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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/83

10:00 a.m., May 30, 1985

J. de Larosière, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	K. Yao, Temporary
	D. C. Templeman, Temporary
	H. G. Schneider
	G. Nguyen, Temporary
	T. Alhaimus
	M. Z. M. Qureshi, Temporary
H. Fujino	M. Sugita
	B. Goos
	Jaafar A.
R. K. Joyce	L. Leonard
	H. A. Arias
	J. Hospedales, Temporary
	H. Fugmann
E. I. M. Mtei	A. Abdallah
	B. Jensen
	E. M. Taha, Temporary
	J. E. Rodríguez, Temporary
J. J. Polak	J. de Beaufort Wijnholds
C. R. Rye	A. V. Romuâldez
	A. A. Agah, Temporary
	A. S. Jayawardena
N. Wicks	T. A. Clark
S. Zecchini	
Zhang Z.	Wang E.

L. Van Houtven, Secretary
B. J. Owen, Assistant

Also Present

IBRD: A. Sonmez, East Asian and Pacific Regional Office. Asian Department: Tun Thin, Director; H. Neiss, Deputy Director; D. Burton, A. Singh. Exchange and Trade Relations Department: M. Guitián, Deputy Director; Y. Boutros-Ghali, H. Hino, P. Neuhaus. Fiscal Affairs Department: A. A. Tait, Deputy Director; H. Bierman, L. Muten, M. A. Wattleworth. IMF Institute: A. M. Tetangco, Jr., Participant. Legal Department: W. E. Holder, Ph. Lachman. Secretary's Department: J. W. Lang, Jr., Deputy Secretary. Treasurer's Department: J. E. Blalock. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: D. Hammann, K. A. Hansen, S. M. Hassan, H.-S. Lee, J.-C. Obame, T. Sirivedhin, M. A. Weitz. Assistants to Executive Directors: I. Angeloni, W.-R. Bengs, G. Biron, Chen J., A. K. Diaby, J. J. Dreizzen, V. Govindarajan, N. Haque, G. D. Hodgson, Z. b. Ismail, J. M. Jones, K. Murakami, E. Olsen, M. Rasyid, D. J. Robinson, M. Sarenac, A. A. Scholten, L. Tornetta.

1. PHILIPPINES - REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered the staff report on the first review under the stand-by arrangement for the Philippines, together with a proposed decision (EBS/85/109, 5/1/85; and Sup. 1, 5/24/85). They also had before them an information notice on the real effective exchange rate of the Philippine peso (EBS/85/102, 4/24/85).

The Deputy Director of the Asian Department noted that the authorities had made one additional commitment on exchange rate policy that they had not wished to include in the letter of intent. If the trade facility became operative as expected in July 1985, the remaining limits on commercial banks' foreign exchange holdings would be abolished and there would no longer be any other regulatory constraints on foreign exchange positions by the commercial banks.

Mr. Rye made the following statement:

> My Philippine authorities find the staff report accurate and the appraisal fair. They wish to make only one clarification. The staff suggestion that "weaknesses in policy implementation have emerged" ought not to be construed as indicative of lagging resolve on the part of the authorities to persevere in the path of adjustment. On the contrary, they continue to be fully committed to the objectives of the program. They have pledged themselves to remain alert to the twists and turns of adjustment and to undertake whatever measures may become necessary to keep the program on track. For this reason, they welcome this review. They regard it as an opportunity for testing their analysis of experience under the program against the Fund's more detached perceptions. My authorities appreciate the staff's candor, their very comprehensive critique, and their advice.
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> There is no need to dwell on achievements under the program: the staff has described them sufficiently in its appraisal, placing appropriate emphasis on the "significant slowdown in inflation," the substantial reduction of the external current deficit for 1984, and the abatement of foreign exchange speculation accompanied by the near-elimination of the black market. Demand management has been vigorously pursued, with the public sector deficit, particularly that of the public enterprises, closely held in check, wage policies moderated, and monetary restraint strongly applied.
>
> My authorities are satisfied, moreover, that the staff, in its report and in the flexibility with which it has approached this review, has shown recognition of the Philippine point of view

concerning the weaknesses that have emerged, e.g., the view that the emergent erosion in the exchange system and the consequent decline in export revenues during the first quarter of 1985 are not unrelated to constraints imposed by reserve money ceilings on the monetary authorities' ability to participate meaningfully and in a timely manner in the foreign exchange market. They do not disagree with the staff that some remaining rigidities in the exchange market may have contributed toward diverting the exchange rate from a course consistent with underlying economic factors. Indeed, toward addressing this problem, they have greatly eased official constraints on banks' foreign exchange positions. At the same time, they are confident that the modified reserve money ceilings afford them the maneuverability they need toward maintaining monetary restraint without preventing a moderate buildup of the Central Bank's international reserves.

Further measures toward a freer exchange system have been implemented. Effective March 19, 1985, the limits on foreign exchange holdings of commercial banks have been liberalized further by excluding their deposits with the Central Bank--up to $15 million--from the calculation of the banks' long position. All exchange restrictions introduced since October 17, 1983 have been rescinded. Effective May 24, 1985, the limit on banks' net foreign exchange positions has been relaxed further by raising the proportion allowed against regular letters of credit from 50 percent to 70 percent, and the proportion allowed against a two-month average of foreign exchange receipts from 10 percent to 30 percent. Approval procedures for service remittances have been streamlined so that applications to the Central Bank that remain necessary will be processed within three business days from completion of documentation.

There has consequently been increased activity in the foreign exchange market, with interbank transactions on and off the trading floor showing a marked uptrend. Central bank purchases from authorized agent banks have increased sharply to $309.23 million in April 1985 from $161.85 million in December 1984, $76.2 million in January 1985, $133.45 million in February, and $145.2 million in March. The Central Bank's participation in the market may be said also to have depreciated the peso/U.S. dollar exchange rate; the Central Bank midpoint rate has consistently been above the reference rate of the Bankers Association of the Philippines.

The rigidity that seems to persist in the exchange market, notwithstanding the liberalization measures taken, may be explained partly by the low level of productive activity in the economy and by the previous inventory buildup, which, in turn, were brought about by shrinking market opportunities. It is noteworthy that no notable rise has occurred in the rates prevailing in both the official and unofficial exchange markets--even though export receipts rose in April 1985 to $333 million, from $196 million in March 1985 and $299 million in December 1984.

In 1984, improvements in the external position of the Philippines exceeded original program estimates. The current account deficit was reduced to 4.5 percent of GNP, as against an original estimate of 5.2 percent. Though not as encouraging as originally projected, the balance of payments in 1985 is expected to show further substantial improvement, with the current account deficit projected to fall to 2.3 percent of GNP. As the staff reports, both the trade and current accounts in the first quarter of 1985 have been broadly in line with targets for the year, the former showing a small deficit of $35 million and the latter a slight surplus of $34 million.

The staff rightly called attention to the "less buoyant" than envisaged performance of both exports and imports in the first quarter of 1985. The prospects through the rest of the year for both are less favorable than originally projected. Prices of coconut products, which constitute the bulk of Philippine traditional exports, have declined more sharply than expected and are likely to remain depressed. Electronic exports, which have for some time led the growth of the nontraditional sector, are now also projected to fall short of program expectations. The authorities are nevertheless determined to maintain balance in the trade account during this crucial period by adjustment on the import side through firm and consistent demand management. It is becoming clear, moreover, that domestic substitutes for imports have become more attractive, particularly for the farm sector, because of higher import costs resulting from the significant devaluation of the peso since mid-1983.

The monetary authorities are increasingly confident that subsequent reserve money and liquidity targets can be met, since day-to-day monitoring of reserve money developments during the past few months has resulted in the building of a more efficient system of control and of response to adverse events. Considerable progress has also been made toward ensuring the reliability of banking system data on public credits, even as the expansion in the number of public entities covered and in the amount of detail required have rendered monitoring operations more challenging. It is true, of course, that during the first quarter of 1985, loss of depositor confidence in some financial institutions necessitated substantial central bank emergency assistance to these institutions, and revenue shortfalls compelled the National Government to withdraw a significant proportion of its deposits with the Central Bank. Aggressive open market sales of central bank instruments, however, effectively neutralized the expansionary effects of these occurrences and, even though the original performance criterion was not met, did contribute to a decline in reserve money from ₱ 34.2 billion at end-February 1985 to ₱ 32.3 billion at end-March--though not without imposing a severe strain on overall output during the period. Barring any major disruptive event, such as a bank run, reserve money performance should be well within the range specified in the revised program.

My Philippine authorities remain committed to limiting in 1985 the increase in reserve money from ₱ 34.3 billion at end-December 1984 to 15 percent in accordance with the targeted increase of about 15 percent in M-3, and consistent with growth, price, and external assumptions for the year. Reserve money levels at end-May 1985 will be limited to ₱ 33.3 billion, at end-July to ₱ 34.0 billion, and at end-September to ₱ 34.3 billion. An adjustment upward of up to ₱ 1.2 billion will be made for the May and July limits to allow for additional purchases of foreign exchange by the Central Bank that will result in an improved net international reserves position beyond program targets. The authorities intend to follow the course of reserve money levels very closely in the light of price and interest rate developments with a view particularly to maintaining real interest rates at positive levels. As the staff has noted, when measured against the annualized six-month inflation rate, interest rates are now highly positive--and have, indeed, been positive through the first quarter of 1985.

Fiscal performance in the first quarter of 1985 was in line with targets for the year as a whole. Levels of foreign financing for the deficit, however, were lower than expected prompting the Government to borrow from the domestic nonbank sector through treasury bill sales. In turn, secondary transactions in the bills market in effect transferred these to the banking sector, bringing about higher than programmed (₱ 1.2 billion versus ₱ 0.9 billion) net banking system credits to the National Government.

The number of public corporations being monitored by the office of the Prime Minister has been increased from 13 to 15. The Human Settlements Development Corporation and the National Food Authority have been added to the list.

My Philippine authorities share the concerns that the staff has expressed in its supplementary report about the 1985 funding gap of ₱ 5.0 billion of the Philippine National Bank (PNB) and the Development Bank of the Philippines (DBP). As the staff has reported, the authorities remain resolved that PNB and DBP access to central bank credit and to budgetary resources will not be allowed beyond levels specified in the program. Steps are being taken to see to it that the gaps are filled, mainly from internally generated resources and through divestment of acquired assets. The medium-term and long-term rehabilitation plans for these institutions are described more than adequately in the supplementary report. It should be added simply that whatever form the reorganization takes, the reforms envisaged will most likely result in substantial private sector involvement in the capital and management structures of these institutions. It is expected that more definite measures will be ready by the time of the second review.

I should like to assure the Board that my Philippine authorities appreciate the significance of the proposed modifications. They do not regard them as a signal for relaxing their efforts toward adjustment but rather as a challenge to their ability to achieve adjustment in a manner at once consistent and sustainable.

Extending his remarks, Mr. Rye noted that on May 20 two of the three agreements making up the commercial financing package for the Philippines had been signed. The first pertained to the provision of new financial loans of about $925 million, equivalent to approximately 7.5 percent of total commercial bank exposure in the Philippines as of October 17, 1983. Second, a revolving trade facility of about $3 billion had been set up, to become operational by late June 1985 and to be in existence through the end of 1986. New money would be disbursed according to a schedule based on drawings under the stand-by arrangement with the Fund. The third part of the financing package--the restructuring of about ₱ 6 billion of non-trade-related debt of the public and private sectors falling due in the period October 17, 1983 to December 31, 1986--remained to be agreed.

