FOR INFORMATION

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To: Members of the Executive Board

From: The Secretary

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Questions:	Mr. Helbling, APD (ext. 36051) Mr. Kim, APD (ext. 36796)

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

Philippines—Assessment Letter for the World Bank

October 2, 2020

This note provides the IMF staff's assessment of Philippines' macroeconomic conditions, prospects, and policies, based on available information as of September 24, 2020. The assessment has been requested in relation to a development loan operation by the World Bank.

Recent Developments, Outlook, and Risks

The COVID-19 crisis has severely hit the Philippine economy. The economy entered the pandemic from a strong position, as a result of bold structural reforms and prudent macroeconomic policies. The containment of the virus outbreak, however, necessitated imposition of stringent quarantine measures, which resulted in a GDP contraction of 12 percent (H/H, s.a.) in the first half of 2020. Financial markets have remained broadly stable after a brief period of increased volatility in March, while gross international reserves rose to US$99 billion at end-August from US$91 billion at end-April. The Philippines has the highest level of confirmed COVID-19 cases in the ASEAN region (over 290,000 as of September 23), with the average number of daily new confirmed cases at about 3,200 during September 1–23.

The near-term growth outlook is clouded by uncertainty surrounding the virus dynamics. In the October 2020 *World Economic Outlook*, real GDP is projected to contract by 8.3 percent in 2020, reflecting the impacts of virus containment measures, social distancing, and weak external demand. Headline inflation is expected to average 2.4 percent in 2020, which is within the 2–4 percent target band of the Bangko Sentral ng Pilipinas (BSP). The current account balance in 2020 is projected to turn to a surplus of 1.6 percent of GDP (from a 0.1 percent deficit in 2019), driven by compression in import demand. Real GDP in 2021 is projected to expand by 7.4 percent, as the economy rebounds helped by the relaxation of quarantine measures and the policy easing in 2020. Over the medium term, the COVID-19 crisis is expected to result in lower levels of potential output and higher structural unemployment, with real GDP growth converging to 6.5 percent by 2025.

Downside risks are large, and their materialization would lead to a further pullback in economic activity in 2020:H2 and slow the recovery. Capacity constraints on the implementation of timely and adequate policy support may hinder efforts to contain rises in unemployment and insolvencies among businesses and households, delaying the economic recovery that is essential to reduce poverty and inequality. Pandemic-prompted protectionist actions elsewhere in the world,

such as export controls and policy-induced onshoring, could become more prevalent and persistent if economic conditions deteriorate. Finally, the pandemic could slow ongoing reforms as populist pressures and the influence of vested interests could rise in the recovery phase. On the upside, the crisis could help expedite some reforms, such as the introduction of the national digital ID and further relaxation of FDI restrictions.

Policy Framework and Settings

The initial government response to the pandemic appropriately focused on containing the rapid spread of the virus and its health impact and providing vital income support to the vulnerable. The first support package implemented in 2020:H1 comprised a large-scale cash aid program for low-income households, financial assistance to small business employees and displaced workers, and distribution of medical supplies and equipment. Due to constraints on infrastructure (for example, on digital-based delivery of cash aid) and administrative capacity, however, the speed of deployment has been uneven. The second package to be implemented during the remainder of 2020 ("the Bayanihan II" or "Bayanihan to Recover As One Act") additionally provides subsidies targeted to hard-hit sectors.

The severity of the COVID-19 socioeconomic impact calls for bolder fiscal action to minimize the scarring effects. The government has appropriately increased the annual budget deficit target for 2020 to 9.6 percent of GDP from 3.4 percent in 2019, reflecting the expected reduction in revenue and the discretionary COVID-19-related government spending (estimated at 2.3 percent of GDP). However, considering the low level of public debt (39.6 percent of GDP in 2019, well below the emerging market average), the Philippines has space for additional fiscal support. Moreover, alternative approaches could be considered to provide more support to micro-, small-, and medium-sized enterprises (MSMEs). For example, the current credit guarantee program for MSME loans could be expanded in size considering the larger impact of COVID-19 than originally expected at the time of the program's launch in April.

