1.8)	(2.6)	(2.2)
Assistance to GFIs	(1.8)	(3.3)	(0.2)	(0.1)	(0.1)	(0.1)
Deficit	-1.9	-5.0	-3.4	-2.8	-3.5	-3.4
			(In billions of pesos; end of period)			
Public sector securities outstanding 5/	95.8	126.0	159.9	160.6	218.2	211.7
Issued by: National Government 6/	59.3	89.8	145.8	145.3	211.3	207.3
Central Bank 7/	34.3	31.8	10.8	11.8	0.6	--
Monitored corporations	2.2	4.4	3.3	3.5	6.3	4.4

Source: Data provided by the Philippine authorities.

1/ Adjusted to reflect reclassification of transfers to local government units to finance capital projects (₱ 1.2 billion for 1986, ₱ 1.5 billion for 1987, and ₱ 1.2 billion for 1988).
2/ Includes ₱ 4.4 billion in the form of write-off of government deposits.
3/ Data on financing are taken from Treasury sources for 1985 and from the monetary survey for 1986-88.
4/ Excludes capital transfers.
5/ Excludes public sector securities held by the monetary authorities, but includes securities held by commercial banks.
6/ Excludes the domestic debt of GFIs assumed by the National Government.
7/ Includes reverse repurchase arrangements.

the World Bank's Economic Recovery Loan (ERL)--has been a matter of concern to the Bank as well. The Bank has discussed remedial action with the authorities, but accepts that in the current situation public investment would remain below 5 percent of GNP, mainly because of implementation bottlenecks. The composition of the public investment program has continued to reflect its orientation toward agriculture and social and human development, which has been endorsed by the World Bank.

Revised projections of the national government budget indicate that revenues and grants are expected to rise by about 0.5 percentage point of GNP in 1988, mainly because of higher proceeds from asset sales. Recurrent expenditure is now projected to reach 15.3 percent of GNP in 1988 compared with 13.8 percent in 1987, largely because of higher personnel and interest costs. The growth in personnel expenditure reflects increases in salaries of military and police personnel (base pay was raised by up to 60 percent) and in minimum wages in December 1987 as well as a cost of living allowance and a 10 percent general salary increase granted with effect from January 1, 1988. The estimates also include the impact of a compensation rationalization package (half of the expected full year cost of ₱ 4.4 billion) and an early retirement and separation package (estimated once-for-all cost of ₱ 3 billion), which are likely to be adopted in 1988. Average compensation, in real terms, of national government employees is expected to rise by 28 percent in 1988, following a 9 percent increase in 1987. Interest payments in 1988 have also been revised upward, partly because of a larger volume of issues of treasury securities now envisaged in support of open market operations. By contrast, maintenance and operating expenditure has been scaled down.

The staff team wondered whether the magnitude of the wage adjustments was appropriate and emphasized the importance of tight control over current expenditure. The authorities explained that the salary increases were intended to offset the decline in real salaries during 1984-86 (estimated at 6 percent) and, beyond that, to enable the Government to attract and retain the most qualified personnel, including at the higher levels. They also pointed out that the lowest wage in the civil service would still be some 25 percent below the poverty level, even after the compensation rationalization. Policy would now aim at keeping real wages broadly unchanged while streamlining the civil service, though a significant reduction in its size was not expected.

Another important issue in the area of fiscal policy is the projected increase in the overall cash deficit of the major nonfinancial public corporations from 0.2 percent of GNP in 1987 to 1.2 percent in 1988 owing to both a decline in internal cash generation and a large increase in capital expenditure. The reduction in internal cash generation in 1988 is mainly attributable to the absence of the special factors that temporarily boosted receipts in 1987 and to full enforcement of the 1987 decision to charge corporations market interest rates on government advances. The staff expressed concern about the weakening in internal cash generation and stressed the need for remedial action. The authorities acknowledged the importance of strengthening the financial position of public corporations and indicated that their present emphasis is on reducing costs and increasing efficiency, but that price and tariff increases would also be considered. In the longer term, they also expected substantial improvements in financial performance as a result of the public enterprise reform (see subsection 6).

In early May, the Government announced several measures, which were designed to ease the pressure for higher wages in the private sector. These measures comprised a 5-7 percent reduction in prices of petroleum products; a ceiling on power tariffs, which implies a reduction in rates (of up to 40 percent) in some islands; and a reduction in the interest rate charged by the National Housing Authority (NHA) from 13 percent to 9 percent. While the staff estimates that the impact on the public finances is small (an increase in the deficit of perhaps 0.3 percent of GNP), 1/ the most recent measures constitute further slippage in fiscal policy. Furthermore, the Government has decided, in principle, to permit public entities to discontinue making counterpart deposits for rescheduled foreign debt, though details of implementation have yet to be worked out.

5. Other external policies

Policies with respect to the debt to equity conversion scheme 2/ were modified in early 1988 because of concerns about the expansionary monetary impact of such swaps. Conversions in 1987 were sizable ($266 million, equivalent to 1 percent of total external debt), 3/ and the pipeline of approved but yet to be effected transactions and of new applications was large in early 1988. In view of this, indicative limits were imposed on the conversion of central bank debt paper, which has been used in the bulk of transactions. However, the actual volume of conversions will be determined flexibly on the basis of monetary developments. The authorities have made efforts to ensure that conversions represent additional investment; the large majority of investment has also been in priority areas.

The Philippines no longer maintains any Article XIV restrictions. While the Central Bank continues to prescribe limits on foreign exchange sales for certain invisibles, these limits are only indicative as bona fide applications for larger amounts are readily approved. The remittance of dividends on some equity investments under the debt to

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1/ Most of the oil price reduction would be absorbed by the Oil Price Stabilization Fund, which is outside the public sector.

2/ Developments under the debt to equity scheme are described in detail in a supplement to the forthcoming paper on recent economic developments.