Owing to a breakdown in communications, the Philippine authorities had not received the supplement to the staff report until the previous day, Mr. Rye explained. He had been informed that the agricultural measures mentioned on the first page of Supplement 1 as having been announced but not yet given legal effect or implemented had in fact been put into effect even though the Executive Order would not be signed until June 5, 1985. A slight qualification was perhaps necessary regarding the reference on page 3 of Supplement 1 to the curtailment of the activities of the National Food Authority (NFA). Although the broad intention was to limit the price stabilization function of the NFA in future to rice and corn, the NFA would retain the capacity to intervene to stabilize the prices of wheat and flour in emergencies when the private market was unable to cope.

His authorities also wished to assure the Executive Board that the purpose of the deregulation of the fertilizer trade, to which reference was also made in Supplement 1, was to give greater emphasis to private sector activities and not directly to increase imports of fertilizers, Mr. Rye said.

There was no clear or conclusive evidence of a major divergence between export shipments and foreign exchange receipts therefrom, in the view of his authorities, who did not fully agree with the staff interpretation of the reasons for the decline in total foreign exchange receipts from exports, Mr. Rye observed. They doubted whether the speculative element had the significance attributed to it by the staff. His authorities had also asked him to note that the reference by the staff to the appreciation of the peso was to the average value of the March quarter and December quarter; there had been little or no appreciation during the first quarter--January-March--when export receipts were said by the staff to have declined by more than export shipments justified.

Mr. Fujino observed that the authorities had reversed the rapid deterioration of the Philippine economy by building on the strong and wide-ranging prior actions they had taken, including the float of the peso and the comprehensive reform of the foreign exchange system, together with tight fiscal and monetary measures. However, despite the reduction in inflation and the improvement of the external imbalances, slippages had regrettably occurred in meeting the performance criteria, and soon after approval of the stand-by arrangement drawings had been suspended. Those slippages did not necessarily indicate a weakened determination on the part of the Philippine authorities to carry out the adjustment effort, as some slippages had been caused by technical factors. The most difficult slippage to evaluate concerned the increase in bank reserves as a result of the unexpected strength of the peso in foreign exchange markets and the suspension of intervention by the Central Bank. Indeed, developments in the foreign exchange market since December 1984 had been puzzling; the balance of payments of the Philippines was in sustained deficit and the economy was undergoing significant adjustment, yet the currency had appreciated even vis-à-vis the U.S. dollar. Restrictions on foreign exchange operations might have been responsible for that appreciation, but he was not quite sure those restrictions were the primary cause.

The significant progress that had been made through the determined efforts and policy stance of the authorities included a remarkable price performance, which had however benefited somewhat from the appreciation of the peso, Mr. Fujino noted. The consumer price index had declined in April, partly in response to temporary factors. The authorities' strict control over the public sector deficit and the maintenance of tight monetary conditions had provided the necessary preconditions for the reduction in inflation. Another factor had been a successful wage policy that had led to a substantial reduction in real wages. On the external front, the current account deficit had been reduced by nearly one half in 1984 compared with 1983, and in the first quarter of 1985 the current account had been slightly in surplus. All the performance criteria relating to the external sector had been met, with the exception of the ceiling on short-term external debt. After long negotiations, the agreement between the Philippines and its creditor banks on new money and the trade facility had finally been initialed on May 20.

In view of those recent developments and the strong determination of the authorities, Mr. Fujino added, the Philippines deserved continued support by the international community; therefore, he strongly supported the proposed decision. However, the success of the program would depend critically on the perseverance of the authorities in their adjustment effort; there was no room for further slippages.

The overvaluation of the Philippine peso and the considerable erosion of the competitiveness of the export sector were a source of great concern, particularly in view of the importance of the export sector in restoring a viable and sustainable balance of payments position, which itself was the key to the success of the whole program, Mr. Fujino went on. The authorities seemed to have encountered considerable difficulties in achieving the desired depreciation of the currency. Specific measures to relax the limitations on banks' net foreign exchange positions had been taken recently, in line with the staff's suggestions. His chair had expressed doubt, when the Executive Board had discussed the request for a stand-by arrangement (EBM/84/183 and EBM/84/184, 12/14/84), about the factors that were said to underlie the narrowness of the foreign exchange market. He was not convinced that those technical constraints on the banks were the primary cause of the insufficient functioning of the market, and he stressed the importance of closely monitoring the operation of the market. One reason for the current appreciation of the peso might be the inflow of capital attracted by the emergence of positive real interest rates. It would be helpful to know what additional measures the authorities could take if recent action proved insufficient. No doubt further liberalization of foreign exchange transactions would take time. Moreover, some of the existing regulations might be justifiable under present circumstances. One idea that might be worth considering would be to adjust the performance criterion on the increase of reserve money, at the time of the next review, so that the authorities would have more flexibility to deal with the impact of the currency appreciation. Due consideration would have to be given to the prevailing rate of inflation.

Strict control of the public sector deficit was imperative to maintain financial stability and to bring down inflation, Mr. Fujino considered. It was disturbing to note that the brunt of fiscal adjustment had fallen on new investment--which had been scaled down in relation to GDP--and on the maintenance of capital stock, both of which were vital for future economic development. According to the highly informative World Bank assessment, the level of investment and maintenance in terms of GNP was very low compared with the past record. That might be tolerable in the present phase of adjustment, but the authorities would have to mobilize domestic resources to ensure the sustained growth of the economy in the longer term.

Further efforts would have to be made to strengthen tax collection under the existing system, Mr. Fujino added. Also, the tax system would have to be modified to raise the elasticity of tax revenue by shifting from the present trade-oriented system to a more broadly based domestic tax base. He looked forward to the completion of the comprehensive review of the tax system to be undertaken with Fund-Bank assistance. He also urged the authorities to expedite the implementation of the tax reform that was under way. The budget target in the new program no longer contained an explicit safety margin, in the form of the revenue contingency incorporated in the original program, and more intensified efforts would be necessary to avoid fiscal slippages.

The operating deficits of public corporations and public financial institutions were the main source of the overall fiscal deficit, and further efforts must be made to reduce them, Mr. Fujino observed. The operating deficit of the public sector was more or less a reflection of the proliferation of earlier inappropriate investment decisions. That was particularly true of the public financial institutions, which had a significant proportion of bad debts in their current portfolios. New investment, which determined the future growth potential of the economy, was being shackled by those uneconomical investment decisions of the past, a situation that should not be allowed to recur in coming years. In more specific industrial sectors, including the coconut and sugar industries, the rationalization of the distribution system should be actively promoted and the price system improved to increase efficiency.

It would be essential to maintain a tight monetary policy in order to reduce inflation, as there was a risk of price increases materializing should the peso begin to depreciate, Mr. Fujino remarked. In that connection, the fragility of the financial system in the Philippines was a cause for concern. Some loan accounts of the banks had become nonperforming as a result of austerity measures; withdrawals of deposits mounted from time to time as depositors became suspicious of the solvency of the institutions. In the circumstances, it was to some extent understandable that the Central Bank felt obliged to embark on rescue operations for some of the financial institutions that had come under attack. However, the need to maintain confidence in the system should be carefully weighed against the danger of excess liquidity that such rescue operations entailed. A more structural and basic strengthening of the banking system might be needed.

Mr. Taha considered that the adjustment strategy of the Philippines was sound. To achieve its main objectives--the reduction of the external imbalance and domestic inflation to sustainable levels--far-reaching financial and structural measures had been implemented and others were planned. It was encouraging that the Philippines had recently concluded a financing arrangement with its main commercial creditors.

The policies under the program should be adequate to restore domestic and external equilibrium, but only if they were strictly adhered to, Mr. Taha noted. The nonobservance of performance criteria at end-December and again at end-March reflected an unfortunate loss of momentum in adjustment which he hoped could be quickly overcome. He urged the authorities to get the program back on track and to implement a consistent set of policies to that end. It was reassuring to learn from Mr. Rye that his authorities continued to be fully committed to adjustment.

The gains made in reducing inflation had far exceeded expectations, notwithstanding the deregulation of prices, Mr. Taha remarked. The authorities should continue their efforts to reduce inflation further in the period ahead.

To ensure that the revenue targets were met and that tight control was maintained on expenditure, outlays within the program limit should be directed toward the most efficient projects, presumably in the framework of the public investment program that had been worked out in consultation with the World Bank, Mr. Taha said. The restrained fiscal stance should be reinforced by a tight monetary policy. Success in carrying out firm demand management policies together with incomes and wage restraint, should enhance exchange rate stability and export competitiveness.

Export growth had been slower than expected, partly because the authorities' felxible exchange rate strategy had been constrained by market rigidities, Mr. Taha commented. As Mr. Rye had put it, the outcome might not be unrelated to the constraints imposed by some of the program ceilings. It was therefore encouraging that steps had recently been taken to improve the responsiveness of the exchange rate to market forces. He would appreciate any further comments by the staff on the adequacy of the measures taken to restore and maintain export competitiveness. A more responsive exchange rate, together with supportive demand policies and the gradual implementation of structural measures, should strengthen the balance of payments over the medium term.

A principal objective of the structural reforms was to mobilize domestic savings and, over time, reduce reliance on foreign borrowing, Mr. Taha noted. The rehabilitation of public corporations and their operation on a commercial basis should help in meeting that objective. The agreed structural measures in the areas of banking and tax reform should also be fully implemented. Mr. Rye's clarification of the measures relating to the agricultural sector was helpful. All those measures would help to revive economic growth once the short-term imbalances were corrected. He supported the proposed decision.

Mr. Goos said that he had been glad to note that the Philippine program was largely on track and that recent adjustment efforts had already produced encouraging results. Although the failure to meet a number of performance criteria for end-December 1984 and end-March 1985 was a matter of concern, it appeared to reflect largely the current extremely difficult phase of adjustment, as shown by the figures on overall growth, production, and investment, as well as on employment in manufacturing. Nevertheless, the adjustment process had barely begun, and despite the considerable social and economic costs, there was apparently no realistic alternative to maintaining and even broadening the process, especially if deeply embedded structural deficiencies were to be tackled successfully. Both the staff's analysis of the country's economic situation and the program agreed for 1985 were appropriate.

The 1985 program appeared feasible, and once the appropriate policies were in place, it should contribute to a further stabilization of the economy, Mr. Goos continued. Although the rephasing of performance criteria relating to the program for 1985 seemed justifiable inasmuch as it had been accompanied by a corresponding postponement of purchases, he would have appreciated some justification for such a modification as opposed to other possible forms of remedial action.

The staff's view that further stabilization in the public sector must not be impaired by expenditure overruns or excessive recourse to public borrowing was fully appropriate, Mr. Goos remarked. The planned restructuring of the revenue system would be vital in that respect, and the authorities should also persevere in their efforts to strengthen further public enterprises. When the stand-by arrangement had been approved, his chair had supported the creation of a special monitoring unit under the direct responsibility of the Prime Minister, and it would be helpful if the staff could comment briefly on how well it had functioned.

