

AMRO Annual Consultation Report

The Philippines – 2018

The ASEAN+3 Macroeconomic Research Office (AMRO)

January 2019

Acknowledgments

1. This Annual Consultation Report on the Philippines has been prepared in accordance with the functions of AMRO to monitor, assess and report its members' macroeconomic status and financial soundness and to identify relevant risks and vulnerabilities, and assist them in the timely formulation of policy recommendations to mitigate such risks (Article 3(a) and (b) of AMRO Agreement).
2. This Report is drafted on the basis of AMRO's Annual Consultation Visit to the Philippines from 15-24 October 2018 (Article 5 (b) of AMRO Agreement). The AMRO Mission team was headed by Dr Matthew Yiu, Group Head and Lead Economist. Members included Dr Zhiwen Jiao (Country Economist for the Philippines), Mr Paolo Hernando (Back-up Economist for the Philippines), Dr Ruperto Majuca (Senior Economist), and Dr Wei Sun (Financial Specialist). AMRO Chief Economist Dr Hoe Ee Khor also participated in key policy meetings with the authorities. This AMRO Annual Consultation Report on the Philippines for 2018 was prepared by Dr Matthew Yiu and Dr Zhiwen Jiao with contributions from Mr Paolo Hernando, Dr Wei Sun, and Ms Diana del Rosario; peer reviewed by Dr Ishikawa (Group Head and Lead Specialist) and Ms Diana del Rosario (Economist); and approved by Dr Hoe Ee Khor.
3. The analysis in this Report is based on information available up to 25 January 2019.
4. By making any designation of or reference to a particular territory or geographical area, or by using the term "member" or "country" in this Report, AMRO does not intend to make any judgments as to the legal or other status of any territory or area.
5. No part of this material may be disclosed unless so approved under the AMRO Agreement.
6. On behalf of AMRO, the Mission team wishes to thank the Philippine authorities for their comments on this Report, as well as their excellent meeting arrangements and hospitality during our visit.

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Executive Summary

Since AMRO's last annual consultation report, the Philippine economy has been facing strong headwinds. However, despite growing macroeconomic imbalance amid intensified external shocks, the economy managed to register robust growth, which only few EMEs in the world were able to achieve. In 2019, economic growth is projected to stay resilient, supported by robust domestic demand. However, policymakers need to remain vigilant on the development of short-term risks and get ready to recalibrate their policy mix to sustain macroeconomic stability.

1. **The Philippine economic growth slowed down in 2018, as high inflation eroded household purchasing power and weaker external demand weighed on exports.** Nonetheless, active government spending has supported a resilient economy, as witnessed by strong growth in gross fixed capital formation and government consumption. The economy expanded by 6.2 percent in 2018, lower than the 6.7 percent in 2017.
2. **Inflation increased sharply to above the target range, largely due to supply shocks.** Headline inflation accelerated in early 2018, and breached the upper bound of the BSP's target range in March 2018 and has stayed above it since. A sharp increase in food prices, soaring oil prices, excise tax hikes, and a weaker peso, all made their contributions.
3. **Economic growth momentum is expected to gradually recover on the back of buoyant domestic demand, while average inflation is expected to settle within the target band of 3.0 percent \pm 1.0 percentage point in 2019.** Economic growth will continue to be driven by domestic demand. The government's "Build, Build, Build" infrastructure program will continue to provide impetus to the economy. Private consumption is also expected to recover as inflation pressure eases and consumer confidence is restored. However, the balance of risks to growth is tilted to the downside, with the potential impact from trade conflicts and sharp tightening global financial conditions, etc.
4. **The external position weakened due to a widening current account deficit and larger non-FDI capital outflows.** As a result, international reserves declined, but still remain more than adequate in terms of imports coverage and to cover short-term external debt coming due. As infrastructure investment projects demand high imports of capital goods and raw materials, the current account will remain in deficit. Non-FDI outflows are expected to ease following the sharp price corrections in domestic assets, and as repayments of foreign debt by domestic residents would have run its course. However, FDI inflows are also likely to moderate in 2019 on the back of lower approvals of new projects in previous years and higher cross border borrowing costs.
5. **Monetary conditions have tightened significantly reflecting the sharp increase in the BSP policy rates and liquidity impact of short-term capital outflows.** Despite the tightening in financial conditions, funding costs to the real economy rose only moderately, in part due to strong competition among banks and the time needed for the higher policy rates to fully filter through. Credit continued to grow rapidly reflecting robust loan demand and the banking sector remains generally sound as credit quality remains satisfactory. Credit growth is expected to remain elevated on the back of buoyant demand. However, as real borrowing

costs have started to rise and as the BSP policy rate hikes begin to pass through, credit and domestic liquidity growth is likely to moderate slightly.