3/ Direct investment flows in the balance of payments comprise only conversions involving nonresidents (about $160 million in 1987).

equity conversion scheme is not permitted within the first four years, which gives rise to an exchange restriction subject to Fund jurisdiction under Article VIII. Investments subject to this restriction have been very small. The staff encouraged the elimination of this restriction, but the authorities stated that they were not now in a position to modify the legal provisions of the debt to equity scheme.

6. Structural policies

Structural reforms have been designed to rationalize incentives, remove distortions, reduce controls, and trim the size and enhance the efficiency of the public sector, thereby creating an environment for sustainable growth based on private investment and activity. Policy implementation has been closely in line with the program (Table 10). 1/

a. Tax reform 2/

Tax reform has aimed at removing the many distortions in the tax system, improving equity, and raising the low revenue elasticity (significantly below unity). Tax reform has been completed with the introduction of a value-added tax (VAT) with effect from January 1, 1988. Although there has been widespread opposition to the VAT, the Government intends to resist pressure for a weakening of the new tax. Tax exemptions for a few public corporations, notably the National Power Corporation (NPC), were reintroduced in 1987, but the Government intends to review the restored privileges and remains committed to replacing exemptions by explicit subsidies and to phase out these subsidies over time, though a time table has yet to be established. Revenue developments in 1987 suggest that the tax reform has resulted in an increase in the income elasticity of the tax system, though a firm estimate is not yet possible.

b. Sugar and coconut sectors 3/

Reform in the sugar and coconut sectors has focused on reducing regulatory controls and government intervention in trading and investment decisions. Thus, export monopolies were dismantled, the ban on copra exports was lifted, and export taxes on coconut products were removed. The restriction on new investments in coconut milling was lifted after some delay. However, to avoid overcapacity, the entry of new mills is still being regulated by the Philippine Coconut Authority. These changes strengthened competition, contributed to higher producer prices, improved income distribution and helped

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1/ Measures in the areas of trade policy reform and reform of the GFIs are also being implemented with World Bank assistance and monitoring in the context of an Economic Recovery Loan.

2/ Details on the tax reform are reported in a supplement to the forthcoming paper on recent economic developments.

3/ EBS/86/222, 9/22/86, Annex VI provides more details.

Table 10. Philippines: Progress with Principal Structural Reforms Under the 1986-88 Stand-By Arrangement 1/

Policy Area	Key Policy Measures	Status as of end-April 1988
1. Public sector policies		
a. Tax reform	Comprehensive revision to simplify tax system, shift reliance to domestic taxes and raise revenue elasticities. Includes a reduction in marginal income tax rates, partial globalization of income taxation, withdrawal of many exemptions, abolition of export duties, a broadening of the sales tax base and simplification of the rate structure, restructuring the excise and import duties, and introduction of a value-added tax.	Completed.
b. Public expenditure program	(i) Reorient public investment program to more rural-oriented, less capital- and import-intensive projects.	Completed for 1986-88 investment programs.
	(ii) Install improved procedures for the appraisal, contracting and monitoring of investment projects.	Improved control procedures in place, but procedural bottlenecks have ocurred.
	(iii) Restore public investment (target was 5 percent of GNP) and maintenance and operating expenditures.	Public investment (at 3 percent of GNP in 1987) remains below target.
c. Public corporations	(i) Restructuring of entire public corporate sector. Out of 296 public corporations, 127 (with total employment of about 40,000) to be privatized and 58 closed.	Privatization of 109 corporations now approved, with detailed disposal plans already prepared for 71 enterprises. Final decisions still awaited on privatization of 18 corporations.
	(ii) Government financial support for corporations to be made more transparent by the replacement of tax exemptions by explicit subsidies and the payment of interest and dividends on Government's capital contributions.	Interest and dividend charges introduced. Most exemptions eliminated, but a few (including those of the National Power Corporation) have been restored.
	(iii) Establishment of a Cabinet-level unit to monitor the performance of those corporations remaining in the public sector. Detailed financial and physical performance targets to be established for the most important corporations.	On schedule. The monitoring organization has been established and core plans covering key performance targets have been drawn up for five corporations.
d. Government Financial Institutions	(i) Comprehensive restructuring of the Philippine National Bank (PNB) and the Development Bank of the Philippines (DBP), involving a transfer of nonperforming assets to a separate Asset Privatization Trust and associated liabilities to the Government; sharp cutbacks in the banks' costs and staffing; and the elimination of noncommercial practices.	Largely completed.
	(ii) Elimination of all special privileges of PNB and DBP, including tax exemptions and government guarantees, together with a withdrawal of special government deposits.	All special exemptions and guarantees eliminated. Phased withdrawal of deposits with DBP is under way and to be completed by end-1989.
	(iii) Partial privatization of PNB after two years of profitable activity.	Partial privatization expected to begin in 1989, but precise timetable not yet established.
	(iv) Sale to private sector of six government-acquired commercial banks to be completed by mid-1988.	Three banks already sold; negotiations under way for the remaining three.

1/ Most of these reforms were drawn up and implemented in close collaboration with the World Bank.

Table 10. Philippines: Progress with principal Structural Reform Under the 1986-88 Stand-By Arrangement 1/(concluded)

Policy Area	Key Policy Measures	Status as of end-April 1988
e. Electric power sector reform	(i) Consolidate regulatory structure and permit private sector investment in electric power generation.	Completed.
	(ii) Phased withdrawal of subsidy to residential consumers in MERALCO Franchise area.	Four-year phased withdrawal begun in September 1987.
	(iii) Establish a new tariff structure based on long-run marginal cost principles.	Approved in principle by Cabinet, but not implemented. Automatic fuel cost adjustments have been suspended since September 1987 and a ceiling on tariffs was introduced in May 1988, implying a reduction of up to 40 percent for some islands.
2. Trade policy	Removal, in stages, of quantitative restrictions on 1,232 categories of imports (accounting for about one quarter of total imports). Where tariffs are adjusted along with the removal of import restrictions, maximum tariff not to exceed 50 percent.	Completed.
3. Agricultural policies		
a. Sugar and coconuts	Dismantling of export and domestic trading monopolies; new institutional arrangements to reduce government intervention in investment and trading decisions and to ensure full public accountability; remove ban on copra exports.	Completed.
b. Foodgrain trading	Withdrawal of the National Food Authority's (NFA) import monopoly on corn and rice and phasing out of its retail activities (Kadiwa stores and Food Terminal) so that NFA's major role is limited to a price stabilization function for rice and corn.	Largely completed. Food Terminal has not yet been sold.
c. Fertilizer imports	Remove restrictions on the importation of most categories of fertilizer.	Completed.