The maintenance of a tight monetary policy was also critical to the program's success, Mr. Goos went on. His concern was that the Central Bank's operations to rescue insolvent banks or enterprises might again undermine monetary policy. The support recently granted to two major financial institutions should be regarded as being of an exceptional emergency nature. The programmed targets for inflation and the external accounts would only be realized if monetary policy were exclusively geared to them without being impaired by extraneous considerations. Furthermore, the stabilization and rehabilitation of private commercial banks should not be the responsibility of the Government. A greater awareness on the part of the banks of the risks of day-to-day operations--or mergers of banks--would probably provide a more efficient means of coping with the negative effects of a restrictive monetary policy on the banking system.

The pronounced decline in real growth and investment appeared to be a consequence not only of restrictive demand management policies but also of severe structural weaknesses in the economy, Mr. Goos observed. Those weaknesses were in turn being exacerbated by the real appreciation of the peso and its negative impact on the country's international competitiveness. The recent modifications to the exchange system introduced by the Central Bank should help to improve the supply of foreign exchange, thereby contributing to a better functioning of the foreign exchange market and a more realistic exchange rate.

It had been a disappointment to his chair at the time of the Executive Board's approval of the stand-by arrangement that it had not been possible to abolish the sugar and coconut monopolies, Mr. Goos recalled. Yet there seemed to be considerable scope for freeing resources in those sectors to promote private activity and for concentrating available resources on efficient investment projects. The authorities should explore using that scope in collaboration with the World Bank.

There were compelling reasons for the authorities to persevere in their adjustment effort, Mr. Goos concluded. The continuing heavy burden of external debt servicing and the need at the same time to ensure that banks and other creditors were willing to provide further financial assistance in the future made continued adherence to the program targets of critical importance. Consideration might have to be given to reducing the amount of Fund assistance provided under the arrangement if the program were interrupted again.

Mr. Schneider stated that he supported the proposed decision. As he had mentioned when the Executive Board had considered the request of the Philippines for a stand-by arrangement (EBM/84/183 and EBM/84/184, 12/14/84), the success of the rather ambitious program envisaged at that time would depend mainly on the determination of the Government to continue its stabilization effort and to implement the policy measures under the program. There had been some positive results, especially in respect of inflation and the fiscal and external deficits. The supplement to the staff report confirmed that significant progress had been made in regaining control over inflation; by the end of April, the 12-month rate had declined to 37 percent. Those results were encouraging, because they had not been accomplished without considerable social and economic costs, mainly in the form of recession and unemployment. It was nevertheless a matter of concern that some slippages in the adjustment process had occurred around the beginning of 1985 so that certain performance criteria had not been met at the end of 1984 and at the end of March 1985. The policies for the remainder of 1985 therefore aimed at correcting weaknesses in the implementation of the policies recommended in the framework of the adjustment program. The measures already announced seemed to be directed at those weaknesses.

Monetary and exchange rate policies were closely interrelated, Mr. Schneider remarked. As he had stressed when the Executive Board had discussed the request for a stand-by arrangement, there was a trade-off between the need to control inflation and the more fundamental necessity to dismantle remaining rigidities in the exchange rate system and bring the exchange rate to an appropriate level. At that time, he had believed that priority should be given to adopting a full floating rate system for the integrated exchange rate market. When the authorities had found themselves faced with an unexpected inflow of foreign currencies, their failure to dismantle the remaining rigidities in the system, namely, the limits on the net foreign exchange positions of the banks, had exacerbated the conflict between the dual objectives of controlling inflation and achieving an appropriate exchange rate. The Central Bank's decision to suspend its exchange market intervention designed to constrain the growth of domestic liquidity had brought about an appreciation of the peso. Thus, although the authorities had put themselves in a position to meet the performance criterion on reserve money and to reach the inflation target, the prospects for an improvement in the trade balance in 1985 had been undermined.

Government revenue from trade transactions had also been reduced and spending cuts had been required to keep the fiscal deficit within the program targets, Mr. Schneider continued. To avoid a recurrence of such difficulties, the limits on the foreign exchange positions of banks had recently been reduced, thereby making it easier to improve the functioning of the exchange rate system and to move in the direction of a more appropriate exchange rate, while maintaining tight monetary and fiscal policies. The effectiveness of fiscal policy would certainly be increased under the new approach to controlling the public sector deficit, namely, by monitoring the national government and public sector borrowing requirements.

However, more direct exchange rate action might be a faster way of restoring the competitiveness lost through the rather sizable appreciation of the peso. Given the depressed international demand for Philippine exports, such action would be a way of ensuring that the trade balance improved in line with the projections for 1985.

The close collaboration of the Fund and Bank staff including the participation of a Bank staff member in the Fund mission and the design of complementary programs by the institutions, could not fail to be seized by the authorities as evidence of the strong commitment of both institutions to assist the Philippines in solving its structural difficulties and finding the path to a sound recovery, Mr. Schneider observed. The authorities had already taken the first steps in such key areas as tax reform, the reorientation of public investments, the rehabilitation of public financial institutions, and the promotion of the agricultural sector. The announcement of measures intended to increase the role of the private sector in agriculture and to improve the mobilization of public sector revenues were especially welcome. However, additional steps would have to be taken to strengthen the position of the authorities vis-à-vis the entire financial community so that those structural weaknesses could be tackled. He therefore urged the authorities to implement without further delay all the envisaged tax measures and to complete the study, undertaken jointly with the World Bank, of a more thoroughgoing tax reform, thereby permitting its early implementation. Similarly, in view of the large impact of the deficits of public financial institutions on the economy, he urged the authorities and the World Bank to proceed quickly with the rehabilitation programs planned for those institutions.

Finally, Mr. Schneider said, he endorsed the staff conclusion that, although some major adjustment steps had been taken, the process of reform would be a long one calling for determination in the formulation and implementation of policies. He hoped that the authorities were fully aware that the sustained recovery of their economy would depend critically on their success in completing the agenda for reform.

Mr. Jaafar commented that the Philippine authorities had made significant progress since 1983 when they had embarked on the stabilization program leading to the current stand-by arrangement. The reform of the exchange system was among the most important achievements. The progress that had been made within a relatively short period was remarkable, especially as the Philippines had experienced a massive capital outflow and related problems in the external sector in 1983. The swift move to re-establish a single foreign exchange market for the peso had been commendable. The commitment to let the peso float in accordance with the dictates of market forces was the essential principle of the reform that the authorities should uphold, thereby ensuring that Philippine exports remained competitive in the international market. To achieve that objective, the authorities should try to avoid aberrations in the value of the peso against the U.S. dollar, such as the one that had occurred at the beginning of 1985 when the peso had appreciated against the dollar when most other currencies had depreciated against it. That unsatisfactory development could not be wholly attributed to the regulatory and behavioral factors mentioned by the staff. He was more inclined to believe that the restrictions on the foreign exchange positions of commercial banks, with the Central Bank being the sole buyer of foreign exchange, was the major factor, and one that could be remedied. It would be helpful to have the staff appraisal of the latest steps being taken by the authorities to ease the remaining restrictions on commercial banks' foreign exchange positions.

The comprehensive tax measures introduced in 1984, which had received the endorsement of the Executive Board when it had approved the stand-by arrangement, had indeed been of significant help in strengthening the Government's revenue position, Mr. Jaafar stated. Of course, the objective of reducing reliance on indirect as opposed to direct taxation should remain. The poor performance of exports across a broad spectrum of commodities and manufactured products was cause for serious concern in terms of the objective of reducing the fiscal deficit to a more sustainable level. For that reason, and because of the high debt burden, the expenditure program should be reviewed and only those projects that offered the best return should be continued. The involvement of the World Bank in the evaluation of projects was thus most welcome.

The need to improve the supply or structural side of the economy had been stressed by his chair, among others, during the Executive Board's discussion of the request for the stand-by arrangement, Mr. Jaafar recalled. Yet no real progress was being made in rehabilitating public financial institutions or in the reform of the agricultural sector. Weaknesses in the policies formulated to reform the sugar industry had not only permitted the continuation of a tightly regulated industry but had allowed the domestic trading monopoly in sugar to be reinstated, with domestic consumers subsidizing producers through a higher domestic retail price. The process of reform was of necessity long term in nature, but the emergence of a trading monopoly within four months of the adoption of the adjustment program was unfortunate. He urged the authorities to take further remedial measures. The reform of the public financial institutions had also proceeded unsatisfactorily, taking the shape of ad hoc responses to funding constraints and a number of other uncertainties that continued to affect the cash flow projections of those institutions. He urged the authorities to prepare an immediate agenda for the reform of the public financial institutions within a realistic medium-term framework; further delay would inevitably affect the orderly management of budgetary and monetary policies. He looked forward to a more complete review of progress in those respects when the Executive Board discussed the staff report for the 1985 Article IV consultation.

Perseverance with the current program was essential if adjustment in the real sense was to be achieved, Mr. Jaafar considered. It was disappointing that some of the targets had not been met, perhaps partly for technical reasons. He had been reassured by the statement in the joint letter from the Prime Minister and Minister of Finance and the Governor of the Central Bank of the Philippines of their continued commitment and readiness to take additional appropriate measures if necessary to achieve the objectives of the program. He could therefore support the proposed decision.

Mr. Joyce observed that the Philippine authorities had made some welcome progress toward external and domestic adjustment in 1984 and early 1985, despite the uneven implementation of the policy measures under the stand-by arrangement and the failure to meet certain performance criteria for December 1984 and March 1985. At the same time, the importance of the slippages that had occurred should not be underestimated. Strong remedial action was required to set the program back on track, as the authorities themselves recognized. Nevertheless, important progress had been made in stabilizing the foreign exchange market, reducing inflation, and strengthening the external account. The signing of the commercial bank financing package and the reduction of external arrears on schedule were also welcome. Those developments suggested that the program was still viable, that the momentum of adjustment could be re-established, and that the Fund's continued support was justified.

A more efficient foreign exchange market and a more appropriate value for the peso should be the cornerstone of the economic program for 1985, Mr. Joyce continued. The appreciation of the peso had hurt competitiveness and could lead to a re-emergence of speculative pressures. The foreign exchange market remained narrow and the periodic withdrawal of the Central Bank from that market had been a major factor in the peso's appreciation. The Central Bank's commitment to maintaining its presence in the market should be helpful, as should the intention to reduce the regulatory restraints on commercial banks alongside the reduction and removal of other trade and exchange restrictions.

The current account deficit was projected to be reduced further from 4.1 percent of GDP in 1984 to 2.3 percent of GDP in 1985, Mr. Joyce noted. However, that did not mean that the adjustment effort could be slackened since the projected improvement generally reflected more favorable expectations for international interest rates and for the services account. The trade account remained weak, and even if the Philippines regained the export competitiveness lost in the first quarter, nontraditional exports would have to increase their share of world markets if the already reduced export growth target in 1985 was to be met. Moreover, the expected recovery of real output in the second half of 1985 might put greater pressure on imports. The outlook for such traditional exports as sugar and cocoa was not promising and further structural reform of those sectors would be needed in line with the World Bank's recommendations on producer and output incentives. The authorities might wish to consider adopting a schedule for phasing out the domestic sugar trading monopoly. No new medium-term balance of payments scenario had been included in the staff report, and he asked the staff whether it expected any significant change from its most recent projections for 1986 and beyond.