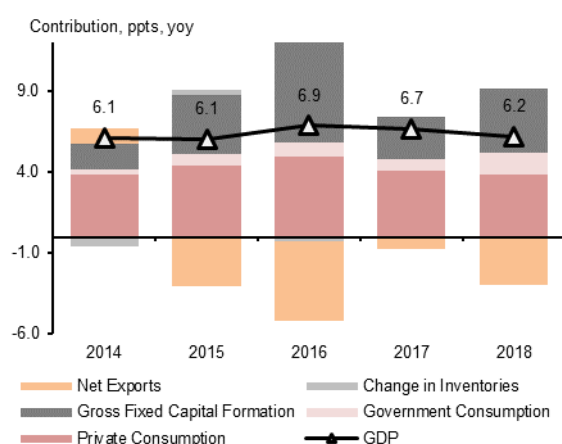
6. **Fiscal position has been enhanced markedly as the first phase of Tax Reform for Acceleration and Inclusion Act (TRAIN) has taken effect and tax administration has improved.** The expanded fiscal space has allowed the government to pursue development programs more aggressively. Supported by better revenues, the government stepped up the pace of disbursement to other agencies and enhanced its implementation capacity. As a result, government spending was able to outpace the fiscal program for the first time. The government will be shifting its budget from an obligation basis to a cash basis in 2019, as part of its efforts to enhance fiscal efficiency.
7. **The major risks facing the Philippine economy are mostly short-term.** Externally, escalating global trade tensions and a sharp tightening of global financial conditions remain the major risks. Domestically, higher-than-expected inflation and pockets of financial vulnerabilities are the key concerns. While domestic risks have started showing signs of easing, external risks have remained heightened.
8. **Fiscal policy should be calibrated to help contain inflation pressure and support the external position, through reprioritizing expenditure.** The government could streamline current expenditures and continue to improve implementation capacity and spending efficiency for infrastructure projects, and adjust the pace of implementation so that it is in line with the absorptive capacity of the economy. Tax reforms should proceed with careful design and implementation, to minimize potential negative impacts on investment and employment during the transition period.
9. **Monetary policy stance should remain appropriately tight to anchor inflation expectation and curb second round effects.** In particular, the policy stance should be aligned with its primary mandate of achieving price stability, with policy decision contingent on the outlook for inflation over the policy horizon and assessment of demand pressures based on domestic and external conditions. To mitigate the impact of supply-side factors on inflation, government agencies need to strengthen their coordination further to ensure the timely implementation of non-monetary measures. A swift implementation of the rice tariffication law and reinforcing price monitoring will help dampen inflation pressures.
10. **The exchange rate should remain flexible as a buffer to absorb external shocks.** While the BSP should intervene judiciously in the foreign exchange market to smooth short-term fluctuations, the exchange rate should continue to be determined by market forces.
11. **The BSP's ongoing efforts to strengthen macro-financial surveillance and develop various macroprudential toolkits should continue.** The introduction of the countercyclical capital buffer as a pre-emptive move to safeguard the economy's financial stability, and collective efforts across agencies to collect information on corporate and household borrowers are very important for effective financial surveillance.
12. **The government should strengthen the reform agenda to continue enhancing the growth potential of the economy.** In addition to further improvements in the physical infrastructure, social infrastructure also needs to be enhanced.

A. Recent Developments and Outlook

A.1 Real Sector Developments and Outlook

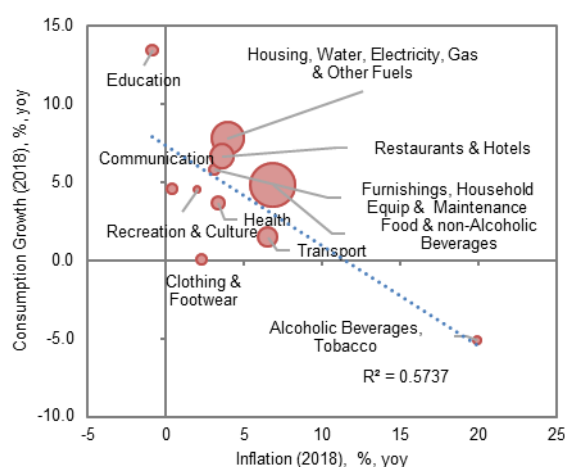
1. **The Philippine economy registered slower growth in 2018, largely due to weaker external demand and private consumption.** Real GDP growth rate declined consecutively from 6.6 percent in 1Q 2018 to 6.0 percent in 3Q 2018 then edged up to 6.1 percent in 4Q 2018, bringing down the growth rate to 6.2 percent in 2018, 0.5 percentage points lower than in 2017. The slowdown resulted mainly from a larger net exports drag (Figure 1), as a high base effect kicked in and slowing global demand weighed on export growth. Besides the pervasive weakening external demand in the Asia region, moderation of domestic private consumption also contributed to the slowdown as a result of higher inflation and weaker consumer confidence (Figure 2). Nonetheless, active government spending has underpinned a resilient economy, as witnessed by strong growth in gross fixed capital formation and government consumption. The strength and weakness of different sources of demand was also reflected in sectoral output growth. While government activity-related sectors such as construction, public administration and defense, and education, generally registered stronger growth, consumption and exports-related sectors, such as trade, hotel and restaurants, and manufacturing, experienced slower expansion. The agricultural sector barely grew, due to weather disturbances.

Figure 1. Real GDP Growth and Its Contribution



Source: PSA; AMRO staff calculation

Figure 2. Consumption Growth and Inflation



Note: The size of the circle is the weight of each consumption item in the CPI basket.

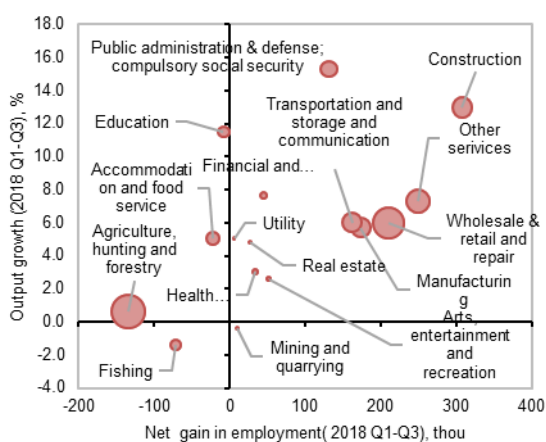
Source: PSA; AMRO staff calculation

2. **Going forward, the economic growth momentum will gradually recover, driven largely by domestic demand.** Private consumption is projected to recover in the second half of 2019, as inflationary pressures eased and consumer confidence is restored. At the same time, the government is expected to continue to provide firm support to the economy through expedited infrastructure projects and continued strong spending on consumption, particularly in an election year. Thus, fixed asset investment is likely to sustain strong growth. However, the tightening of financial conditions may hold back and limit the upside potential of investment. In contrast to the recovery of domestic demand, export growth is expected to remain tepid, on

the back of slowing global demand amid trade conflicts and a maturing global IT cycle. Overall, the Philippine economy is expected to grow by 6.4 percent in 2019.