alleviate rural poverty. The reform of the coconut sector has been of particular importance, as it affected a large segment of the population.

c. Government Financial Institutions

Operations of the GFIs, mainly the Development Bank of the Philippines (DBP) and the Philippine National Bank (PNB), during the late 1970s and early 1980s resulted in a massive misallocation of resources, the accumulation of large nonperforming assets, and a substantial burden on the public sector and the balance of payments arising from large debt service obligations. Reform of the GFIs has focused on the disposition of the nonperforming assets and restructuring of the DBP and PNB, including the removal of special privileges. Non-performing assets were transferred to the newly established Asset Privatization Trust (APT) for sale to the private sector, while a similar amount of liabilities was assumed by the National Government. Sales by the APT amounted to ₱ 4.6 billion in 1987 and are forecast to increase in 1988. Detailed rehabilitation programs for both the DBP and PNB are being implemented and both banks have achieved substantial cost savings through closure and relocation of branches and large voluntary reductions in staffing. The PNB has returned to profitability and a partial privatization is to be considered within the next two years. The DBP has consolidated its operations, with only a small amount of new lending taking place for agriculture and small-scale industry, but the exact role of the DBP in the future has yet to be determined.

The next stage of GFI reform entails formulation of reform programs for the smaller institutions, mainly Philguarantee and the Land Bank of the Philippines, as well as completion of the divestment of six government-acquired banks; three of these banks have already been sold.

d. Trade policy reform

Since mid-1986, quantitative import restrictions on 1,232 items have been removed (this includes the lifting of restrictions on 129 items in April 1988) and replaced by tariffs of up to 50 percent. With this action, a substantial further opening of external trade has been achieved. The share of total imports subject to quantitative restrictions has fallen from 36 percent in 1984 to an estimated 10 percent at present.

The authorities have recently announced a program concerning the 637 remaining restricted imports (Annex VI). Items on an initial list will be liberalized in three stages to be completed by mid-1989, but decisions on whether or not to liberalize the 455 items on List B will only be made at successive six-monthly intervals between end-1988 and end-1989. List B contains many important consumer durables as well as cars, trucks, and motorcycles for which development programs have been put in place. Under these programs, firms are licensed to produce for the domestic market in return for certain commitments, for example, on local value added and foreign exchange earnings. The authorities indicated that these development programs might be extended to other consumer durables. The staff commended the authorities for the progress made under trade policy reform, but noted the lack of specificity with respect to liberalization of List B items. The staff also observed that once investments under the development programs are in place, the removal of restrictions might be difficult, as domestic production is unlikely to be profitable at world market prices because of its relatively small scale. The authorities emphasized that they had adopted comprehensive trade policy measures in the last two years despite strong internal opposition and a difficult external trading environment. They stated that they remained committed to trade policy reform, but that they had to proceed carefully so as not to jeopardize the program as a whole.

As part of the tax and trade policy reforms, a minimum tariff of 10 percent was imposed on all items that were not previously taxed or taxed at lower rates, and a maximum tariff rate of 50 percent was set. The objective was to achieve, over time, a more even structure of nominal protection of 20-30 percent. Some increases in tariff within the 10-50 percent range took place on a number of items, in conjunction with the removal of quantitative restrictions. Legislation for tariff rates outside the 10 to 50 percent rate was passed by Congress but tariffs above 50 percent were vetoed by the President.

e. Nonfinancial public corporations

Policy in this area aims at privatizing a large number of corporations (a total of 127 corporations with some 40,000 employees, equivalent to about one quarter of total employment in the public corporate sector) have been recommended for privatization. Those remaining in the public sector are to be made more efficient and market oriented. Detailed privatization plans have now been submitted for 71 corporations, and the President has recently approved the privatization of 17 large corporations (including Philippine Airlines). From among the large corporations, decisions are pending only with respect to certain subsidiaries of the Philippine National Oil Company (PNOC). Proceeds from sales are expected to be about ₱ 1-2 billion in 1988 and ₱ 2-3 billion in 1989. No change of the regulations regarding foreign participation is envisaged. 1/ The corporations remaining in the public sector will be revamped and monitoring of their performance will be strengthened. These and other initiatives have cleared the way for negotiations with the World Bank on a Public Corporate Sector Reform loan.

1/ Current regulations, in principle, limit foreign ownership to 40 percent of equity but exemptions have been granted on a case-by-case basis.

f. Land reform

The land reform decree signed by the President in mid-1987--but not yet put into effect--has since been debated intensively in the Congress. The major issues are the pace of distribution of private agricultural lands other than tenanted rice and corn lands, the maximum size of retained holdings, and fair compensation for landowners. The two houses of Congress have recently adopted different versions of the land reform bill. Some progress was made during 1987 in the distribution of lands initiated under the previous reform (1972) and not subject to congressional ratification. The financing of the land reform program has yet to be fully worked out. Preliminary projections for 1987-92 show a funding gap of ₱ 16 billion, which is expected to be met through government and foreign sources. 1/

7. Medium-term projections

At the time of the discussions the authorities were only in a position to present tentative indications of their main objectives and economic policies for the period beyond 1988. A fuller picture is expected to emerge by mid year when the current review of the Development Plan for 1987-92 is completed.