Significant progress had been made in reducing inflation, although owing in part to the appreciation of the peso and to reductions in key administered prices, Mr. Joyce observed. He asked the staff whether that downward adjustment in administered prices had been advisable. The need to reverse the peso's appreciation would require further reductions in the inflation rate and greater control over the growth of reserve money, which had shown serious slippages in 1984 and early 1985. The recent increase in open market activities to contain monetary expansion had been facilitated by the significant growth in the volume of treasury bills outstanding. The authorities' commitment to a more disciplined monetary policy during the rest of 1985, with the responsibility for that policy being concentrated more on the Central Bank, was welcome, as was the amendment to the program permitting some flexibility in reserve money targets to give the Central Bank leeway for higher than programmed increases in international reserves.

Fiscal policy overall had been restrictive, despite revenue shortfalls, and must remain so especially in view of the increase in budgetary expenditures associated with the National Government's obligation to honor maturing guarantees extended previously by public financial institutions, Mr. Joyce continued. Efforts to restrain public spending had focused on reducing capital and maintenance expenditures. While unprofitable investments--both public and private--had been an important factor contributing to current financial difficulties, the World Bank apparently considered that the investment program for 1985 was generally appropriate and that any further reduction in capital and maintenance expenditures would be undesirable. Therefore, although he supported the planned increase in maintenance expenditures, the National Government and public enterprises would have to generate sufficient revenue to finance both capital and maintenance outlays. Slippages in meeting revenue targets had already occurred in 1985--for instance, some previously removed exemptions had been partially reinstated--and he asked the staff whether those slippages threatened the fiscal target and what additional measures might be considered in the comprehensive review of the tax system that was under way.

Fortunately, some effort had been made to reduce the drain of public enterprises and public financial institutions, on the Treasury in particular, Mr. Joyce commented. However, he agreed with the staff that those efforts to date had been largely ad hoc, and he urged the authorities to prepare a realistic and comprehensive plan for the rehabilitation of those institutions over the medium term.

Finally, Mr. Joyce said, he was pleased with the ability of the Fund and Bank staff to work together effectively in a country where structural reform was at least as important as demand management. The World Bank's analysis of the investment program was a useful contribution to the Fund staff report, and he looked forward to more such contributions from the World Bank. The adjustment effort in the Philippines could be sustained and bear fruit, despite the slippages that had occurred. Therefore, he supported the proposed decision.

Mr. Wicks stated that he could support the proposed decision. The program had got off to a somewhat difficult start, partly for reasons outside the authorities' control but also because of slippages in policy implementation. But there was no doubt that progress was being made, notably in reducing inflation. He had been encouraged by the staff assessment that "the further adjustment programmed for 1985 appears feasible, but it will require that the authorities persevere in their policy implementation." The second half of 1985 was indeed likely to prove no easier than the first, and the full commitment by the authorities to what was of necessity a rigorous program would be crucial if it were to be put into effect successfully.

The recent appreciation of the exchange rate, accompanied by a poor export performance in the first quarter of the year, was a prime concern, Mr. Wicks considered. The reasons for that appreciation were difficult to understand. Presumably, since the black market rate was close to the official rate, underlying demand was being equilibrated with supply. Perhaps the supply of foreign exchange had been artificially large, due to a combination of unprogrammed short-term borrowing and a rundown in central bank gross reserves since December, combined with the restrictions on commercial banks' net foreign asset holdings that had apparently forced the banks to become involuntary suppliers of foreign exchange to the markets. Equally, the relatively tight monetary policy would have induced capital inflows and dampened demand, although it was puzzling that the exchange rate had continued to appreciate when monetary policy had been relaxed at the turn of the year. Any light that the staff or Mr. Rye could shed on the matter would be helpful.

Whatever the underlying reason for the appreciation, it was clearly important for the Philippines that the exchange rate ensured adequate external competitiveness, Mr. Wicks added. The reduction in exports in the first quarter of 1985 and the reluctance of exporters to repatriate foreign exchange earnings, despite high domestic real interest rates, suggested that the exchange rate was not adequate at the moment and that there was a need for the closest possible monitoring of future developments and possibly further measures beyond those reported by the Deputy Director of the Asian Department.

It was encouraging that efforts to improve control of the parastatals continued, including in particular the addition of the Human Settlements Development Corporation to the group of corporations subject to close monitoring, Mr. Wicks said. Nevertheless, some 300 other parastatals continued to enjoy almost total autonomy with often overlapping and conflicting responsibilities; further efforts in that area were thus needed. The importance of the monitoring unit in the Prime Minister's office deserved re-emphasis, but unfortunately, there were indications that it had not been effective so far. He doubted whether the unit could be effectual until it was given some power to control, rather than to monitor, the spending of the parastatals, and he asked the staff or Mr. Rye what measures might be taken to strengthen the unit.

The World Bank staff's assessment of the investment program had been very helpful to the Executive Board, Mr. Wicks considered. He attached special significance to three aspects of the assessment. First, he shared the concern about the low level of capital expenditures in the budget and underlined the view that further reductions could seriously limit the pace of economic recovery. Some priority needed to be given in future years to capital expenditures, within the constraints of macroeconomic policy generally. Second, new investment must be sound. It was worrying that some of the projects under consideration, such as the copper fabrication plant and the coal development project, seemed of only low investment priority. It would be a tragedy if the authorities were to waste national resources as they had in the past. Finally, and of most concern to him, was the enormous decline in maintenance expenditures for existing plants. The highest priority must be given in future years to allocating resources to maintain existing capital stock.

The need to find resources for financing capital expenditures underlined the importance of increasing revenue, Mr. Wicks commented. The slippages reported in the adoption of both individual measures and the timetable for the tax reform were unfortunate, and he encouraged the authorities to push ahead as quickly as possible.

The position of the financial institutions, especially the Philippine National Bank and the Development Bank of the Philippines, remained a serious concern and a threat to the program for the rest of the year, Mr. Wicks remarked. Like the staff, he underlined the importance of establishing medium-term rehabilitation programs for those banks as soon as possible. On a technical point, he wondered why a limit was set in the program for central bank credit to the Philippine National Bank but not for the Development Bank of the Philippines as well.

Finally, Mr. Wicks observed that the emphasis in the current program on structural measures was gratifying. Great persistence and a commitment to structural reform would be necessary if the distortions created in past years were to be corrected. The measures in the coconut and sugar sectors were an encouraging first step, and he looked forward to further such measures.

Mr. Zhang commented that the overall performance of the Philippines under its adjustment program in 1984 and the first few months of 1985 showed some striking and welcome progress, as indicated by the trends of a number of key variables. Both government expenditures and the external current account deficit for 1984 had been reduced substantially. The significant slowdown in the rate of inflation, which had begun in the latter part of 1984, was continuing into 1985. At the same time, the authorities had also taken several major policy measures in a determined effort to correct structural imbalances in the economy. However, the achievements had been obtained at great economic and social cost. In 1984, real output had declined, unemployment in the industrial sector had risen considerably, and net investment had fallen by one third. While deflation of that magnitude might have been inevitable in the initial stages of adjustment, it was essential that the orientation of Fund-supported programs should in future be shifted gradually toward the attainment of economic recovery and growth together with external balance.

The nonobservance of the performance criteria on short-term external borrowing, as well as three other monetary targets, did not seem to reflect fundamental slippages in the implementation of the adjustment program, Mr. Zhang considered. In fact, both monetary and fiscal policies had remained highly restrictive on the whole, and since March 1985 the authorities had intensified their effort to sterilize the substantial increase in net international reserves. He could accept the modification of the relevant performance criteria and he supported the proposed decision.

Mr. Hospedales noted that the adjustment of the Philippine economy had yielded considerable results in important areas, although the experience had been difficult and painful. The attempt to adjust the economy to lower income and wealth levels provided a classic example of the potential risks and costs of postponing adjustment and of relying heavily on external borrowing to maintain a strategy of growth in the face of a massive deterioration in the terms of trade. The Philippine experience thus called into question the appropriateness of such adjustment programs for achieving internal and external balance as a way of reaching a stable and sustainable growth path.

The Philippines had suffered severe external shocks in the past decade in the form of declining terms of trade and increasing world interest rates, Mr. Hospedales continued. The strategy of external borrowing to finance growth had led to massive debt accumulation. With the reduced inflow of resources following the debt crisis, a comprehensive and consistent adjustment program had become inevitable. There was no doubt that considerable progress had already been made: the current account of the balance of payments had been strengthened; wage and inflation control had been impressive and in line with program targets; and public finances had improved. But despite those gains, there had been significant reductions in output and employment, and in savings and investment; the recovery would take a number of years and would depend crucially on the choice of an appropriate mix of policies and, most important, on the determination of the Philippine authorities to carry them out.

As a prolonged user of Fund resources--having had eight arrangements in support of programs since 1974--the Philippines must put its economy onto a sustainable growth path as early as possible, Mr. Hospedales stated. The deep economic recession must not be allowed to continue. For that reason, an appropriate balance must be struck between adjustment and financing in the context of the structural nature of the country's problems and the corresponding need for strong adjustment efforts. An indispensable first requirement was the early implementation of the financial package of debt restructuring, new financial loans, and a revolving trade facility. In that respect, he welcomed the information provided by Mr. Rye.

The recent strengthening of the program suggested that the deviations from the performance criteria for end-December 1984 and end-March 1985 had not warranted a substantial disruption in financing, Mr. Hospedales noted, since the thrust of the adjustment effort was in the right direction, reflecting the determination of the authorities to keep the program on track. In any event, the design of the program might have been deficient, as it was based upon a multiplicity of performance criteria, especially when those of the Fund were added to those imposed under the World Bank structural adjustment loans. Nevertheless, it was incumbent on the Philippine authorities to take further steps to improve the policy environment. The ratio of domestic savings to GNP, which had fallen by 5 percentage points in 1984, must be increased to replace in part the resources available from external borrowing. It was unfortunate that the authorities had found it necessary to relax their tight monetary policies in 1984, leading to the infringement of certain performance criteria. To maintain the favorable inflation trend and a positive real interest rate, the need for a tight monetary policy could not be overemphasized. It would be a difficult task but the benefits would be substantial, especially the effects on the allocation of resources.

The program was most vulnerable to developments in the external sector, Mr. Hospedales continued. The prospects for medium-term recovery were precarious and depended on increased exports, import substitution, and lower world market interest rates. Given the present availability of financing and the continued compression of imports, growth would be severely constrained for a long time if policies were not strengthened to improve the competitiveness of the economy and redirect resources to export and import substituting sectors. The Philippine authorities must direct their efforts to that area as a matter of urgency. The evolution of the exchange rate provided evidence that substantial progress had been made in achieving a more realistic market-determined exchange rate. To preserve the gains that had been made in that respect, it would be essential for the authorities not only to follow an adequate pay restraint policy but to improve further efficient and flexible functioning of the foreign exchange market. Unless an interbank market, with active participation of the Central Bank, could be developed, the redirection of resources would be severely constrained and export growth curtailed. For that reason, he welcomed the announcement of policy changes to remove any remaining impediments.