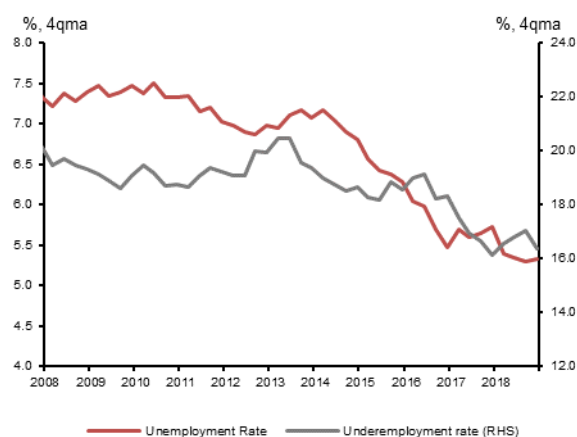
3. Job creation fluctuated with economic expansion, while the unemployment rate resumed its mild declining trend. Employment continued its recovery trend from a low of 39.3 million in 1Q 2017 to 41.8 million in 1Q 2018, then declined to 40.7 million in 3Q 2018 and reverted back to 41.3 million in 4Q 2018. On average, the labor market managed to add 0.8 million jobs in 2018. The major sectors that witnessed job gains include construction, manufacturing and service sectors such as wholesale, retail and repairs, transportation, storage and communication, and public administration, defense and social security. The distribution of job gains was largely in line with sectoral output expansions (Figure 3). The rapid increase in employment in the construction, public administration, and defense and social security sectors reflected the government’s keen efforts to enhance infrastructure and social security. The skewed distribution of job gains towards low productivity sectors indicates that the challenge for the Philippine economy to produce quality jobs still remains, particularly given its fast-growing young population. Owing to the employment recovery, the unemployment rate, by and large, resumed the mild declining trend. However, the underemployment rate edged up from 16.1 percent in 2017 to around 16.4 percent in 2018 (Figure 4).

Figure 3. Employment and Output Growth by Sectors



Note: The size of the circle is the share of each sector in the total employment.
Source: PSA; AMRO staff calculations.

Figure 4. Unemployment Rate And Underemployment Rate

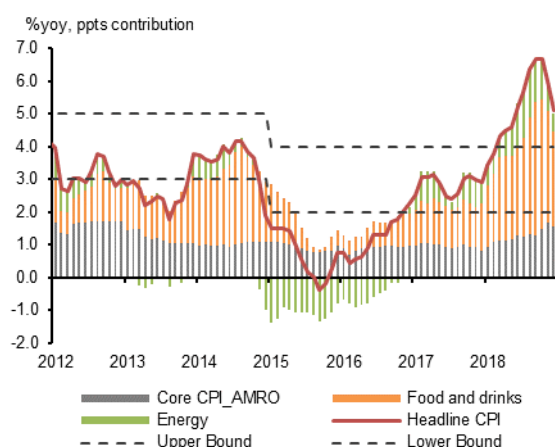


Source: PSA; AMRO staff calculations.

4. Inflation increased to above the target range, largely due to supply shocks. Headline inflation has accelerated since early 2018 and climbed all the way to 6.7 percent in September and stayed there in October before it declined to 5.1 percent in December. It breached the upper bound of the BSP’s target range in March 2018 and has stayed above it since (Figure 5). On average, inflation increased by 5.2 percent in 2018, much higher than the 2.9 percent in 2017. The sharp increase in food prices was the single largest driver of inflation. Meanwhile, soaring oil prices, excise tax hikes, and a depreciation of the peso, all made their contributions. Overall, food and energy-related items accounted for around 80 percent of the

price increase. In addition, core inflation¹ (excluding all food and energy related items) also witnessed a notable increase, albeit less striking than the headline inflation (Figure 6). Although it is difficult to distinguish how much of the rise can be attributed to higher tax rates and indirect effects from the supply shocks, the broad price increases among the core inflation items and worsening of inflation expectations may indicate that demand pressures and second-round effects have already built up. Furthermore, the rapid growth of consumer goods imports, especially durable goods, also reveals resilient demand, which could be spurred by wage rise and personal income tax cut.

Figure 5. Inflation and Contribution

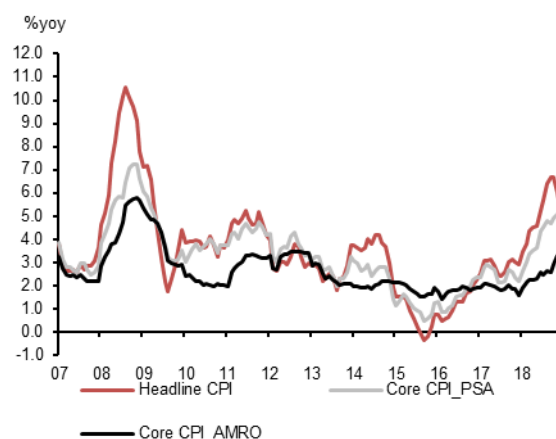


Note: (1) energy includes electricity, gas and other fuels under housing items and fuel and lubricant under transportation; food and drinks include all food and drinks and tobacco. The remains are used to calculate AMRO's Core inflation.

(2) Inflation data are 2012 based, data prior 2013 are 2006 base, and the series are connected together.

Source: PSA; AMRO staff calculations

Figure 6. Headline Inflation and Core Inflation



Note: (1) energy includes electricity, gas and other fuels under housing items and fuel and lubricant under transportation; food and drinks include all food and drinks and tobacco. The remains are used to calculate AMRO's Core inflation.

(2) Inflation data are 2012 based, data prior 2013 are 2006 base, and the series are connected together.

Source: PSA; AMRO staff calculations

5. Inflation is projected to revert to the target range in 2019. As inflation momentum appears to have slowed down due to the moderation in food and non-food inflation, and with the implementation of various non-monetary measures² including the passage of the rice tariffication law³, average inflation is expected to settle within the target band of 3.0 percent \pm 1.0 percentage point in 2019. However, the actual inflation trajectory is subject to uncertainties, such as volatile oil prices and slower-than-expected implementation of rice tariffication law.

Authorities' Views

¹ Here core inflation is calculated by AMRO to exclude all food and energy related components, the core inflation released by PSA only excludes rice, corn, fresh meat, chilled or frozen fresh fruit, fresh or dried vegetables cultivated for their fruit, fresh or dried vegetables cultivated for their roots, natural gas, liquefied or in the gaseous state, gas oils for motor vehicles.

² Non-monetary measures include: (1) a removal of non-tariff barriers on fish, chicken, seafood, and sugar, (2) release of all available rice stocks in National Food Authority (NFA) warehouses and importation of additional rice stock to beef up current NFA inventories and (3) a joint taskforce with National Police, National Bureau of Investigation, Department of Trade and Industry to monitor and ensure that rice stocks from ports reach NFA warehouses and retail outlets, etc..