While emphasizing the preliminary nature of the projections, the Philippine authorities presented a medium-term balance of payments scenario for the period 1988-93 (Table 11). 2/ This scenario is based on a target of 6 percent for annual average growth of real GNP. The authorities expect that achievement of this target would require a substantial (but yet to be specified) increase in the ratio of gross fixed investment to GNP from the estimated 1988 level of 17 percent, as existing capacity has now become more fully utilized. The required import volume growth is projected at 8 percent. Export volume would increase by about 8 1/2 percent per year during 1989-92, implying annual volume growth of nontraditional exports of 12-13 percent, somewhat faster than in recent years. The current account deficit would rise from 1 1/2 percent of GNP in 1988 to a peak of about 3 percent of GNP in 1991 but decline to 2 1/2 percent of GNP by 1993. The widening of the current account deficit would reflect the increase in investment needed to support growth.

1/ This gap arises from the excess of projected expenditure for compensation and post-reform activities over revenues from the sale of assets from the Asset Privatization Trust and sequestered assets as well as other receipts.

2/ The assumptions with respect to oil prices, external market growth and interest rates are identical to those of the last world economic outlook exercise. The projected increases in export and import prices in dollar terms are somewhat lower than staff estimates based on WEO projection, but the implied improvement in the terms of trade is the same (1/2 of 1 percentage point per year).

Table 11. Philippines: Medium-Term Balance of Payments Projections, 1987-93 1/

	1987	1988	1989	1990	1991	1992	1993
Trade balance	-1,017	-1,085	-1,390	-1,460	-1,445	-1,410	-1,355
Exports, f.o.b.	5,720	6,590	7,235	8,180	9,315	10,530	11,900
Imports, f.o.b.	-6,737	-7,675	-8,625	-9,640	-10,760	-11,940	-13,255
Services and transfers (net)	478	546	367	231	39	-3	-3
Services (net)	-76	-102	-258	-392	-620	-722	-790
Of which: interest payments	(-2,226)	(-2,299)	(-2,324)	(-2,480)	(-2,694)	(-2,817)	(-2,899)
Transfers (net)	554	648	625	623	659	719	787
Current account	-539	-539	-1,023	-1,229	-1,406	-1,413	-1,358
(in percent of GNP)	(-1.6)	(-1.4)	(-2.5)	(-2.8)	(-3.0)	(-2.7)	(-2.4)
Capital account	-653	-531	-325	-476	-236	31	-333
Medium- and long-term loans	-1,214	-1,231	-808	-1,110	-867	-695	-1,190
Inflows 2/	981	917	1,227	1,270	1,314	1,360	1,408
Of which: to be arranged	(—)	(—)	(—)	(77)	(348)	(566)	(1,027)
Outflows	-2,195	-2,148	-2,035	-2,380	-2,181	-2,055	-2,598
Direct investment (net)	205	167	147	150	154	203	262
Other (net)	356	533	336	484	477	523	595
Net international reserves (- increase)	-264	-332	-938	-1,170	-1,553	-643	-755
Gross reserves (-increase)	22	178	-648	-571	-1,050	-471	-504
Liabilities	-287	-510	-290	-599	-503	-172	-251
Use of Fund credit (net)	-138	-67	-191	-351	-305	-172	-70
Purchases	150	97	—	—	—	—	—
Repurchases	-288	-164	-191	-351	-305	-172	-70
Financing gap	-1,456	-1,402	-2,286	-2,875	-3,195	-2,025	-2,446
Rescheduling	1,456	1,106	897	996	934	742	569
Paris Club	599	300	—	—	—	—	—
Commercial banks	857	806	897	996	934	742	569
Possible further Paris Club rescheduling 3/	—	296	547	511	479	494	—
Residual exceptional financing	—	—	842	1,368	1,782	789	1,877
External financing to be arranged 4/	—	296	1,389	1,956	2,609	1,849	2,904
Memorandum items:							
Gross official reserves	1,959	1,850	2,425	2,919	3,892	4,282	4,703
(In months of imports)	2.3	1.9	2.3	2.5	3.0	3.0	3.0
External debt outstanding	28,070	28,213	29,566	31,041	33,134	33,905	37,199
(In percent of GNP)	81.8	75.7	73.3	70.9	69.8	65.9	66.8
Debt service ratio (in percent)							
Before rescheduling	51.1	44.8	41.4	42.9	38.4	33.6	33.4
After rescheduling 3/	35.3	31.1	28.2	30.5	27.4	25.4	30.0
Interest payments in percent of GNP (before rescheduling)	6.5	6.2	5.8	5.7	5.7	5.5	5.2

Sources: Philippine authorities.

1/ Assumes annual average real GNP growth of 6 percent, export volume growth of 8.5 percent, import volume growth of 8 percent, annual improvement in the terms of trade by 0.5 percentage point and average 6-month LIBOR of 8 percent.

2/ From official and multilateral sources.

3/ Assumes Paris Club rescheduling with terms comparable with those for 1987 and the first half of 1988.

4/ Medium- and long-term loans and rescheduling to be arranged and residual exceptional financing.

The inflow of medium- and long-term loans from bilateral and multilateral lenders is expected to increase substantially in 1989, owing to a pickup in project implementation and larger program loans, and to remain unchanged in real terms thereafter. An important aspect of the scenario is the projected buildup in gross official reserves from its current level of less than two months of imports to three months of imports by 1991. Indeed, the authorities believe that, given the uncertain external environment, a more rapid rebuilding of reserves than currently envisaged would be desirable.