Nevertheless, he was not satisfied that the conditions for the simultaneous pursuit of internal and external balance were being created, Mr. Hospedales remarked. The tight monetary policy had resulted in high positive interest rates that had contributed to increased capital inflows and resulted in the recent appreciation of the Philippine currency. Thus, the achievement of external balance had been frustrated. The staff might wish to comment on the steps taken by the Philippine authorities to ensure that the trend in the exchange rate was corrected without loosening domestic monetary conditions. The wide array of performance criteria seemed to be impeding orderly adjustment, which was a key condition for the implementation of any program.

Finally, the efforts of the authorities to tackle the structural problems of the Philippine economy would be important in achieving a more efficient use of resources and realizing the potential long-run capacity for output, Mr. Hospedales noted. More effective revenue policies were needed, including the implementation of domestic-based taxes and long-run tax reform, as recommended by the staff. The policy reforms under the companion World Bank structural adjustment loans would serve as a major underpinning for the program, although he cautioned against attempts to impose cross-conditionality between the two institutions. He supported the proposed decision.

Mr. Wijnholds commented that progress had certainly been made in the Philippine economy, particularly in reducing inflation and the external account deficit, but clearly there was still much more to be done. He welcomed the efforts by the staff and the authorities to get the program on track again but could not help feeling that slippages might reoccur. Although unexpected developments could be said to have contributed to the failure to meet certain performance criteria, he doubted that that was so with respect to the breach of the short-term debt ceilings. The larger than foreseen short-term borrowing had had an effect on the demand for foreign exchange, which had been lower than expected, thereby contributing to the unexpected appreciation of the peso.

He was pleased that the financing gap estimated for 1985 was in line with the original program assumptions, although that result was mainly due to lower interest payments, Mr. Wijnholds noted. The fall in international interest rates had nearly offset the unfavorable impact of both lower than projected exports and the repayment of short-term oil credits. With the agreement between the Philippines and the banks having been signed, after what seemed to have been unusually difficult and lengthy negotiations, the needed financing had been secured for 1985 and the necessary rebuilding of gross reserves could take place.

Several explanations had been given for the mystifying appreciation of the peso, Mr. Wijnholds remarked, with the authorities pointing to capital inflows in response to tight monetary conditions and higher real rates of interest, and the difficulties of sterilizing such inflows. The staff seemed to put more emphasis on institutional problems affecting the functioning of the foreign exchange market apart from the recourse to short-term borrowing. He hoped that the staff would be proved right in its relatively optimistic statement that certain institutional changes were expected to revitalize the foreign exchange market and result in a lower rate for the peso, thereby strengthening exports. The measures that Mr. Rye had enumerated as having been taken indicated an earnest desire by the authorities to solve the problem of rigidities in the foreign exchange market. A more realistic exchange rate was of obvious importance in view of the disappointing performance of exports. There was also the question of the extent to which the appreciation of the peso had contributed to the lowering of inflation.

While he could support the proposed decision, Mr. Wijnholds concluded, further determined and sustained adjustment efforts would have to be made by the Philippine authorities if the revised program were to be kept on track and a more lasting economic recovery achieved.

Mr. Zecchini observed that the economic adjustment effort of the Philippines was continuing and that major policy action and structural reforms had been or were being implemented. All the major elements of the strategy envisaged when the Executive Board had approved the arrangement in support of the program had been covered by such action, including the exchange system, the tax administration, agricultural prices, and the finances of public enterprises. In addition, monetary and incomes policies were broadly consistent with the adjustment effort. Undoubtedly, the adaptation to the new policies had led to some difficulties, as shown for instance by the reduction in exports in the first quarter of 1985, and certain slippages in policy implementation had emerged. However, broadly speaking, the adjustment effort deserved continued Fund support.

The difficult external position of the Philippines and the ensuing necessity to generate the largest possible inflow of foreign exchange meant that exchange rate developments would be of critical importance during the remainder of the program period, Mr. Zecchini noted. The exchange rate had been appreciating in real terms since the inception of the float, particularly when the monetary authorities had abstained from intervening in the market. Although the appreciation could be interpreted as a sign of restoration of market confidence, it nonetheless entailed an unwarranted loss of competitiveness in export products that must be prevented at the present stage. Competitiveness abroad would have to be maintained either through market intervention or through an enlargement of the market by allowing commercial banks to operate in it on a larger scale.

It had been suggested by the staff that the difficulties the authorities had been experiencing in sterilizing the effects of foreign exchange intervention might have made them reluctant to intervene more extensively, Mr. Zecchini remarked. That reaction would be unfortunate as use of the exchange rate instrument could have led to the attainment of both the desired exchange rate developments and the badly needed flow of reserves into the Central Bank. The obstacles preventing that desirable outcome could be overcome if the authorities were in a position to carry out domestic open market operations on a wider scale, thereby limiting the effects of balance of payment developments on domestic liquidity. The larger amounts of treasury and central bank bonds in the hands of the public at present might well have created the market conditions that would permit greater use of exchange rate instruments in the future; he asked what scope the authorities and the staff saw for greater recourse to open market operations in conjunction with foreign exchange intervention.

Another possible way of reducing the pressure on the exchange rate might consist of enlarging the size of the exchange market itself, Mr. Zecchini added. Allowing commercial banks to hold greater amounts of foreign exchange should reduce the flow of reserves into the Central Bank and lessen the upward pressure on the peso. By gradually relaxing the limits on foreign exchange holdings by banks, the authorities seemed to favor that course of action, which was not however without costs or shortcomings. First, it might not be desirable to reduce the flow of foreign exchange toward the Central Bank because that inevitably reduced the control that could be exerted over foreign exchange resources. Second, larger commercial bank holdings would not necessarily stabilize the market or, as the staff had put it, "improve the operation of the float." The banks would have greater flexibility to operate in the market but the effects on exchange rate developments and on the broader objectives of the program remained an open question.

Mr. Yao noted that substantial progress had been made toward the restoration of internal and external balance in the Philippine economy despite slippages under the 1984 economic and financial program. The revised 1985 program was indicative of the authorities' resolve to tackle the underlying weaknesses leading to those slippages and consequently warranted the Fund's continued financial support.

Restrictive demand management policies had been implemented under the 1984 financial program, Mr. Yao recalled. As a result, inflationary pressures had subsided, the differential between the exchange rates for the peso on the black and the official markets had been narrowed substantially, and the outflow of capital had been reversed. Furthermore, the budget deficit had been reduced more than envisaged under the program, and the external current account deficit was slightly less than originally projected.

While those achievements were commendable, the authorities could make further progress toward financial stability if they paid closer attention to the public nonfinancial enterprises and the government financial institutions whose weak financial situations were adversely affecting monetary and fiscal objectives, Mr. Yao observed. Although the deficit of the 13 major nonfinancial institutions had been lower in 1984 than envisaged under the program, national government financing of the deficit had been 26.7 percent higher than programmed due to a shortfall in foreign financing. In response to the pressure on central government finances, the authorities had taken a step in the right direction by monitoring the activities of the state enterprises as well as by increasing the number of state enterprises to be monitored. However, further measures were urgently needed.

The performance of the public financial institutions was critical to the Government's ability to meet the budgetary and monetary performance criteria under the program, Mr. Yao added. In 1984, and again in March 1985, the ceilings on reserve money had not been met largely because the Central Bank had intervened to prevent a run on the deposits of those institutions. The public financial sector played a key role in the adjustment process, and he had therefore noted with satisfaction the Monetary Board's decision to set up a committee to undertake a thorough study and formulate a rehabilitation program for the sector. He hoped that the review would be initiated soon and completed expeditiously so that appropriate action could be taken.

The progress made toward narrowing imbalances in the Philippine economy should be followed up by further determined adjustment efforts to set the stage for financially sustainable growth, Mr. Yao concluded. He supported the proposed decision.

Mr. Mtei remarked that the review under the stand-by arrangement offered some assurance that the economic policies of the Philippines were beginning to have a positive impact on the performance of the economy. The imbalance in the external account had narrowed considerably in 1984, and on the domestic front, inflation had subsided. There had also been a slight reduction in the budget deficit relative to GDP, and monetary policy had remained greatly supportive of the balance of payments and price targets. The projections for 1985 indicated that the authorities intended to continue the adjustment process. That development was welcome in light of the concern expressed by a number of Directors when the Executive Board had approved the stand-by arrangement in December 1984 over the fact that the Philippines had become a prolonged user of Fund resources. Inevitably, the significant structural imbalances in the economy could be tackled successfully only over an extended period of time, and sights had to be set beyond the short term even though the program was for only 18 months.

He regretted that the Philippines had been able to make only one purchase since the stand-by arrangement had been approved because performance criteria for the end of December 1984 and the end of March 1985 had not been met, Mr. Mtei added. However, the staff had been helpful in proposing a rephasing of purchases that would enable the Philippines to draw the entire amount approved in December in five equal drawings. The considerations underlying the staff proposal were of particular interest to him, especially as some countries had experienced a reduction in their access to Fund resources under an arrangement when problems had prevented them from making purchases according to the original timetable; Malawi was a case in point.

Financial adjustments in 1984 had exacted a heavy toll on the economy, Mr. Mtei noted. After registering marginal growth in 1983, real GDP had declined by 5 1/2 percentage points in 1984, with serious consequences for employment in the economy as a whole and in the manufacturing sector in particular. Meanwhile, the outlook for 1985 was not encouraging because output in real terms was expected to remain stagnant. The situation was clearly untenable and adjustment policies would have to pay greater attention to economic growth in order to achieve stable equilibrium in the longer term.

There had been an obvious substantial decline in real terms in public sector investment expenditures, Mr. Mtei observed. The authorities should not ignore the warning by the World Bank in its assessment of the public sector investment program that "the current level is low by historical standards, and appears to be below the level necessary in the long run to sustain an economic recovery." In addition, if the substantial decline in maintenance and operating expenditures were to continue, the existing capital stock would deteriorate rapidly. Those developments suggested that steps should be taken to increase the mobilization of domestic resources, which was low for a country at the stage of development attained by the Philippines. Government revenue was projected to be equivalent to only 11 percent of GNP for 1985, and priority should be given to reforming the tax system. He was pleased to note that the authorities were moving in that direction, and he would be interested in comments by the staff on the status of the comprehensive tax review that should be under way with assistance from the World Bank and the Fund. It was also important that efforts aimed at improving the financial position of the public enterprises be continued.

The supplement to the staff report indicated that the liberalization of the exchange system was continuing and that further action was expected that should improve incentives to productivity in the agricultural sector, Mr. Mtei said. However, the supplement also drew attention to two possible areas of concern. First, the likelihood of a shortfall in exports would affect the country's ability to service its external debt. Second, delays in the disbursement of foreign loans had resulted in higher domestic financing than programmed for the first quarter of 1985; the authorities should establish a method of operation with foreign partners that would ensure timely disbursements.