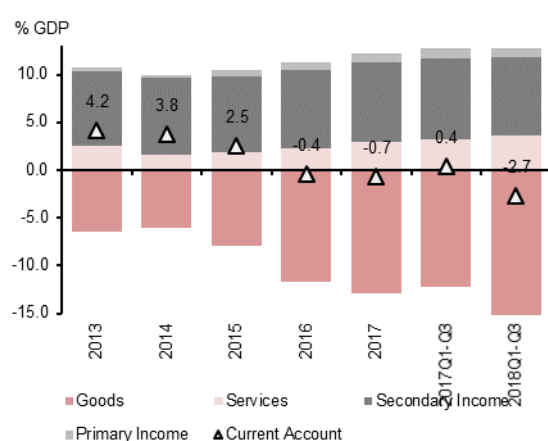
³ The Rice Tariffication bill was approved by the Senate on November 14, 2018 and ratified by both chambers of Congress on November 28, 2018. The rice tariffication bill has been transmitted to the Office of the President for signing into law as of January 15, 2019. With the passage of this bill into law, the Philippines will replace its rice importation from a quota-based system with a tariff-based system. For ASEAN countries, the rice import tariff will be 35 percent, and for non-ASEAN countries the tariff rate will be 50 percent. In order to protect the domestic industry, a Rice Competition Enhancement Fund will be setup.

6. The authorities see a stronger growth outlook in the coming year. They believe as more infrastructure projects break ground in 2019, infrastructure investment will accelerate. Moreover, in their view, the weakness in private consumption was temporary, as the declines were mostly in consumption of tobacco and alcoholic drinks, which were targeted by the excise tax hikes. As inflation declines and consumer confidence is restored, private consumption will recover. The government projected GDP to grow by 6.5-6.9 percent in 2018 and targets 7.0-8.0 percent in 2019 and beyond. On the inflation front, the authorities generally agree with AMRO's assessment, and the inflation outlook will be more favorable with the passage of the rice tariffication law. The BSP estimated that the rice tariffication law, if implemented in March 2019, can reduce inflation by 0.7 percentage point in 2019. The BSP has forecasted inflation to be 3.2 percent in 2019.

A.2 External Sector and the Balance of Payments

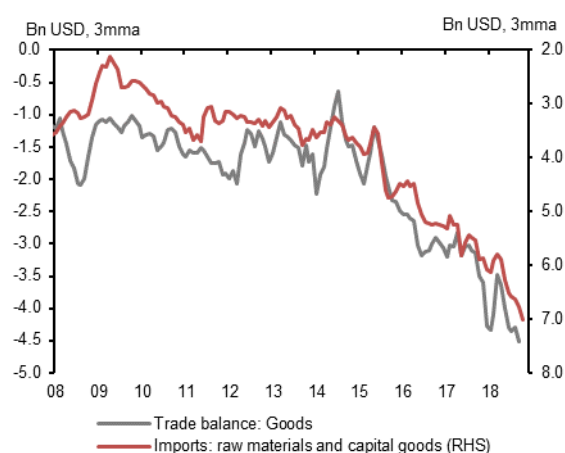
7. **The current account deficit widened markedly on the back of strong fixed asset investment.** The current account deficit widened from 0.7 percent in 2017 to 2.7 percent of GDP in the first three quarters in 2018 (Figure 7). The worsening of the current account balance was mainly driven by a growing trade deficit of merchandized goods, while overseas remittances and trade in services remained relatively stable. Trade deficit exhibited a sharper deteriorating trend (Figure 8), as the government started to push forward its ambitious infrastructure initiative. The investment push created a mounting demand for capital goods and raw materials that can only be met by imports. In the first three quarters of 2018, imports of capital goods and raw materials surged 16.1 percent, whereas goods exports declined 1.7 percent. Given that most of the investment projects are ongoing or waiting to break ground, and given the domestic capacity constraints, the current account is likely to remain in deficit in the next few years.

Figure 7. Current Account



Source: BSP; AMRO staff calculation

Figure 8. Trade Balance and Imports of Capital Goods and Raw Materials

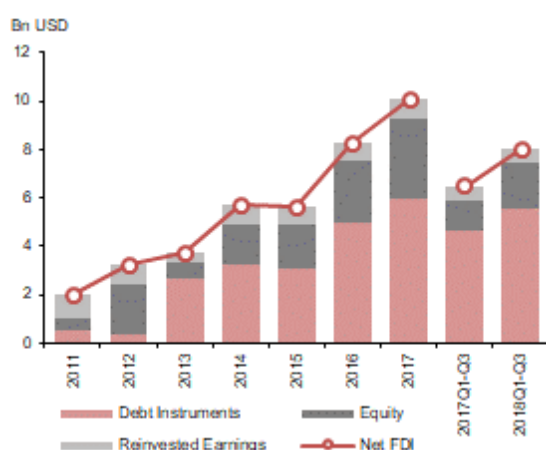


Source: BSP; AMRO staff calculation

8. **FDI continued to register strong inflows, supported mainly by investment in debt instruments.** FDI inflows increased 17.4 percent in the first three quarters of 2018 to USD 8.5 billion. The pattern of FDI inflows remained relatively stable in terms of types of funding.

