Philippines—Assessment Letter for the Asian Development Bank
July 27, 2015

The Philippine economy has continued to perform strongly. Real GDP grew by 6.1 percent in 2014 but slowed to 5.2 percent in the first quarter of 2015. The main growth drivers in 2014 were household consumption, private construction, and exports of goods and services. The first quarter 2015 slowdown was due to the effects of dry weather on agricultural production, weak global demand, and slow budget execution. Growth is projected at 6.2 percent in 2015 as lower commodity prices lift household consumption and improved budget execution raises public spending. Unemployment fell to 6.8 percent in 2014, with 1 million new jobs created, and is expected to fall further in 2015. Bank loans grew by a rapid 20 percent in 2014 but slowed to 14.5 percent in May 2015. The slowdown in loan growth has been broad based, including for real estate and construction. Consistent with projected investment growth, bank loans are expected to grow at about 15 percent in 2015. Banks remain well capitalized, with low levels of nonperforming loans and abundant liquidity.

Inflation fell below the bottom of the BSP's target band (3±1 percent) in June 2015 led by lower fuel and rice prices. Despite the strong pace of economic activity, there is no evidence of price or wage pressures and considerable slack remains in the labor market. Low oil prices, partly offset by somewhat higher food prices deriving from El Niño conditions, should keep inflation near the bottom of the BSP's target band this year. The current account surplus rose to 4.4 percent of GDP in 2014 against the backdrop of lower oil prices, subdued import volumes, and robust export growth, and it is expected to widen to 5.0 percent of GDP in 2015 due to lower oil prices and continued inflows from business process outsourcing and remittances. While the peso has been stable vis-à-vis the U.S. dollar since early 2014, it has appreciated in real effective terms. After falling by US$4 billion in January 2014 (to US$79 billion or 11 months of imports), gross international reserves have remained broadly stable.

The strong performance of the Philippine economy in recent years has helped improve living conditions, but financial inclusion and infrastructure quality remain low. Poverty incidence (national definition) fell to 26 percent in 2014 from 28 percent in 2012, due to robust growth and public policies such as the conditional cash transfer program, universal health insurance coverage, and expanded education. Unemployment and underemployment have also fallen, but remain high compared to peers. Infrastructure quality remains among lowest in the region, and is a key impediment to private investment growth and broad-based economic activity. Financial market access for poor households and small and medium size companies remains low, limiting employment creation and small business activity.

Risks to the outlook are tilted to the downside. The main upside risk is a stronger lift to demand from lower oil prices. On the downside, tighter global financial conditions and a surge in financial volatility, amplified by low market liquidity, could lead to large capital outflows and tightening of domestic financing conditions, but the Philippines' strong fundamentals should provide a cushion. Continued budget under execution could slow down needed improvements in public infrastructure. Finally, there is a downside risk associated with severe El Niño conditions, leading to a poor harvest and a rapid run-up in food prices and inflation, affecting the poor severely. The Philippine authorities are well equipped to respond as needed with suitable policies should any of these risk scenarios materialize, particularly given the economy's strong fundamentals, ample policy space, and strong foreign reserve position.

Economic policies should focus on pursuing key medium-term priorities while keeping macroeconomic and financial stability. Key medium term priorities include improving infrastructure, education, and living conditions, as well as financial deepening and inclusion. However, their pursuit of these objectives needs to be managed carefully in the current context of strong economic growth and robust (though moderating) credit expansion.

Fiscal policy should focus on supporting infrastructure investment and inclusive growth. Returning to the authorities' medium-term deficit target of 2 percent of GDP by increasing public infrastructure spending and implementing much-needed post-typhoon reconstruction and social spending in the 2015 budget is appropriate given the needs in these priority areas and on the back of expenditure under-execution in 2014. It is also consistent with debt sustainability as the 2 percent of GDP deficit target would reduce the debt-to-GDP ratio over the medium term. Staff's projections are less ambitious than the authorities' in 2015 in light of limitations in current execution capacity. Going forward, the authorities plan to increase infrastructure spending from 3 percent of GDP in 2014 to 5 percent by 2016, including by facilitating PPP projects. Staff projects public capital expenditure at 3.8 percent of GDP in 2016, while PPP projects could amount to 1 percent of GDP, bringing overall infrastructure investment to 4.8 percent of GDP in that year. Additional revenue will be needed to meet continuing large infrastructure and social needs, including by rationalizing tax incentives, eliminating certain VAT exemptions, and raising fuel excises, which would more than offset the losses from adjustments in corporate and personal income taxes.