This balance of payments scenario leaves annual financing gaps of between $2-3 billion during 1989-93. 1/ To cover this gap, the authorities intend to pursue a strategy that would involve both the provision of new money and debt exchanges that would contribute to a reduction in debt. They are now in the process of discussing these issues with official creditors and commercial banks. The authorities plan to request further debt rescheduling from Paris Club creditors, and Table 11 shows, for illustrative purposes, the estimated effect of a rescheduling of Paris Club debts through 1992. 2/ The residual exceptional financing gap (after rescheduling) would be about $1.2 billion per year during 1989-92, virtually identical to that implied by the medium-term scenario presented in the second program review (EBS/87/204, Supplement 1). If it is assumed that no new rescheduling arrangements will be sought for the period after 1992, 3/ the residual financing need would be $1.9 billion in 1993. These residual gaps would have to be filled through concerted or spontaneous new lending from banks, debt exchanges resulting in a debt reduction, and larger-than-currently envisaged official support and direct investment (no assumptions have been made about possible future use of Fund resources). The authorities' projections imply a decline in the debt/GNP ratio from 82 percent in 1987 to some 67 percent in 1993. There would also be significant reductions in the debt service ratio and in the ratio of interest payments to GNP.

1/ Preliminary staff estimates indicate that (i) a 1 percentage point increase (decline) in LIBOR would raise (reduce) the financing gap by about $150 million per year; (ii) a $1 per barrel increase (decline) in oil prices would raise (reduce) the financing gap by about $100 million per year; and (iii) a 1 percentage point increase (decline) in export volume growth would reduce (raise) the financing gap by about $100 million per year.

2/ Based on the assumption that the terms would be similar to those obtained in the last arrangement, covering all principal and 70 percent of interest payments.

3/ Although the current rescheduling arrangement with bank creditors covers the period 1987-92, the rescheduling of previously rescheduled principal repayments provides for significant debt relief during 1993-94.

The staff's comments focused on the assumptions regarding external trade volumes and the policies required to achieve both the growth target and external adjustment. The staff stated that the envisaged export growth appeared to be optimistic, as it assumed that the volume of nontraditional exports would grow about twice as fast as the Philippines' external markets (based on the March 1988 WEO projections). This required the adoption of aggressive export policies as well as a substantial easing of supply constraints. With respect to the import projections, the staff expressed the view that, with the adoption of appropriate pricing and structural policies, import volume growth could be lower than projected. The effect of this would be to broadly offset the impact on the current account of a more realistic assessment of the export prospects.

The staff also emphasized that the achievement of current account adjustment over the medium term was critically dependent on containing private consumption and a large reduction of the consolidated public sector deficit from its estimated level of 5 1/2 percent of GNP in 1988. Fiscal adjustment would require the adoption of strong measures, because on the basis of present policies a decline in the deficit appeared unlikely. Continuation of structural reform was also required to support fiscal adjustment, and to ensure, in combination with appropriate pricing policies, efficient investment and a reduction in the import intensity of expenditure. While the authorities acknowledged the need for lower fiscal deficits, they stated that they had yet to form a view as to the degree of reduction and the necessary policy measures. The authorities also agreed with the necessity of continuing with structural reforms, but they thought that the impact on import propensities would be both limited and slow to materialize.

IV. Staff Appraisal

The Philippine economy has recovered remarkably well from the severe recession experienced in the mid-1980s. Growth was robust in 1987 and there is every expectation that it will remain strong in 1988. At the same time, major new balance of payments problems have been avoided, the external debt situation has improved, and close cooperation with the international financial community has been maintained. The successful implementation of bold structural reforms designed to eliminate the complex network of government intervention and regulation that was one of the root causes of the severe economic and financial crisis in the mid-1980s deserves special recognition. All these are substantial achievements, for which the Philippine authorities must be commended.

Impressive as these successes have been, the challenges that lie ahead are no less substantial. The balance of payments pressures that emerged in late 1987 in the wake of political events are but one example of the susceptibility of the economy to both internal and external shocks. The episode underscores the need for vigilance and strong and timely policy responses.

In the current situation, the rapid growth of domestic demand, notably of public and private consumption, entails serious risks for maintaining internal and external balance. Most recent developments reinforce especially the concern about a rise in inflation. In view of this, the recent tightening of monetary policy was a necessary step. Care must, however, be taken to avoid too strong a reliance on monetary policy lest investment crucial to future growth be discouraged. The concerns about the use of monetary policy as the primary tool of stabilization are, to some extent, reinforced by weaknesses in its implementation, as illustrated by the temporary surge in money growth in late 1987. These weaknesses arise from the large debt service burden--the legacy of the financial crisis of the early 1980s--weighing on the Central Bank. Replacing Central Bank bills by primary issues of treasury securities (and the depositing of the proceeds at the Central Bank) for purposes of open market operations has been an important first step of reform. Although this is a difficult and sensitive issue, consideration should now be given to transferring the debt service burden to the Treasury.

The authorities' intention to make use of exchange rate policy in the case of a sustained weakening of the balance of payments is very much welcomed. Indeed, the aim must be to forestall a deterioration in the balance of payments and the associated loss of confidence through timely policy action. While the strong growth of exports of manufactures in 1987 suggests that the present level of competitiveness is adequate, the inflation differential vis-a-vis trading partners and competitors has widened. This indicates a need for greater exchange rate flexibility. The need for action would be reinforced, if the recent large wage increases in the public sector were to spill over to the private sector.

The staff's principal concerns are in the area of fiscal policy where considerable slippage has occurred. The sharp increase in personnel expenditure by the National Government in 1988 not only aggravates the pressure on prices and the balance of payments, but also worsens the outlook for fiscal adjustment over the medium term. At the same time, capital expenditure, though still growing strongly, has been scaled downward, and while this reflects a more realistic assessment of implementation capacity rather than cutbacks of appropriations, it weakens the prospects for growth. Every effort must be made to avoid a further escalation of personnel expenditure while increasing capital expenditure that meets stringent investment criteria. The recent reduction in petroleum prices and electricity tariffs weakens public sector finances, and an effective lifting of the requirement to place deposits in blocked accounts for rescheduled foreign liabilities would not be conducive to financial discipline. The tax reform has been successfully implemented, and the authorities' resolve to resist the various efforts at weakening the VAT legislation is commendable.