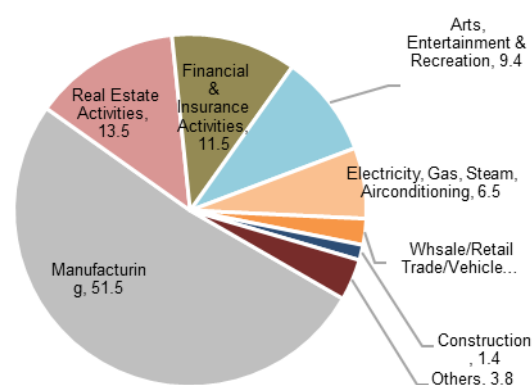
Investment in debt instruments still took the lion’s share of around 67 percent, equity FDI took up 25 percent, and reinvestment of earnings took the balance, generally on par with the averages since 2013 (Figure 9). However, the growth rates of different components were pretty volatile and varied. In the first ten months of 2018, equity FDI declined by 28.1 percent to USD 2.0 billion, investment in debt instruments rose by 18.6 percent to USD 5.9 billion, whereas earning reinvestment increased by 2.3 percent. Most of the investments came from Asia, with Singapore, Hong Kong, and China playing a growing role recently. In the first ten months of 2018, Singapore, Hong Kong and China overtook Japan and the U.S. as the top sources of investment. By industry, a little more than half of equity FDI went into manufacturing, 25.0 percent went to financial and real estate, and 9.4 percent went to entertainment and recreation (Figure 10). However, FDI is unlikely to sustain its remarkable growth in 2019, owing to the decline in approved projects and rising cross-border borrowing costs⁴.

Figure 9. The Composition of FDI



Source: BSP; AMRO staff calculations

Figure 10. FDI by Sector in 2018 (Jan-Oct)



Source: BSP; AMRO staff calculations

9. Non-FDI capital outflows intensified on the back of deepening domestic economic imbalance and external financial market turbulence. Since early 2018, global financial conditions have tightened sharply as interest rates rose and the U.S. dollar strengthened. Together with the ongoing escalation of trade tensions, these unnerved global investors, who became risk averse and sent the emerging markets into painful selloffs. The Philippine economy was no exception. Soaring inflation and the worsening current account aggravated investors’ concerns and resulted in the worst performing stock market (Figure 11) among ASEAN peers and a currency whose depreciation was second only to Indonesian Rupiah in the region. However, the outflows behind the market turmoil were mostly from resident investors (Figure 12). On a gross basis, domestic residents (mostly banks and other financial institutions) increased their holdings of foreign assets through portfolio investment (mostly debt securities) by USD 3.5 billion. Meanwhile domestic banks’ repayment of short-term loans resulted in an outflow of USD 1.7 billion. On the other hand, nonresidents’ unwinding of their portfolio investment positions remained moderate and selective. In the first three quarters of 2018,

⁴ For explanation see part B2.

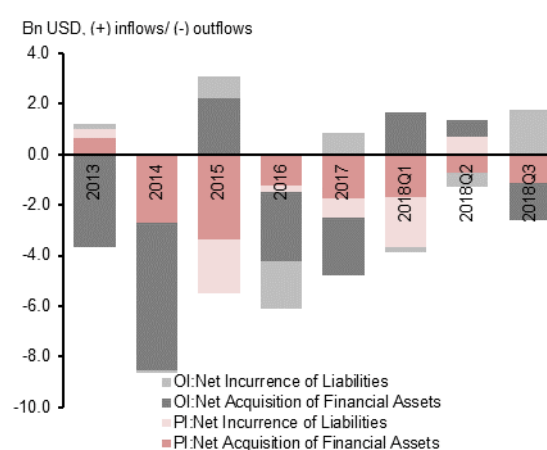
nonresidents reduced their equity investment by USD 1.6 billion, while increasing their holding of debt securities by USD 2.3 billion, most of which happened in 3Q 2018. On a net basis, portfolio investment registered an outflow of USD 2.8 billion, whereas other investments witnessed an inflow of USD 1.8 billion. The net inflows of other investments owe much to domestic residents' use of their foreign currency and deposits holdings (USD 2.0 billion) for debt repayment and the government's increase in cross border borrowing (USD 0.7 billion) particularly in 3Q 2018. After the sharp corrections in asset prices and exchange rate depreciation in the first three quarters of 2018, and front-loaded debt repayments, domestic assets became more attractive, and the debt repayment pressure for domestic borrowers has decreased, and as a result, short-term capital outflow pressure has eased. In 2019, a modest turnaround of short-term capital flows can be expected, provided external environment does not worsen much.

Figure 11. Equity Index in the Region



Source: National authorities; AMRO staff calculations

Figure 12 Non-FDI Capital Flows



Source: BSP; AMRO staff calculations

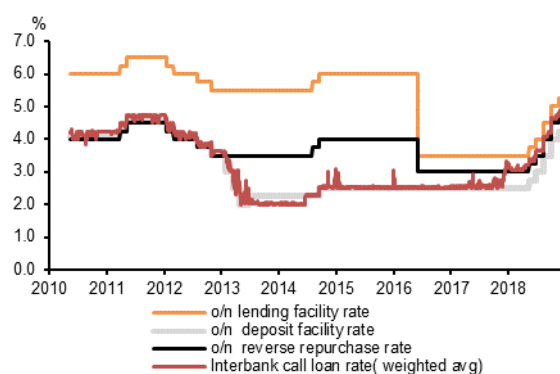
10. **As the overall external position worsened, international reserves declined, albeit remaining adequate.** Although the financial account managed to register a net inflow of USD 4.0 billion, supported by strong net direct investment inflows and other investments, it was not sufficient to cover the USD 6.5 billion current account deficit. The resultant funding gap was mainly met by a drawdown of the BSP's international reserves. Accordingly, gross international reserves declined from USD 81.6 billion in 2017 to USD 74.7 billion by the end of October 2018, the lowest level since July 2011, then edged up a bit to USD 79.2 billion in December 2018. Despite the decline in external buffers, international reserves are more than sufficient to cover the country's short term debt repayment needs. Gross international reserves was still equivalent to 7.0 months of goods and service imports and payments of primary income, and 6.0 times larger than repayment need of short-term debt based on original maturity and 4.1 times based on residual maturity by the end of December 2018.