Current monetary settings are appropriate judging from: inflation projections within the target band; estimates of the output gap near zero, and credit growth within normal metrics. Credit growth was strong in 2014, including in the construction and real estate sectors, spurring concerns about rising macro-financial imbalances. The BSP's tightening measures last year (the banks' required reserve ratio was increased by 200 basis points, to 20 percent, and policy rates were increased by 50 basis points), and autonomous tightening since then due to rising real interest rates and an appreciating REER, has succeeded in moderating credit growth, making it more balanced, and bringing inflation down, by the first half of 2015. Nonetheless, the BSP should remain vigilant and be ready to tighten policy if signs of rising inflation pressure and accelerating broad-based credit growth were to emerge going forward. However, rapid food price increases due to El Niño conditions should be addressed by allowing food imports in a timely manner and would not justify monetary tightening unless second round effects were to appear.

Macroprudential policies should continue to play an important role by limiting any buildup of systemic vulnerabilities, including due to excessive credit growth in specific sectors. In light of the acceleration in credit growth in 2014 and risks of domestic asset price booms, the BSP conducted stress tests on banks' real estate loan exposures and required corrective actions, enhanced monitoring of banks' exposures to all types of real estate, and provided guidance on the higher risk weights to be imposed on mortgage loans where loan-to-value ratios exceed 60 percent. These measures have helped to restrain credit growth to the real estate sector. Single borrower limits (set at 25 percent of core capital) should be strictly enforced with the additional 25 percent allowance for exposures to PPPs allowed to lapse. Staff encourages ongoing efforts to strengthen the financial stability supervisory framework, including by capacity building and enhanced coordination among the stakeholders of the Financial Stability Coordinating Council. In particular, staff supports the draft bill broadening the BSP's financial stability mandate and providing it with greater access to nonbank financial information that is currently being discussed in Congress. The SEC has taken steps to enhance its corporate data collection efforts and promote capital market development, and staff encourages further efforts in this direction.

Structural policies need to focus on key medium-term priorities to allow the country reap the dividends from its young and growing population. These priorities are improving infrastructure, education, and spending for social needs to reduce poverty, as well as financial deepening and inclusion. Staff supports the authorities' plans to increase infrastructure spending while also facilitating Public Private Partnerships. Sustained efforts to improve the investment selection and implementation processes, as well as additional revenue, are also needed. Staff also supports the government's plans to improve human capital and social services for the poor, including by expanding the conditional cash transfer program, universal health insurance coverage, and education. Alternative forms of financing and hedging such as corporate bond and equity markets need to be developed to mitigate concentration risks and rising leverage, and to broaden the spectrum of financing vehicles for large public private partnership projects. Developing noncredit related areas of financial inclusion is also important, including increased banking services provision in rural areas, wider coverage of insurance services, an increased role for the pension industry, and making equity capital more accessible for medium size enterprises.

The Philippines is on a standard 12-month consultation cycle. The 2015 Article IV mission was concluded on May 26 and the IMF's board meeting is scheduled for August 26. The next Article IV consultation is planned for June 2016.