Structural reform has occupied a central place in the adjustment strategy and the measures adopted have reduced government intervention in decision making, eased the pressure on public finances and improved incentives for private sector activity and investment. With reform of the sugar and coconut sectors having been completed and the reform of the GFIs at an advanced stage, the attention is now shifting to non-financial public enterprises and land reform. The privatization of a sizeable number of enterprises and increased efficiency of those remaining in the public sector would make an important contribution to financial stability and sustaining growth. It is also important, both from an economic and social perspective, that a comprehensive land reform program soon be adopted. The rather modest recent and projected inflows of foreign direct investment suggest the need for a review of foreign investment regulations and approval practices. It is hoped that the authorities will apply the limits on debt to equity conversion, which reflect concerns about the monetary impact of the swaps, in a flexible way to permit this scheme to continue its useful, though limited, role in reducing the external debt burden.

Considerable strides have been made in the area of trade policy reform. The authorities must be commended for these efforts and their resistance to the introduction of tariffs above 50 percent. The elimination of the bulk of quantitative import restrictions is a remarkable achievement deserving international recognition. At the same time, the process of reform, which is in the country's own best interest, must continue. In particular, it is important to adopt soon a more specific program for the next phase of removal of quantitative import controls, especially since certain import substitution schemes are now under active consideration.

Looking beyond the current year, the central issue facing the Philippine authorities is to ensure sustainable growth and a viable balance of payments over the medium term. Attainment of these objectives will require the continuation of both forceful adjustment policies and strong support from the international financial community. The path of the external current account in the authorities' preliminary medium-term projection is broadly consistent with rapid growth as well as adjustment, provided that strong policies, focusing on fiscal adjustment and continued structural reform cast in a medium-term framework, are adopted.

The need to pursue sound macroeconomic policies can hardly be overemphasized, but an adequate external cash flow is an equally essential underpinning of a medium-term program. The financing gaps implicit in the authorities' preliminary medium-term balance of payments scenario are substantial and, to some extent, they reflect the desire to rebuild foreign reserves from their low 1987 level. While the financing requirements need to be reassessed on the basis of a fully specified macroeconomic framework, it is clear that both official creditors and commercial banks would be called upon to provide sizeable financial support, in one form or another, over the medium term, and a continued catalytic role of the Fund also would be necessary.

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. In the absence of clear indication that this restriction will be temporary, the staff does not recommend its approval at this time. The staff urges the authorities to achieve the aims of the debt to equity conversion scheme by means other than those involving an exchange restriction.

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

Philippines: Basic Data

Area:	300,000 sq km
Population (1987):	57.4 million
Annual rate of population growth (1978-86):	2.4 percent
Gross national product (1987):	34.3 billion
GNP per capita (1987):	$597

	1984	1985	1986	1987	1988 Proj.
			(Changes in percent)		
GNP and prices					
Real GNP	-6.8	-4.2	2.0	5.7	6
Of which: Agriculture	2.4	3.3	3.7	0.4	...
Manufacturing	-7.2	-7.7	0.8	7.1	...
Nominal GNP	39.0	13.3	3.7	14.0	13.8
Implicit GNP deflator	49.1	17.6	1.8	7.3	...
Consumer price index (end-period)	50.8	5.7	-0.3	7.5	6-7
Nominal GNP (in billions of pesos)	527.4	597.7	619.8	706.3	804.0
National Government					
Total revenue	24.3	21.3	14.9	30.2	19.3
Total expenditure and net lending	26.0	19.7	38.0	11.0	22.5
Money and credit 1/					
Net domestic assets 2/	2.5	13.5	4.5	3.9	6.3
Domestic credit	-8.2	-4.5	-8.7	-12.5	10.8
Public sector credit	10.5	19.3	-11.9	...	...
Private sector credit	-11.5	-9.7	-7.8	16.1	18.6
Total liquidity	6.9	8.1	11.3	8.3	14.8
M3	7.3	9.7	12.3	11.5	13.7
Base money	11.6	8.3	23.9	11.7	11.7
Interest rate (90-day money market rate; end-period)	36.3	12.6	8.1	12.3	13
External sector					
Exports, f.o.b. (in U.S. dollar terms)	7.7	-14.1	4.6	18.1	15.2
Imports, f.o.b. (in U.S. dollar terms)	-18.9	-15.8	-1.3	33.6	13.9
Exchange rate (period average)					
Nominal effective	-29.5	-7.3	-21.2	-9.3	...
Real effective	-1.1	9.5	-22.0	-8.0	...
Peso/dollar (level)	16.7	18.6	20.5	20.6	...
			(In millions of U.S. dollars)		
Balance of payments					
Exports, f.o.b.	5,391	4,629	4,842	5,720	6,590
Imports, f.o.b.	-6,070	-5,111	-5,044	-6,737	-7,675
Services and transfers, net	-589	464	1,198	478	546
Current account balance	-1,268	-18	996	-539	-539
Overall balance 3/	-200	991	813	264	332
External debt (end-period)					
Total	25,418	26,252	28,256	28,070	28,213
Medium- and long-term 4/	15,082	16,564	21,635	21,864	23,136
Short-term	9,492	8,573	5,378	3,931	3,869
IMF	844	1,115	1,243	1,275	1,208
Debt service (as a ratio to exports of goods and services) 5/	45	33	34	35	31
Gross official reserves (end-period)					
(In months of imports of goods and services)	1.1	1.5	3.7	2.3	1.9
			(In percent of GNP)		
Gross domestic investment	17.4	14.3	13.2	14.6	17.3
Gross national saving	13.4	14.3	16.5	13.0	15.9
National government revenue	10.8	11.5	12.8	14.6	15.3
National government expenditure and net lending	12.7	13.5	17.8	17.4	18.7
National government deficit	-1.9	-1.9	-5.1	-2.8	-3.4
M3 (end-period)	23.0	22.3	24.1	24.6	23.6
Exports	17.1	14.4	15.9	16.7	17.7
Imports	19.2	15.9	16.6	19.6	20.6
Current account balance (-)	-4.0	-0.1	3.3	-1.6	-1.4
External debt	80.6	81.7	92.9	81.7	75.7

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

1/ End-period; may differ from growth rates calculated using 10-day average test periods.