A.3 Monetary Condition and Financial Sector

11. **Monetary conditions have tightened with the sharp increase in BSP's policy rate and the liquidity impact of short-term capital outflow.** The BSP has raised its policy rate five times, by a cumulative 175 basis points to 4.75 percent since May 2018, to anchor inflation

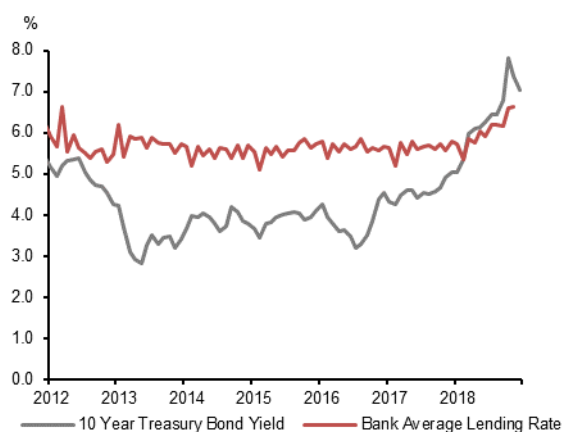
expectations and contain second-round effects. Market interest rates have gradually risen amid a tighter monetary policy stance by the BSP. Short-term domestic market interest rates have been generally trending upwards and moving steadily within the interest rate corridor (IRC) (Figure.13), reflecting the increased traction of BSP policy actions on domestic interest rates following the adoption of the IRC framework. Capital outflows arising from tighter global financial conditions and investor risk aversion also facilitated the rise in interest rates across tenors, causing the yield curve to shift 200-300 basis points higher relative to the beginning of 2018. Despite the tightening in financial conditions, funding costs to the real economy rose only moderately, in part due to strong competition among banks and the time lag needed for the impact to fully filter through. The average lending rate to the real economy rose about 100 basis points to 7.0 percent in December since the BSP started its rate hike in May 2018, while the 10-year government bond yield spiked 200 basis points to around 7.0 percent (Figure 14).

Figure 13. Policy Rates



Source: BSP

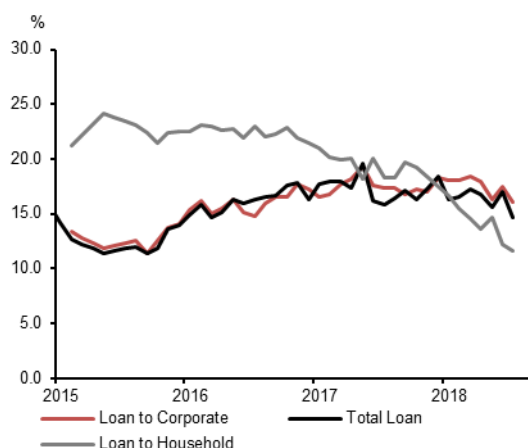
Figure 14. Government Bond Yield and Average Lending Rate



Source: BSP; Haver

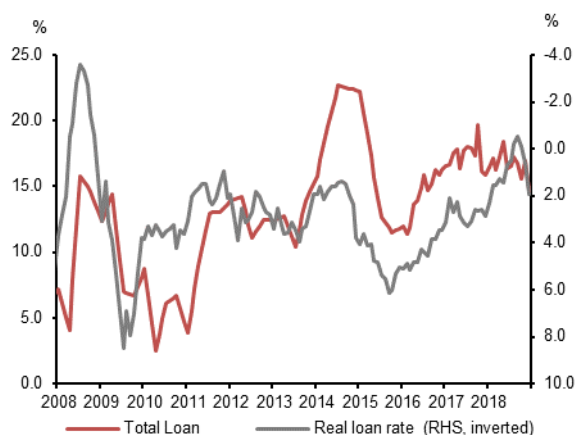
12. **Credit continued to grow rapidly on the back of strong demand.** Despite tighter monetary conditions, the banking system continued to extend credit strongly, with gross total loan portfolio rising at around 15 percent as of end-November 2018. While corporate loans sustained robust growth, the pace of household loans continued to moderate after its growth rate peaked in early 2017 (Figure 15). Most of the loans went into traditionally capital-intensive industries, such as manufacturing, real estate, financials, and utilities, and wholesale and retail trade, which took up around 57 percent of the total. The rapid credit expansion has provided firm support for the production of those sectors. The slowdown in household loan growth resulted largely from the cliff effects of front-loaded auto sales before the tax hikes, whereas credit card loan growth remained strong, possibly reflecting healthy borrowing appetite. Going forward, credit growth is expected to remain elevated on the back of buoyant demand and growing competition among banks to consolidate market shares. However, as real borrowing cost has started to rise, credit growth rate is likely to be on a moderating trend (Figure 16).

Figure 15. Bank Loan Growth



Source: BSP; AMRO staff calculations

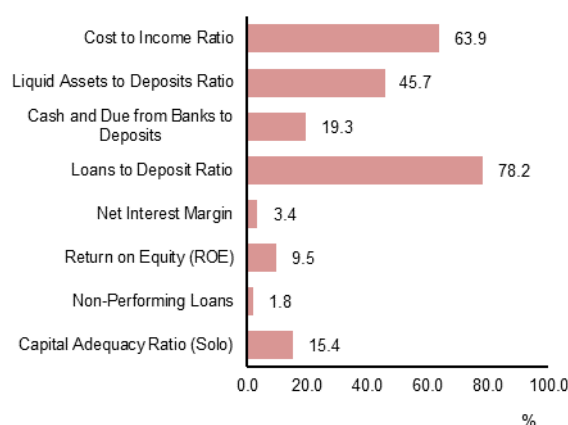
Figure 16. Loan Growth and Interest Rate



Note: real loan rate is the weighted average loan rate minus inflation
Source: BSP; AMRO staff calculations

13. **The banking system has remained generally sound, as reflected in strong financial soundness indicators (Figure 17).** Despite continued rapid credit expansion, the capital adequacy ratio is well above the regulatory requirements for the system, as a whole. As of end-September 2018, the banking sector capital adequacy ratio on solo basis stood at 15.4 percent. Liquidity is generally ample as indicated by the loan-to-deposit ratio and liquid assets to deposit ratio, which stayed at around 78 percent and 46 percent, respectively. Loan asset quality appears to remain healthy, with non-performing loans ratio at only 1.8 percent. Although there is no nascent signs of underwriting standard deterioration in the prolonged period of rapid credit growth, it is still prudent to closely monitor the quality of loan portfolio. The profitability of the banks remains solid, supported by high and stable net interest margins.