Mr. Templeman stated that the Philippines and the Fund both had an important stake in the success of the Philippine program. Having had eight arrangements with the Fund since the beginning of 1974, the Philippines was a prolonged user of Fund resources. Outstanding obligations to the Fund were already high and were scheduled to exceed 207 percent of quota at the end of the present stand-by arrangement. Success in the case of the Philippines must encompass both additional macroeconomic adjustment and significant structural change since it had become apparent that sustainable growth and financial stability could be achieved only if certain fundamental structural and institutional reforms that had been dealt with inadequately in past years were overcome. For those reasons, he regretted especially that, after a prolonged and difficult negotiation on the arrangement, the Philippines had already missed a number of performance criteria both for end-December 1984 and for end-March 1985. It was true that the slippages were not particularly large but they tended to undercut the credibility of the program. Nonetheless, he could agree to the proposed modifications in the stand-by arrangement, including the introduction of some new end-May performance criteria and the stretching out of the remaining drawings. However, his continued support assumed a strengthening of financial policies and a more rapid implementation of structural reforms.

A wide array of proposed structural reforms demanded close attention, such as tax and tariff reform, strengthening of the public enterprise sector, rehabilitation of the public financial institutions, the reorientation of public investment, and agricultural reforms, particularly in the sugar and coconut sectors, Mr. Templeman continued. The World Bank was playing a crucial role in several of those areas. His own Government was working closely with both the Fund and the Bank to coordinate its bilateral aid in the agricultural sector. His authorities had been particularly interested in recent measures to decontrol the price of rice, curtail the functions of the National Food Authority--which had been partially privatized--permit private import and distribution of fertilizer, phase out credit and irrigation subsidies, and open up wheat imports and flour distribution to the private sector. Unless the authorities fully and faithfully implemented the basic measures already announced in those areas, good macroeconomic management alone would not suffice to restore economic growth, financial stability, and a sustainable external position.

Weakness in monetary policy had been an important proximate cause of several missed performance criteria, Mr. Templeman commented. In fact, the effectiveness of monetary policy had tended to be impeded by a pattern of on-again off-again restraint. Monetary growth targets had been raised, compared with the original program, from 11 percent to 15 percent for reserve money and from 13 percent to 15 percent for M-3. He wondered whether those increases were still entirely compatible with macroeconomic objectives. Interest rates had been another key element of the program, yet for most of 1984, real interest rates had been negative; fortunately, they had become highly positive when calculated on the basis of recent reduced rates of inflation. He agreed with the staff on the importance of maintaining real positive rates, both to discourage capital flight and to aid in the recovery of national savings, which had fallen from over 25 percent of GNP in 1981 to about 14 percent in 1984.

The financial problems of the Philippine National Bank (PNB) and of the Development Bank of the Philippines (DBP) remained serious, Mr. Templeman added. For 1985, it appeared that additional internal measures would be required to close the financial gaps of the PNB and the DBP but that the authorities would not allow the Central Bank and budgetary assistance to go beyond program limits. In that connection, he welcomed the creation of a subcommittee in the Central Bank to formulate a rehabilitation program to deal with the structural deficits of those two institutions. The help of the World Bank was particularly welcome, and he looked forward to the announcement of an action program in the second half of 1985.

Another area of concern was the operation of the new exchange rate system, Mr. Templeman stated. Not only had the system produced a real effective appreciation of the peso of 15 percent since December 1984 but the market had remained rather thin. He hoped that the latest increase in the freedom of commercial banks to hold foreign exchange would improve the functioning of the market. Presumably, some of the special factors that had led to the peso appreciation might be temporary and the Central

Bank's need to reach international reserve targets in 1985 should act as a brake on any excessive transitory strength of the peso. Unfortunately, the unexpected appreciation might be triggering speculative pressures in the form of adverse leads and lags, and ultimately could discourage the growth of exports.

The good progress made so far in reducing the deficit in the public sector should be recognized, Mr. Templeman remarked. The consolidated public sector deficit, which had amounted to about 5 percent of GNP in both 1981 and 1982, had been reduced to less than 3 percent of GNP in 1984. Reductions had occurred in the deficits both of the National Government and the public enterprises. Furthermore, all of the improvement in the balance of the National Government had been the result of expenditure restraint. The ratio of revenue to GNP had actually fallen to quite a low level by international standards--less than 11 percent of GNP in 1984--which might however be a sign of weakness in the tax system and of a need for tax reform.

Unfortunately, as other Directors had pointed out, a rather large share of the expenditure restraint had taken the form of cuts in capital and maintenance expenditures, which could eventually jeopardize economic growth prospects, Mr. Templeman continued. In that connection, he welcomed the appraisal by the World Bank of the 1985 public investment program in the Philippines. Particular attention needed to be given to the financing problems of the nonfinancial public enterprises, particularly the large deficits of the National Power Corporation. The staff report indicated Bank's need to reach international reserve targets in 1985 that additional measures were to be taken to close the Philippine National Bank's financing gap in 1985, but he wondered whether anything had been done beyond what was reported in the staff report and the supplement. He endorsed in particular the overall goal of improving the quality and comprehensiveness of data on the public corporations, the creation of a monitoring unit in the office of the Prime Minister, and attempts to improve policy control over investment and resource mobilization by the public corporations.

Good progress had also been achieved in reducing inflation and liberalizing trade, Mr. Templeman commented. A reversal of inflationary expectations was the key to success in reducing inflation rates, which had proved to be an especially intractable problem in so many countries. It was important that price deceleration continue in the Philippines, which had not had a long history of high rates of inflation, so as to avoid pressures for sharp wage increases or experiments with indexing schemes. In the trade area, the elimination of general prior approvals for imports of machinery and equipment was commendable, and he hoped that plans to phase out a large number of prior approval requirements for commodity imports would be carried out as planned by the end of 1985.

In conclusion, Mr. Templeman considered that some good progress had been made in economic adjustment, especially in working toward fiscal and external balance and in reducing inflation. But macroeconomic policies, particularly monetary policy and exchange rate policy, needed to be pursued more steadily and forcefully. In addition, structural and institutional reforms were particularly necessary if economic adjustment was to provide a durable base for future growth. He was somewhat disappointed at the pace of progress in that respect and encouraged the authorities to move forward more rapidly.

Mr. Qureshi recalled that when the Executive Board had discussed the Philippine request for a stand-by arrangement, many Directors had pointed to the need for a strong, comprehensive, and well-defined adjustment program to return the economy to stability from a near-crisis situation and to break from a long but less than satisfactory adjustment record. It had also been noted that a significant move in that direction could be made by the successful implementation of the current program, which incorporated substantial prior action, especially in the exchange and trade areas; a considerable tightening of demand management; and significant--and overdue--structural reform. Approaching the first review of the Fund-supported program in that light, he found the results somewhat mixed. Several favorable developments, to which adjustment measures implemented in 1984 had contributed, included a marked slowdown in the rate of inflation that appeared to be in line with the price projections in the program; a reduction in the current account deficit for 1984 that exceeded program projections; the abatement of foreign exchange speculation; and a progressive tightening of demand management that included considerable monetary restraint.

Despite those encouraging aspects, however, the adjustment effort required some firming up in a number of areas, and weaknesses in policy implementation needed to be corrected in a timely manner in the recent gains were not to be jeopardized, Mr. Qureshi continued. The non-observance of two performance criteria at end-December 1984 and three performance criteria at end-March 1985 had been attributed by the staff to weakness in policy implementation, which should thus be strengthened in the relevant areas in the period ahead. More action, including structural measures, was needed to establish a truly flexible exchange rate to help preserve export competitiveness, to rehabilitate public corporations, and to improve fiscal management which, while containing the public sector deficit, should allow expenditures to be directed toward the most productive uses. Menawhile, continued monetary restraint would be necessary to prevent a rekindling of inflation.

On balance, Mr. Qureshi remarked, he was in broad agreement with the staff appraisal, and especially with its call for perseverance with respect to the programmed adjustment for 1985. On fiscal policy, in view of the recent cutbacks in expenditures that had particularly affected development and maintenance spending, it was encouraging that detailed proposals were currently being prepared in collaboration with the Fund and the World Bank for strengthening domestic resource mobilization through further tax reform. He looked forward to being informed of those details and of the schedule of implementation of those proposals at the time of the second review. He asked the staff to indicate whether the deficit target for the current year assumed any impact from the envisaged reforms, or whether any gain in revenue that might result from the additional tax measures, which would probably be implemented later in the year, would be additional to the effect that already had been programmed.

The increase in the number of public corporations under close monitoring was welcome, as was the intention of the authorities to increase further the number of corporations to be subject to such monitoring for future reviews of the program, Mr. Qureshi said. Significant steps had also been taken recently toward streamlining the operations of the National Food Authority and extending the role of the private sector in agriculture. However, he shared the staff's concern about the lack of a consistent and realistic medium-term framework for the rehabilitation of public corporations in order to avoid the emergence of new funding needs that could interfere with orderly demand management. In that connection, he welcomed the intention of the authorities to propose, in consultation with the World Bank, a comprehensive reform of the public financial sector later in 1985.

The recent appreciating trend of the peso had adverse implications for the preservation of competitiveness, Mr. Qureshi remarked, and appeared to have had some negative impact on foreign exchange receipts. The peso appreciation, however, remained something of a puzzle, as Mr. Wicks had also noted, and the staff analysis did not provide a fully satisfactory explanation. As recently as the past year, the country had been confronted with a very difficult foreign exchange situation in which confidence in the currency had been at a rather low ebb. Part of the explanation for the peso appreciation was of course to be found in the restrictions on commercial banks' foreign exchange positions. The recent easing of those restrictions, and their proposed elimination in July 1985, would help to bring the exchange rate more in line with underlying economic factors. However, the question was whether the restrictions on banks' foreign exchange holdings could by themselves account for much of the recent appreciation of the peso. If the recent appreciating trend was not supported by underlying market forces, why was there no significant differential between the black market and the official exchange rates? Could part of the explanation be that the reduction in inflation accompanied by increases in nominal interest rates under the program had significantly increased the attraction of the peso? It would be helpful if the staff could offer any other explanatory factors.

In conclusion, Mr. Qureshi said, in view of the staff assessment that the program remained broadly on track, he could go along with the proposed rephasing of purchases under the arrangement.

Mr. Jensen observed that since mid-1984 the Philippine authorities had shown determination in correcting the internal and external imbalances of the economy. The strong measures of fiscal and monetary adjustment, the free floating of the exchange rate, and the removal of most exchange restrictions had already been noted by others. The high social and economic costs in terms of growth and employment had also been mentioned.

He himself wished to express concern about two crucial aspects of the program, Mr. Jensen continued. The most significant progress made so far had been on inflation. Strict demand policies had been pursued, but at the same time a substantial revaluation of the exchange rate had taken place. Because the Philippines had an open economy, with foreign trade accounting for approximately 35 percent of GNP, exchange rate developments might be a critical factor underlying the inflation trend. Previous devaluations had pushed up inflation in the Philippines, and the recent revaluation might be operating in the opposite direction, namely, squeezing inflationary pressures out of the economy. As the competitiveness of the export sector had to be restored, he asked the staff or Mr. Rye to comment further on the potential threat to the target with respect to inflation.