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

3/ After rescheduling and concerted lending; equivalent to the change in net international reserves of the banking system.

4/ Includes IMF Trust Fund.

5/ Including IMF. After rescheduling for the period 1985-88. Assumes Paris Club rescheduling in the second half of 1988 on terms comparable with those obtained in 1986 and the first half of 1987.

Philippines: Social and Demographic Indicators 1/

Area	**Population**	**Density**
300 thousand sq. km.	57.4 million Annual rate of growth: 2.4 percent	191 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	6,100
- female	66 years	Population per hospital bed ratio	590
Infant mortality rate			
(Age under 1, in percent per 1,000 live births)	54		
(Age 1-4, in percent per 1,000 population)	5		
Income distribution		**Education**	
Percent of household income		Primary school enrollment rate 2/	97
Highest 10 percent	37	Secondary school enrollment rate 2/	55
Lowest 20 percent	5		
Access to safe water			
Percent of population - urban	66		
- rural	62		
Nutrition			
Per capita calorie intake (calories per day)	1,808		
Per capita protein intake (grams per day)	51		

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 - Fund Relations
(As of March 31, 1988)

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:	1,189.33	270.06
(c) Fund credit:	787.70	178.86
Of which: Credit tranches	245.94	55.84
EFF	6.67	1.51
SFF	25.00	5.68
EAR	286.00	64.94
CFF	224.10	50.89
(d) Reserve tranche position:	38.83	8.82

III. Stand-By and Extended Arrangements

(a) The current stand-by arrangement was approved on October 24, 1986.
Duration: October 24, 1986 through August 23, 1988
Amount: SDR 198 million or 45 percent of quota
Utilization: SDR 128 million
Undrawn balance: SDR 70 million

(b) 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

Philippines--Fund Relations (continued)

(c) 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:	0.11
(As percent of net cumulative allocation)	0.09

V. Administered accounts

(a) Trust Fund loans	
(i) Disbursed	151.47
(ii) Outstanding	35.98
(b) SFF Subsidy Account	
(i) Donations to Fund	None
(ii) Loans to Fund	None
(iii) Payments by Fund	47.73

VI. Overdue obligations None

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 has depreciated against the U.S. dollar and stabilized at about ₱ 20.4 = US$1 from February 1986 to August 1987. Since then, there was a slight depreciation to ₱ 20.8 = US$1.

VIII. Last Article IV Consultation: The 1986 Article IV consultation report (EBS/86/222 and Sup. 1) was discussed by the Executive Board on October 24, 1986 (EBM/86/173). The following decision (Decision No. 8428-(86/173) was adopted:

Philippines--Fund Relations (concluded)

1. The Fund takes this decision relating to the Philippines' exchange measures subject to Article VIII, Sections 2(a) and 3 in concluding the 1986 Article XIV consultation with the Philippines, in light of the 1986 Article IV consultation with the Philippines conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund welcomes the maintenance by the Philippines of an exchange system free of restrictions on payments and transfers on current international transactions other than the recently introduced limitation on the remittance of certain dividends, in connection with the debt to equity conversion scheme, as described in the forthcoming report on recent economic developments, which is subject to approval under Article VIII, Section 2(a). The Fund urges the authorities to look into the possibility of achieving their investment aims by means other than those involving an exchange restriction.

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 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.

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 1986-88

Between January 1, 1986 and March 31, 1987, the Bank approved five loans to the Philippines, totaling $493 million in new commitments (Table 1). Included in this 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 and is expected to be disbursed in three equal tranches over the next three years. The first tranche has been fully disbursed.

Table 1. Loan Approvals in 1986-87

(In millions of U.S. dollars)

	Amount	Date
1. Manila Water Distribution	69	4/3/86
2. Rural Roads II	82	6/10/86
3. Economic Recovery Loan	300	3/17/87
4. Economic Recovery Technical Assistance Project	10	3/17/87
5. Provincial Ports Projects	32	5/26/87
Total	493	

As of March 31, 1988, there were 31 Bank-assisted projects undergoing implementation in the Philippines. Disbursements totaled $189 million in 1986 and $262 million in 1987. The Bank estimates a level of disbursements of $295 million during 1988 and $429 million during 1989.

The Bank has a number of projects under development for possible approval in 1988. These include a Public Corporation Reform Project, which will support a program of divestiture of nonfinancial government corporations and improvements in the management and operation of those corporations remaining in the public sector. In agriculture, a loan for irrigation operations support will help define a realistic program for rehabilitation and maintenance of the irrigation system. A housing sector loan will support reforms of various housing finance entities in the Philippines, and provide support for mortgage lending. Other lending operations being developed include a power sector development project, which will finance the expansion of geothermal based power, and improvements in the electricity distribution system.

1/ Prepared by World Bank staff.

World Bank Activity in the Philippines (continued)

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 in the industrial sector, agriculture, transportation, and in public sector resource management. In addition, reports on poverty, education, energy/power, and the financial sector are being prepared and will be discussed with the Government during 1988. A mission will visit Manila in May/June to begin work on a new Country Economic Memorandum, which will serve as background documentation for the next meeting of the Consultative Group.

Disbursement figures for World Bank loans for 1986, 1987, and 1988 are summarized in the following table.