Figure 17. Selected Bank Performance Indicators As of end-September 2018

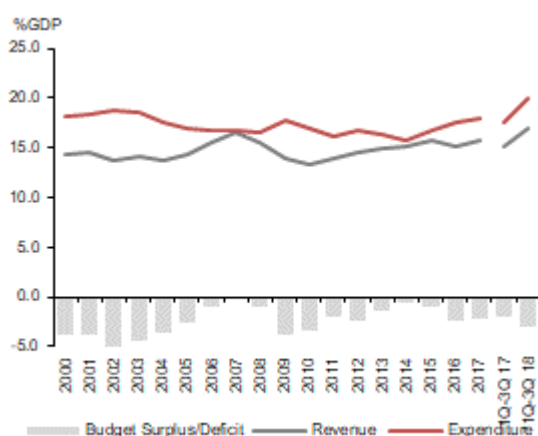


Source: BSP.

A.4 Fiscal Sector

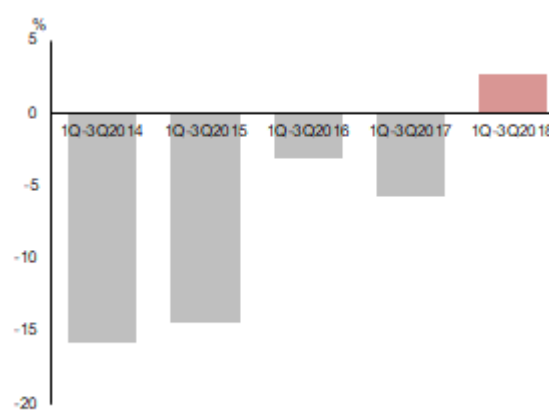
14. **Fiscal position has been markedly strengthened as the first phase of the Tax Reform for Acceleration and Inclusion Act (TRAIN)⁵ has taken effect and tax administration has improved.** Total government revenue increased by 17.2 percent in the first three quarters of 2018, pushing its share to GDP from 15.6 percent in 2017 to 16.9 percent—the highest ever achieved for the first three quarters of the year (Figure 18). The rapid growth of government revenue was broad-based, resulting from higher tax revenues and non-tax revenues. Tax revenues rose by 15.7 percent in the first three quarters of 2018, the highest growth rate in the last twenty years barring 2006. At the same time, non-tax revenue surged by 32.9 percent, largely due to higher collections of dividends from the government shares of stocks, guarantee fees, and share in the profit of the Philippine Amusement and Gaming Corporation (PAGCOR).

Figure 18. Fiscal Expenditure and Revenue



Source: BTr; AMRO staff calculation

Figure 19. Underspending Rate



Note: Underspending rate = fiscal spending / fiscal program-1
Source: DBM

15. **Expanded fiscal space has allowed the government to pursue development programs more aggressively.** Supported by the higher revenues, the government stepped up the pace of disbursement to other agencies and enhanced its implementation capacity. As a result, government spending was able to outpace the program (Figure 19) and the chronic underspending of previous years seems to have been solved. In the first three quarters of 2018, total government spending increased by 23.6 percent, 2.6 percent higher than the PHP 2.4 trillion program. Meanwhile, capital spending, growing by 45.9 percent, reached 570.8 billion, 7.2 percent higher than the program. In addition to the improved budget execution of major infrastructure agencies, which in the past marked with low utilization, the acceleration of infrastructure spending was also due to faster implementation and cleaning of prior years' accounts payable as the government transitions to a cash-based system⁶ in 2019. As the

⁵TRAIN is the abbreviation of the Tax Reform for Acceleration and Inclusion Act.

⁶The cash-based budget system requires agencies to obligate and implement contracts intended for the fiscal year and to be fully delivered by the end of the fiscal year, while under obligation-based budget system, the time period could stretch to 24 months and beyond. Details of comparison between these two budget systems can be found in the 2019 Budget Documents.

government sped up its pace of spending, fiscal deficit just hit the 3.0 percent target in the first three quarters of 2018, up from 1.9 percent in the same period 2017.

16. **Fiscal position has remained sound.** The national government debt stayed at around 42 percent of GDP in the first three quarters of 2018, with debt service cost declined mildly. Debt service⁷ as percentage of GDP declined to 5.0 percent in the first three quarters of 2018 from 5.1 percent in the same period of 2017. The government remains committed to lowering the level of government debt as a percentage of GDP in the next few years⁸ and will aim to keep the fiscal deficit within the 3 percent limit in the medium term. However, given the government's resolve to push forward its ambitious infrastructure initiative, fiscal expenditure is likely to remain strong with capital spending as the primary driver in the years ahead. The government's continuous effort towards realizing its "Build, Build, Build" (BBB) program may have negative impact on the government's finances and lead to higher budget deficit and debt accumulation by the country, particularly if the expected returns from the BBB program will not fully materialize.

B. Risks, Vulnerabilities and Challenges

17. **There are no notable systemic risks in view; the major risks facing the Philippine economy are mostly short-term ones.** Externally, escalating global trade tensions and a sharp tightening of global financial conditions remain the major risks. Domestically, higher-than-expected inflation and pockets of financial vulnerabilities are the main concerns. While domestic risks have started to show signs of easing, external risks may continue to intensify. The development of those risks and their impacts need to be closely monitored and properly addressed.

Table 1. Heat Map of Short-term Risks

Risks		Likelihood			Size of impact In 2018-19
		2017	2018	2019	
Domestic	higher-than-expected inflation	Low	High	Low	Low to Medium
	pockets of financial vulnerabilities	Low	Low	Low	Low to Medium
External	escalating trade conflicts	Medium	High	High	Medium
	sharp tightening of global financial conditions	Low	High	High	Medium



Source: AMRO.

⁷ Based on Version 2 debt service data from the Bureau of the Treasury (BTr).

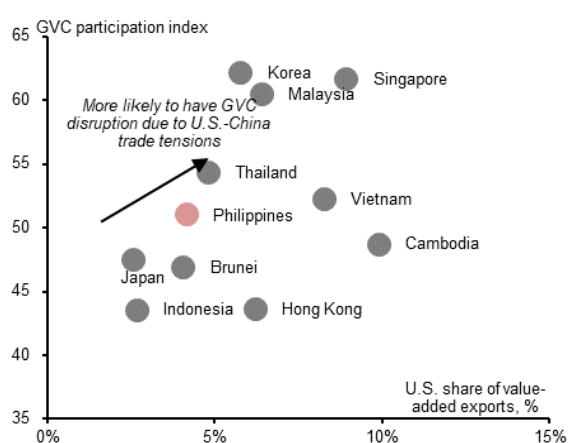
⁸ In the 2019 Budget, the government projected government debt as percentage of GDP to decline from 42.1 percent in 2017 to 41.7 percent in 2019 and consecutively down to a target of 38.6 percent in 2022.