The Philippine adjustment effort was strongly predicated upon substantial external support, and the provision of new loans of about $925 million to finance the 1985 external gap was important, Mr. Jensen remarked. But probably more important than the amount of financing was the timely phasing of the inflows because of their impact on international reserves, which were an indicator of other flows in the economy. As was characteristic in debt rescheduling arrangements, the recently concluded arrangement between the Philippines and its commercial bank creditors called for the disbursement of resources to be linked to Fund drawings. Two such drawings had not taken place because of nonobservance of some performance criteria. Interruptions in the planned flow of capital often had potentially negative effects on the implementation of other crucial and sensitive policy measures. He asked whether either the staff or Mr. Rye considered that such marginal statistical deviations had had a negative multiplier impact on other variables, such as capital flight and/or exchange rate speculation, in the Philippines.

Mr. Jayawardena remarked that despite some slippages, the Philippines had made commendable progress under the stand-by arrangement. The commitment of the authorities to adjustment had been unwavering, and they thus fully deserved the proposed rephasing and continuing support of the Fund, especially as they had no alternative. He supported the proposed decision.

His views on the situation in the Philippines were similar to those of Mr. Joyce, Mr. Jayawardena added. Despite the explanations given, he joined those Directors who remained somewhat puzzled by the behavior of the exchange market, which should be improved. He also emphasized the need to phase out monopolies, particularly in the sugar and coconut sectors. He endorsed Mr. Wicks's views on the reform of the public enterprise sector.

The Deputy Director of the Asian Department said that the factors underlying the temporary deviation of the exchange rate from what the staff regarded as the medium-term equilibrium rate had been identified but it was very difficult to attribute relative weights to them. The temporary reflow of capital--in the month of December only--had had some effect. Short-term borrowing had also alleviated the foreign exchange constraints somewhat. Institutional rigidities continued to exist; the

Philippines had not been used to a completely free exchange market and floating exchange rate. From a certain point in time, the banks had been forced, because of the restrictions on their foreign exchange positions, to be sellers on the exchange market. Also, the accumulation of inventories as price expectations fell had reduced the demand for foreign exchange for imports and, in general, the tighter monetary policy had had a similar effect. The shrinkage of the black market and speculation, which had still been feverish in the last months of 1984, had finally abated, owing in part to the fact that it was no longer very profitable to hoard various imported goods.

A temporary firmness of the exchange rate had been inevitable during the initial phase of the stabilization when priority was being given to breaking inflation through a sharply restrictive monetary policy, the Deputy Director added. As financial conditions returned to normal, the exchange rate could become competitive in the market. Among the further measures necessary to support such a trend were the complete elimination of remaining restrictions on banks' foreign exchange positions; the continuation of regular intervention by the Central Bank, which would be assisted by the new reserve money targets; and an acceleration of import liberalization. It remained to be seen whether all those measures would be fully effective and what additional action might be necessary.

The recent appreciation of the exchange rate had only made a small direct contribution to reducing inflation, the Deputy Director explained, because the share of imports in GNP was only about 15 percent and the share of imports in the consumer price index was even smaller. A more flexible exchange rate, therefore, should not lead to a marked acceleration of inflation, although certain import prices, in particular for energy, would increase. Nevertheless, the inflation target for 1985 should be attainable.

The first stage of the tax reform had already been implemented as a prior action, effective October 1, 1984, the Deputy Director recalled. Work was continuing on the second stage. The Fund-World Bank mission had just returned and was formulating tax measures for negotiation during the second review for later implementation. As in the first stage, the measures would aim basically at a further broadening of the tax base, at limiting exemptions, at extending the coverage of excise taxes, and possibly at increasing some tax rates. The reinstatement of two exemptions that had been withdrawn from the first tax package should not threaten the budgetary outturn because their estimated revenue effect was about ₱ 300 million out of the total effect of ₱ 8.3 billion.

There might still be a need for some rescue operations for financial institutions, the Deputy Director noted, and the monetary targets in the program should leave room for them, provided that those operations continued to be subject to appropriate conditions. First, the Central Bank set conditions on the banks that received emergency credit or required banks to merge; second, once deposits withdrawn in the form of currency flowed back into the banking system, the Central Bank reabsorbed them through open market operations. Under those circumstances, the deviation from the progammed reserve money path would only be temporary. The most important action by the Central Bank was however preventive. The monitoring of banks as well as nonbank financial institutions was much closer than it had been; thus, difficulties could be detected at an early stage and action could be taken so that the need for a major rescue operation could be avoided.

The financial consequences of the large open market operations necessitated by the restrictive monetary policy were remarkable, the Deputy Director considered. There had been a major shift of financial assets held by the public to central bank and treasury bills, which together had risen from less than ₱ 10 billion at the end of 1983 to close to ₱ 53 billion at present. One result had been a shift of the financial assets of nonbanks from time deposits and bills payable to open market instruments. Time deposits had been part of M-3, which therefore had become a less reliable indicator of monetary conditions.

The recent downward adjustment of energy prices would almost certainly have to be reversed during the course of 1985, the Deputy Director remarked. However, it had had the psychological effect of further dampening inflationary expectations. In addition, the bimonthly adjustment of energy prices according to a fixed formula had made it much easier to avoid the political difficulties that had been associated with previous price adjustments.

The number of public enterprises in the nongovernment public sector that remained outside the scope of the strict monitoring process was small, the Deputy Director commented. All the major public enterprises, accounting for about 80 percent of total expenditure of public enterprises, were monitored. Furthermore, the companies not subject to monitoring were of course subject to indirect control in the sense that they were restricted by credit policy, did not receive budgetary support, and did not have their borrowing guaranteed by the Government.

The Development Bank of the Philippines (DBP) was no longer fully operational and was in partial liquidation, the Deputy Director explained. The DBP had little scope for generating its own resources and had therefore been perceived to be a clear case for budgetary support. The Philippine National Bank (PNB), however, was an ongoing bank with a large field of activity. Therefore, the PNB was able to take internal rehabilitation measures and generate its own resources, as it would have to do in 1985, given the prospective financing gap that would not be closed unless monetary and budgetary policy targets were changed. The special unit in the Central Bank was working on a daily basis with staff of the PNB on a program for immediate action to close the financing gap. An independent longer-term effort was under way on a plan for the structural rehabilitation of the PNB.

The deviations from the performance criteria in December 1984 and March 1985 had not compromised the adjustment effort, the Deputy Director considered. During that period, the gradual move toward the final agreement on the financing package with the commercial banks had removed uncertainties, and the finalizing of the package would further stabilize expectations.

The number of performance criteria was not very great, the Deputy Director of the Asian Department indicated. However, the program had evolved during a long period of negotiations, and it had become necessary to add criteria simply to make the program comprehensive and tight. Although some of those criteria might have made it a little more difficult to administer and monitor the program--for instance, the ceiling on central bank credit to the Philippine National Bank--it would be possible to adapt them to operational needs, based on experience, as had been done recently with the fiscal criteria.

The staff representative from the Asian Department observed that low investment, and in particular low maintenance and operating expenditures, had been found by the World Bank to be a major bottleneck in the implementation of projects. In the short run, priority could be given to the completion of existing projects, a number of which would shortly come on stream. Those projects were in the main related to irrigation and were expected to have a favorable impact on agricultural growth over the medium term. However, the low level of investment could not be sustained for long, and additional resources would have to be mobilized. A major uncertainty was the timing of the activation of the nuclear power plant, which would have a major impact on the finances not only of the National Power Corporation but of the public enterprises generally. Consistent with the priorities that the staff had discussed with the authorities, the copper fabrication plant had been dropped; the coal development project was not a major new initiative but largely a rehabilitation project.

The monitoring unit in the office of the Prime Minister operated on two levels, the staff representative explained: coordinating policy and collecting statistics. The staff continued to feel that the unit was not operating as efficiently as it should at either level. However, the quality of the data collected had improved and additional corporations had been brought under the unit, not only the Human Settlements Development Corporation and the National Food Authority, but the subsidiaries of certain other corporations that had been excluded from the monitoring process at an earlier stage. Furthermore, public corporations had been held to strict investment targets, and investment decisions had been screened much more strictly than before.

The tax reform was not expected to have any net effect on revenue in 1985, the staff representative noted. Taxes based on domestic trade would be substituted for those based on foreign trade. However, over the medium term, structural reforms would be needed to raise the present low tax ratio.

The medium-term projections presented in the staff paper on the request from the Philippines for a stand-by arrangement (EBS/84/226, 11/5/84; and Sup. 1, 12/10/84) had not been updated because there had been no major changes in the scenario, the staff representative from the Asian Department concluded. The staff report for the 1985 Article IV consultation would include alternative scenarios and a revision of the major assumptions. The latter would reflect three favorable developments since the earlier projections had been made. First, commodity prices had been somewhat higher than expected; second, oil prices had been lower than assumed; and third, interest rates had also been lower than predicted. Export growth would be slower--about 10 percent instead of about 15 percent--principally in response to international constraints affecting world demand for major nontraditional exports, such as textiles and electronics. However, the value of traditional exports should exceed the earlier projections. There was not likely to be much change in the import projections overall. The current account was likely to be somewhat weaker than expected; although the trade balance would remain positive through the 1980s, the shift toward a surplus would come somewhat later than expected earlier. The debt service ratio would be higher.

The Deputy Director of the Exchange and Trade Relations Department remarked that the number of performance criteria in an arrangement was based on a judgment of how many were required to monitor performance and achieve the objectives of a program; within the constraint that criteria should be the minimum necessary, account had to be taken of the characteristics of the country. If comprehensive data were available, only one criterion on, for instance, the public sector financing would be needed. Under previous arrangements with the Philippines, ceilings had been set on national government operations alone; in the process of increasing the scope of monitoring of the overall public sector two or three ceilings had had to be formulated that in effect served the purpose of one comprehensive criterion.

The original intention for the review had been to set performance criteria for June and September 1985, the Deputy Director of the Exchange and Trade Relations Department noted, but once it had become clear that some criteria had not been met for December 1984 and were not likely to be met in March 1985, the process of review had been delayed; therefore, it had seemed advisable to formulate criteria for the months of May and July--and subsequently for September and December--to ensure that the adjustment was not delayed further. The pending financial arrangement with banks and other creditors, which was necessary for the viability of the adjustment program, had also called for some urgency in bringing the program back on track. In that process, it had been necessary to rephase the drawings. Once there was some deviation from the program, the extent of access to the Fund's resources was a function of the length of time it took to get the program back on track relative to the remaining period under the arrangement; consequently, the size of the deviation was also a factor. In the case of the Philippines, the deviations had not been of such a magnitude that correction seemed possible by establishing new performance criteria as of May on which the next drawing would be contingent.

Also, a year remained under the arrangement over which five drawings had been phased. Even phasing of the drawings had seemed reasonable because the program was essentially on track and the testing periods remaining within the arrangement were broadly as originally intended.

The Deputy Director of the Asian Department, in response to a question by Mr. Fujino, said that the figures in Table 13 did not indicate that reserve money could exceed the ceiling, as of each date cited, by ₱ 1 billion. The counterpart of the excess was an increase in net international reserves above what was projected in the program.

Mr. Jensen said that he wondered about the impact on the balance of payments in 1985 of any delay in the disbursement of new bank loans, which were generally disbursed in proportion to the amount to be drawn under a stand-by arrangement, as a result of the rephasing necessitated by the failure to meet the targets for December and March.

The Director of the Asian Department responded that the agreement with the banks on the financing package had not been finalized until recently, when the new bank loans had been rephased but the total amount to be disbursed in 1985 had not been changed. The balance of payments had not been directly affected, other than by a shift in the reduction of arrears from the first to the second half of the year.