Greater emphasis could be given to short-term job creation and social protection by reprioritizing public spending. Due to the relatively larger-than-expected impact of COVID-19 on low-income households and businesses in the informal sector, there is now an even greater urgency for some of the government's socioeconomic priorities, such as undertaking infrastructure projects with high job content and enhancing social protection. While the Bayanihan II will provide another round of temporary relief to vulnerable households, regular social protection programs should be strengthened in anticipation of the lasting consequences of COVID-19 for poverty and inequality.

The BSP has taken forceful actions to support the economy. The central bank reduced its policy rate four times in 2020:H1 by a cumulative 175 bps to 2.25 percent and lowered the reserve requirement ratio (RRR) for commercial banks by 200 bps to 12 percent. Furthermore, the BSP has sought to reduce risks of bond market instability from higher government deficit financing through temporary repo financing to the government and secondary market purchases of government bonds. Further monetary policy accommodation of government deficits should be clearly circumscribed to the early recovery phase from the pandemic and remain compatible with the BSP's monetary policy objectives. Bond purchases or advances should be guided by a well-defined last resort criterion, linked to unfavorable bond market and broad financial conditions.

Monetary policy is appropriately accommodative and could be loosened further if significant downside risks materialize. Considering the benign inflation outlook and moderate external pressures, the BSP has space to make additional data-dependent cuts in the policy rate. The current inflation and credit conditions also provide an opportunity to further lower the RRR, still comparatively high at 12 percent.

The BSP has relaxed prudential rules to ease the financial burden of vulnerable borrowers. The BSP has introduced a series of temporary regulatory relief measures to encourage banks to provide financial assistance to their borrowers through temporary grace periods for loan payments or loan restructuring. While the Philippine banking system was well capitalized before the pandemic, the asset quality is expected to deteriorate substantially in the short term. The authorities should closely monitor the evolution of underlying vulnerabilities and prepare contingency plans, supported by reforms of resolution mechanisms. The institutional framework for macroprudential policy could be further strengthened, based on the recommendations of the forthcoming Financial Sector Assessment Program.

An intensification of the reform momentum would strengthen the post-COVID-19 recovery and longer-term growth. The planned introduction of the national ID system and implementation of the financial inclusion initiative would complement the ongoing social assistance programs by facilitating the identification of eligible households and delivery of cash aid. In the medium term, more resources and incentives for climate change adaptation and mitigation will be needed to induce more investment and changes in emission patterns.

IMF Relations

The Philippines is on a standard 12-month Article IV consultation cycle. The 2019 Article IV consultation was concluded by the IMF Executive Board on January 27, 2020.

Philippines: Selected Economic Indicators

Population (2019): 107.3 million
Quota: SDR 2,042.9 millions (0.43 percent of total quota)
Per capita GDP (2019): US$3,512
Poverty rate $1.90 a day (2015): 6.1
Main products and exports: electronics, machinery, agriculture products, and business process outsourcing
Key export markets: Hong Kong SAR, Japan, United States, European Union, China, Singapore, and Thailand

	2016	2017	2018	2019	2020 Proj.	2021 Proj.
Output						
Real GDP growth (%)	7.1	6.9	6.3	6.0	-8.3	7.4
Prices						
Inflation (%, annual average)	1.3	2.9	5.2	2.5	2.4	3.0
National government finances						
Fiscal balance (% GDP)	-2.3	-2.1	-3.1	-3.4	-9.6	-8.4
Money and credit						
3-month PHIREF rate (%) 1/	2.0	3.3	6.5	3.1	...	...
Balance of payments						
Current account (% GDP)	-0.4	-0.7	-2.5	-0.1	1.6	-1.5
Exchange rate						
REER (% change)	-2.9	-4.5	-2.8	4.8	...	...

Sources: Philippines authorities; World Bank, World Development Indicators; and IMF staff projections.

1/ Benchmark rate for the peso floating leg of a 3-month interest rate swap. As of December 2019.