Table 1. Philippines: Selected Economic Indicators, 2010–16

Nominal GDP (2014): P 12,634 billion ($285 billion)
Population (2013): 97.2 million
GDP per capita (2013): $2,797
Poverty headcount ratio at $1.25 a day at PPP (2012): 19 percent
IMF quota: SDR 1,019.3 million
Main products and exports: electronics, agriculture products, and business process outsourcing
Unemployment rate (Q2:2015): 6.4 percent

	2010	2011	2012	2013	2014	2015	2016
						Staff proj.	
GDP and prices (percent change)							
Real GDP	7.6	3.7	6.7	7.1	6.1	6.2	6.5
CPI (annual average)	3.8	4.7	3.2	2.9	4.2	2.1	3.5
CPI (end year)	3.6	4.2	3.0	4.1	2.7	3.4	2.7
Investment and saving (percent of GDP)							
Gross investment	20.5	20.5	18.2	20.0	20.9	22.0	22.3
National saving	24.1	23.0	21.0	24.2	25.4	27.1	26.7
Public finances (percent of GDP)							
National government balance (authorities' definition)	-3.5	-2.0	-2.3	-1.4	-0.6	-1.5	-2.0
National government balance 1/	-3.6	-2.1	-2.4	-1.5	-0.6	-1.5	-2.0
Nonfinancial public sector balance 2/	-3.3	-0.8	-0.6	0.6	0.9	0.0	-0.5
Revenue and grants	18.5	18.6	19.4	20.1	20.1	20.6	20.7
Expenditure	21.7	19.4	20.0	19.5	19.2	20.6	21.2
Nonfinancial public sector debt	54.8	55.3	53.0	51.3	47.8	45.5	42.5
Monetary sector (percent change, end of period)							
Broad money (M3) 3/	10.0	7.1	9.4	31.8	11.2	9.3	...
Interest rate (91-day treasury bill, end of period, in percent) 4/	1.3	1.7	0.5	0.5	2.5	2.1	...
Credit to the private sector (in percent) 3/	8.9	19.3	16.2	16.4	19.9	14.5	...
External sector							
Export value (percent change)	26.2	4.1	21.2	-4.0	7.3	3.5	5.5
Import value (percent change)	24.7	9.5	11.3	-4.8	2.3	1.6	7.1
Current account (percent of GDP)	3.6	2.5	2.8	4.2	4.4	5.0	4.5
Capital account (US$ billions)	0.1	0.2	0.1	0.1	0.1	0.1	0.1
Financial account (US$ billions) 5/	-11.5	-5.3	-6.8	2.2	10.1	7.1	6.1
Direct investment (net) 5/	1.6	0.3	1.0	-0.1	0.8	0.0	-0.7
Errors and omissions (US$ billions)	-3.5	0.3	-4.6	-4.2	-5.5	-5.2	-4.9
Overall balance (US$ billions)	15.2	11.4	9.2	5.1	-2.9	3.1	4.3
Total external debt (percent of GDP) 6/	36.9	33.7	32.0	28.9	27.3	25.6	23.1
Debt service ratio 7/	13.6	13.6	9.9	11.1	8.7	11.1	10.6
Reserves(US$ billions)	62.4	75.3	83.8	83.2	79.5	81.7	84.5
Reserves/short-term liabilities 8/	403.4	482.5	397.9	405.5	359.4	361.2	366.8
Exchange rate (period averages)							
Pesos per U.S. dollar	45.1	43.3	42.2	42.4	44.4	44.5 9/	n.a.
Nominal effective exchange rate (2005 =100)	100.0	99.0	102.6	105.4	102.7	109.6 9/	n.a.
Real effective exchange rate (2005 =100)	100.0	100.7	105.6	109.8	109.5	117.9 9/	n.a.

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

1/ Fund definition. Excludes privatization receipts and includes deficit from restructuring of the previous central bank (Central Bank-Board of Liquidators).
2/ Includes the national government, 14 government-owned enterprises, social security institutions, and local governments.
3/ Universal and Commercial Banks, May 2015 (year-on-year).
4/ Secondary market rate, the latest data point is May 2015.
5/ In BPM6. An increase in either assets or liabilities is always positive and a decrease is always negative. Net investment is assets minus
6/ Includes external debt not registered with the central bank, and private capital lease agreements.
7/ In percent of exports of goods and nonfactor services.
8/ Reserves as a percent of short-term debt (including medium- and long-term debt due in the following year).
9/ January - May 2015.