Table 2. IBRD/IDA Estimated Disbursements, 1986-88

(In millions of U.S. dollars)

	1986	1987	1988
Disbursements on projects, pipeline 10/83	111	136	140
Disbursements on new loans made after 10/83	78	126	210
Total	189	262	350

2. Outstanding financial relations

a. IBRD/IDA lending operations (as of March 31, 1988)

	Commitments IBRD	Commitments IDA	Undisbursed
	(In millions of U.S. dollars)		
Seventy one loans and five credits disbursed	2,681.5	73.0	
Present commitments	1,465.9 1/	34.4 1/	652.3
Total	4,147.4	107.4	652.3
Repayments	940.5	1.6	
Debt outstanding	3,206.9	105.8	

1/ Net of cancellations

World Bank Activity in the Philippines (concluded)

b. IFC investments

(as of March 31, 1988)

Total gross commitments	218.3
Less: repaid, sold, or cancelled	128.0
Total commitments held by IFC	90.3

Recent economic and sector reports:

The Philippines: Issues and Policies in the Industrial Sector, July 30, 1987, No. 6706-PH.
The Philippines: Agricultural Sector Strategy Review, October 31, 1987, No. 6819-PH.
Philippines: Transport Sector Review, March 31, 1988, No. 7098-PH.
Philippines: Selected Issues in Public Sector Resource Management, April 15, 1988, No. 6887-PH.

Technical assistance:

The IBRD has provided technical assistance to the Philippines through its standard lending operations. A recently approved Economic Recovery Technical Assistance Project for $10 million will support the rehabilitation programs of the two largest government financial institutions; finance a study of the government social security insurance system; and provide consultants, training, and equipment to improve selected operations within the Central Bank, the Ministry of Finance, and Asset Privatization Trust.

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 November 1988.

Philippines--Statistical Issues

1. Outstanding statistical issues

a. Real sector

A technical assistance mission on real sector statistics visited the Philippines in February 1987. The mission identified the major deficiencies in national accounts, price statistics and labor market indicators and suggested a number of measures for improving the quality and currentness of these indicators.

b. Government finance

The data published in International Financial Statistics (*IFS*) are on the same basis as those in the *Government Finance Statistics Yearbook (GFSY)*. In the most recent issue of *IFS*, there are data on the principal budget aggregates through December 1987, some of which are on a preliminary basis. However, the 1987 *GFSY* contains data only through 1985. In addition, the data in the *GFSY* only cover the operations of the central government and the local governments. There is a need to expand coverage to include data for the social security system. There is also a need to improve data on financing so as to permit reconciliation with data derivable from the debt tables and the monetary accounts.

c. Monetary accounts

There are differences between the data used in staff reports, those published in *IFS*, and the data reported by the authorities on report forms designed by a 1983 ASD/STA mission. STA and ASD are attempting to reconcile the three sets of data to establish a common data base. This would alleviate the authorities' task of reporting data to the Fund.

2. Coverage, currentness, and reporting of data in IFS

The table below shows the currentness and coverage of data published in the country page for the Philippines in the May 1988 issue of *IFS*. The data are based on reports sent to the Fund's Bureau of Statistics by the Central Bank of the Philippines which during the past year have been provided on a timely basis.

Philippines--Statistical Issues (concluded)

Status of IFS Data

		Latest Data in May 1988 IFS
Real sector	- National accounts	Q4 1987
	- Prices	January 1988
	- Production	n.a.
	- Employment	n.a.
	- Earnings	n.a.
Government finance	- Deficit/surplus	December 1987
	- Financing	December 1987
	- Debt	Q4 1986
Monetary accounts	- Monetary authorities	January 1988
	- Deposit money banks	January 1988
	- Other financial institutions	December 1987
Interest rates	- Discount rate	November 1987
	- Bank lending/deposit rate	February 1988
	- Government bond yield	n.a.
External sector	- Merchandise trade: Values	November 1987
	- Unit values 1/	November 1987
	- Balance of payments	Q2 1987
	- International reserves	March 1988
	- Exchange rates	March 1988

1/ Export prices for commodities available to December 1987.

Philippines: Trade Policy Reform

1. Removal of quantitative import restrictions during May 1986-April 1988:

Total number of items:	1,232
Of which:	
Raw materials and intermediate inputs	307
Intermediate goods, construction materials, and capital goods	215
Consumer goods and other products	710

2. Quantitative restrictions on remaining 637 items

a. List A (104 items)

To be liberalized by June 30, 1988:	
(1) Nonmetric measuring devices	31
(2) Games and amusements	4
(3) Live animals for breeding	6
	41
To be liberalized by December 31, 1988:	
(1) Radio telecommunication equipment	8
(2) Glassware/dinnerware/silverware	8
(3) Spare parts/machinery for pulp and paper industry	7
(4) Consumer durables	2
(5) Cinematographic films and other works	9
(6) Other items, not elsewhere classified (NEC)	9
	43
To be liberalized by June 30, 1989:	
(1) New trucks and engines	20

b. List B (455 items)

Animals and meat products	31
Coffee	9
Fish and fish preparation	36
Sugar	3
Fertilizers	19
Potatoes/onions/garlic	4

Philippines: Trade Policy Reform (concluded)

Cement and cement products	5
Antibiotics	23
Vessels and appurtenances	14
Radiation apparatus	21
Spare parts, machinery, and equipment 1/	34
Consumer durables/electrical goods	33
Raw materials, parts, components for consumer electronic products	73
Trucks and buses	10
Motorcycles	2
Cars, jeeps	10
Used tires	2
Cigarette paper	1
Newsprint	1
Spare parts for cars, trucks, etc.	73
Coconut industry machinery	4
Coal and derivatives	5
Diesel/gasoline engines	26
Refined petroleum products	15
Total	455

Decisions on whether or not to remove the quantitative restrictions will be made on one third of the items each, by December 31, 1988, June 30, 1989 and December 31, 1989, respectively.

c. List C: for continued regulation

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 3/	40
Pesticides	7
Rice and corn 3/	12
Total	114

Sources: Philippine authorities and staff.

1/ Related to iron and steel, cement and textile industries.

2/ No specific classification is indicated since items under this category are normally declared under generic names.

3/ Yellow corn and meat to be moved to List B.