Mr. Rye said that his authorities were under no illusions about the magnitude of the challenge before them, including the major structural tasks to which many Directors had drawn attention. He was sure that they would be heartened by the various expressions of support extended to them.

It was easy to exaggerate the extent of the overvaluation of the peso at present, Mr. Rye continued. As Chart 1 (EBS/85/102) illustrating the information notice system index of the real effective exchange rate showed, there had been a marked appreciation recently but the rate was not all that far out of line with the longer-term norm. Even so, as exchange rate developments around the world showed, it was not unusual for currencies to be out of line with what might be called underlying economic influences, even when the adequacy of exchange markets was not in question. It was reasonable to hope, with the staff, that the exchange market in the Philippines would operate more smoothly with experience. In addition, there was scope for removing the remaining restrictions, which however had been applied with appropriate flexibility: a number of banks already had foreign exchange holdings considerably in excess of the limits, in some cases by 70-80 percent against regular letters of credit.

His authorities were awaiting with great interest the report of the joint Bank-Fund mission on taxation, Mr. Rye commented. The mission, which had completed its task during the past week, had worked closely with relevant agencies and with the Prime Minister. The Philippine authorities had assured him that they were unlikely to have any major problems with what they understood to be the general drift of the report and recommendations.

What were commonly called parastatals remained a major problem, Mr. Rye remarked. It would take considerable time to deal with the legacy of ill-conceived decisions and inadequate management from past years. Monitoring of public sector enterprises would not be sufficient, as some Directors had mentioned. The very purpose of placing the monitoring unit under the Prime Minister had been to make sure that once an emerging problem had been recognized, control could be quickly and firmly exercised. Nevertheless, the monitoring itself did seem to be having a salutary effect.

The need for monetary restraint had to be weighed against the need to uphold the integrity of the financial system as a whole, Mr. Rye observed. It had been difficult to achieve the right balance in recent months because the problems of certain financial institutions had had to be tackled. But a balance had to be struck; it was not simply a question of bailing out one or two institutions but of restoring confidence in the financial system, an objective that had been reconciled with monetary restraint. It was unfortunate that the difficulties of particular financial institutions had arisen late in both the December and March quarters because it took several weeks for open market operations to mop up the excess liquidity created by support operations. He could assure Executive Directors that the prime concern of his authorities had been to maintain an appropriately firm monetary policy.

Real interest rates were a major constraint on economic recovery at present, in the view of his authorities, Mr. Rye stated. They fully recognized the need for ensuring that interest rates remained positive over time. But as the reduction in inflation was confirmed, it should be possible in the months ahead to come to lower nominal rates while maintaining appropriately positive real interest rates. The inevitable consequences for open market operations would have to be taken into account.

Major structural measures had already been taken to reform the coconut and sugar sectors, Mr. Rye noted, as should be clear from paragraph 15 of the letter from the Prime Minister and Minister of Finance and the Governor of the Central Bank of the Philippines. The sugar industry worldwide was in desperate straits: no country could produce sugar profitably at present world prices. In the Philippines, large areas of the countryside were wholly dependent on sugar, and the World Bank would assist the authorities in restructuring the industry.

The Chairman made the following concluding remarks:

> There was a broad consensus among Directors that the adjustment program in the Philippines was taking effect and that it had begun to produce tangible results. Directors welcomed the progress made in reducing the inflation rate in a relatively short period. They attributed this performance in particular to continued tight fiscal and monetary control by the authorities, as well as continued wage restraint. They also noted that external

adjustment was proceeding about as programmed, although serious concern was expressed regarding the sizable real effective appreciation of the exchange rate and the recent indicators of the export performance and outlook. Directors pointed out that the Government had started to correct structural weaknesses in a number of areas and several Directors stressed that progress in these efforts was crucial to achieving the sustained adjustment at which the program was aimed. Directors welcomed the conclusion of the commercial bank financing package that was finally signed on May 20, 1985.

Directors noted with concern that several performance criteria had not been observed for two test dates. They hoped that these developments would not detract substantially from the overall progress being made under the program. On the whole, they believed that the 1985 program remained viable and they urged the authorities to avoid any further slippages, for which there was no room. In the interest of longer-term price stability, Directors stressed the importance of persevering with a tight monetary policy and cautioned that the progress recorded thus far could well be reversed quickly if financial policies weakened the control over the monetary aggregates. It was noted that the monetary ceilings that had been agreed for the period through September 1985 provided scope for an expansion in reserve money somewhat above the indicative targets of the original program, to some extent to allow for additional net international reserve accumulation. Several Directors expressed concern that the necessary tight monetary stance could be undermined by the Central Bank's "rescue operations" of certain financial institutions. A structured and comprehensive approach to those problems was needed to improve the solidity of the Philippine financial system without impairing the basic objectives of monetary policy.

Directors urged the authorities to maintain the prescribed tight fiscal stance. No further expenditure overruns should be incurred, and no slippages in revenue should be allowed to occur, it was stressed. Directors noted the improvement in the financial position of a number of major public enterprises but added that further progress was urgent, and for this purpose they urged that the authority of the monetary unit in the Prime Minister's office be strengthened.

Many Directors voiced their concern about recent export performance. They noted the disappointing results for the first quarter of 1985, which reflected not only exceptional and unexpected factors affecting the coconut sector, but also the weak performance of nontraditional exports. While less favorable world demand conditions were of course an important underlying factor, in looking to the future, Directors stressed the need for adequate incentives for the export sector, including a competitive exchange rate. Export performance was central to the adjustment program, and every effort must be made to nurture export growth.

Considerable attention was directed to the performance of the exchange system. A number of Directors recalled the emphasis they had placed at the time of the approval of the stand-by arrangement on a smooth-functioning and flexible exchange system. Directors noted the progress made so far, including the elimination of the differential with the black market. However, the staff paper pointed to a decline in the repatriation of export proceeds in the first quarter of 1985, which Directors agreed was a matter of concern, particularly in light of the downward revision in export growth in 1985. In that context, Directors were pleased at the response of the authorities in further adapting the exchange system to increase its market orientation. They welcomed the easing of constraints on the banks' foreign exchange positions and urged the authorities to abolish the remaining rigidities in the exchange system. The authorities should be ready to intervene on the exchange market in a way that was consistent with the targeted accumulation of reserves and the competitiveness of the peso while offsetting the domestic effects of such intervention by appropriate monetary policy action.

Many Directors also noted the sharp cuts in public investment; they stressed the paramount importance of improving the efficiency and profitability of investment and of choosing only the most productive projects and excluding those--the copper fabrication plant was mentioned in that respect--that were not a matter of priority. They also noted the sharp cuts in maintenance expenditures, which should not be allowed to lead to a deterioration of the capital stock.

Directors noted the measures that had recently been announced regarding structural reforms in agriculture. Those reforms, together with measures to improve the tax system, reorient public sector investment, and rehabilitate public financial institutions, were key elements of the program and essential for the success of the longer-run adjustment process. However, several Directors noted with concern the delay in the structural reform of the coconut and sugar sectors, and they looked forward to progress in that area without further delay. Moreover, the delay in establishing rehabilitation programs for certain public financial institutions could threaten achievement of the financial targets of the program in 1985. Directors also emphasized the need for fundamental reforms of the revenue system to increase the capacity of the Government to generate domestic savings; in particular, the tax base should be broadened and tax collection strengthened. They regretted the delays in introducing the needed reform measures. I would add to the emphasis placed by Directors that programs of reform in all structural areas were urgently required, not only to safeguard the integrity of the financial program, but also to lay a sound foundation for a sustained revival of growth over the medium term.

Structural reforms were also of concern to the World Bank, which was playing a crucial role in helping the authorities establish priorities and agendas for action. The World Bank assessment of the 1985 public sector investment program was welcomed by a number of Directors. There were many areas of collaboration with the World Bank in the implementation of the program, and the Philippines was one of a number of countries where such intensive collaboration was being pursued. That collaboration has, in my view, already added to the comprehensiveness of the program, and would strengthen the prospects for sustained growth over the medium term.

The Executive Board then took the following decision:

1. The Philippines has consulted with the Fund in accordance with paragraph 4(d) of the stand-by arrangement for the Philippines (EBS/84/226, Sup. 2 (12/18/84)) and the letter from the Prime Minister and Minister of Finance and the Governor of the Central Bank of the Philippines dated October 31, 1984, with annexed memorandum, in order to reach understandings subject to which the Philippines may make further purchases under the stand-by arrangement.

2. The letter of the Prime Minister and Minister of Finance and the Governor of the Central Bank of the Philippines dated April 30, 1985 shall be attached to the stand-by arrangement for the Philippines, and the letter of October 31, 1984 shall be read as supplemented by the letter dated April 30, 1985.

3. Accordingly, paragraphs 4(a), (b), and (c) of the stand-by arrangement are modified to read as follows:

> 4. The Philippines will not make purchases under this stand-by arrangement that would increase the Fund's holdings of Philippine currency in the credit tranches beyond 25 percent of quota or increase the Fund's holdings of that currency resulting from purchases of borrowed resources beyond 12 1/2 percent of quota:
>
> (a) during any period in which the data at the end of the preceding period indicate that
>
> (i) the limit on net international reserves of the monetary authority specified in paragraph 2 and Table 1 of the letter of April 30, 1985, or
>
> (ii) the limit on reserve money specified in paragraph 11 and Table 2 of the letter of April 30, 1985, or

(iii) the limit on net domestic borrowing of the National Government specified in paragraph 10 and Table 2 of the letter of April 30, 1985, or

(iv) the limit on the domestic borrowing requirement of the public sector specified in paragraph 10 and Table 2 of the letter of April 30, 1985, or

(v) the limit on central bank credit to the Philippine National Bank specified in paragraph 12 and Table 2 of the letter of April 30, 1985

is not observed; or

(b) if

(i) the limit on approval of new nonconcessional external borrowing with maturities of 1 to 12 years and 1 to 5 years specified in paragraph 6 and Table 1 of the letter of April 30, 1985, or

(ii) the limit on short-term external debt referred to in paragraph 6 of the letter of April 30, 1985

is not observed; or

(c) if the limit on external payments arrears referred to in paragraph 5 and Table 1 of the letter of April 30, 1985 is not observed.

4. In paragraph 4(e) of the stand-by arrangement the words ", while the Philippines has any overdue financial obligation to the Fund, or" shall be eliminated. The following paragraph 5 shall be inserted after paragraph 4, with paragraphs 5 through 11 renumbered 6 through 12:

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

5. Paragraph 2(a) of the stand-by arrangement shall be modified to read as follows:

2. (a) Purchases under this stand-by arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 85 million through July 1, 1985, the equivalent of SDR 191 million through September 1, 1985, the equivalent of SDR 297 million through November 1, 1985, the equivalent of SDR 403 million through February 1, 1986, and the equivalent of SDR 509 million through May 1, 1986.

Decision No. 7992-(85/83), adopted
May 30, 1985

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/85/82 (5/29/85) and EBM/85/83 (5/30/85).

2. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/85/137 (5/28/85) is approved.

APPROVED: April 7, 1986

LEO VAN HOUTVEN
Secretary