B.1 Global Trade Tensions

18. **The continued escalation of global trade tensions may lead to a sharp slowdown of the global economy.** Since early 2018, global trade tensions, particularly between the U.S. and China, have gone through several rounds of escalation and de-escalation. Although the U.S. and China have recently agreed to suspend any further escalation of the conflict for 90 days from December 1, 2018, in order to allow both sides to negotiate an agreement to resolve the conflicts, the prospect of reaching an agreement is widely regarded as uncertain by most analysts. The risk of a resumption of the trade war should not be discounted. The global economy may therefore be subjected to the impact of a full scale trade war between the two economic giants, with major spillovers to the Asian region due to its large exposure to exports.

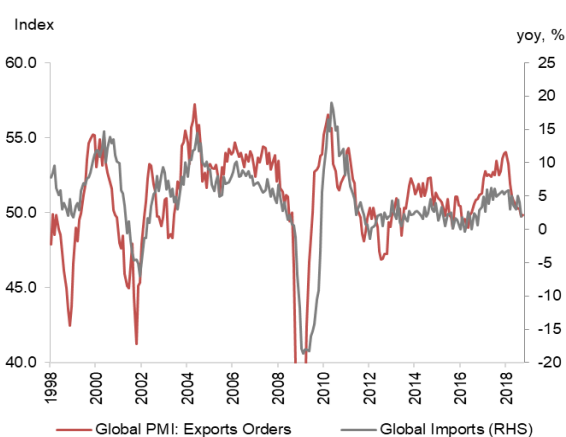
19. **Although the Philippines' limited integration into global value chains can provide some protection against the direct impact from the trade conflicts (Figure 20), the overall impact could be larger than the baseline scenario.** AMRO's baseline scenario forecast that tariffs imposed so far could reduce of the Philippine's GDP growth by 0.1 percent. With much of the impact from the trade conflicts in 2018 materializing in 2019 and the risk of a further escalation, global exports growth may collapse (Figure 21) and lead to a significant slowdown of the Philippine economy. According to AMRO's regional team estimates, trade conflicts can shave off as much as 0.4 percentage points from Philippine GDP growth, should the adverse scenario materialize. Building in the indirect impact from weaker confidence and tighter financial conditions, such as large capital outflows, the potential impacts would be even larger.

Figure 20. Participation in Global Value Chains



Source: OECD; AMRO staff calculations

Figure 21. Global Imports and Global Exports Orders



Source: CPB; Markit

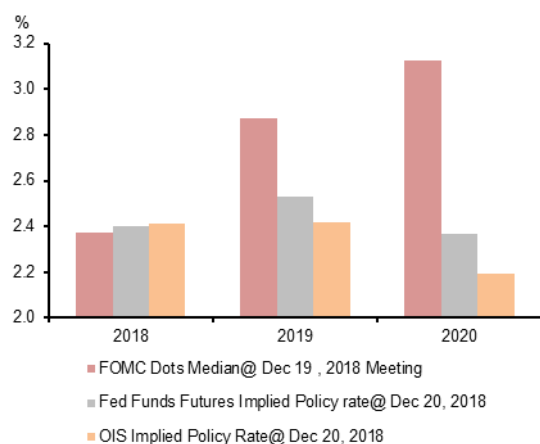
B.2 Tightening Global Financial Conditions

20. **Notwithstanding signs of stabilization and easing since late October, global financial conditions may tighten again and at a faster pace than anticipated.** Over the past few years, global financial conditions have tightened significantly mainly through three inter-related channels: normalization of the U.S. Fed's monetary policy, the strengthening of

the US dollar, and the repricing of risks. Despite the tighter global financial conditions, currently the market has priced in less rate hikes than the Fed dot plots suggest (Figure 22). A forced convergence will occur if the import tariff hikes and strong economy were to cause inflation to accelerate and the Fed acts more aggressively to contain the inflationary pressure. This will also lend strength to the U.S. dollar. Besides, investor sentiment may turn risk averse again. A more aggressive Fed, a deterioration of trade conflicts, a sharper-than-expected slowdown in major economies or renewed geopolitical tensions, either happening separately or jointly, can trigger an immediate risk-off sentiment, prompting another round of abrupt repricing of risk and creating disruptive volatilities.

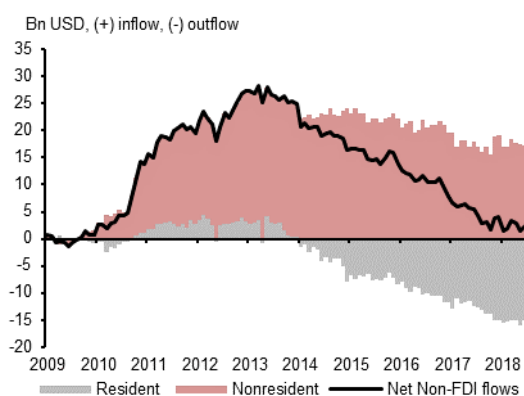
21. **Short-term capital outflow pressure may intensify again.** The resultant sharp tightening of global financial conditions will heighten the volatility in the Philippine financial markets and potentially accentuate the contagion from other emerging markets as well. Meanwhile, likely weaker exports with continued strong domestic investment could lead to a larger current account deficit, thus further undermining investors' confidence. Heightened financial market volatilities and renewed depreciation pressures on the peso could spur foreign investors to unwind their investment positions that have been accumulated over past several years, and prompt domestic residents to continue to increase their holding of foreign assets (Figure 23). Nonetheless, outflow pressures from debt repayments will be much relieved, as such repayment from domestic banks and corporates may have largely run its course.

Figure 22. US Fed Rate Expectations



Source: Bloomberg.

Figure 23. Cumulative Non-FDI Flows Since 2009



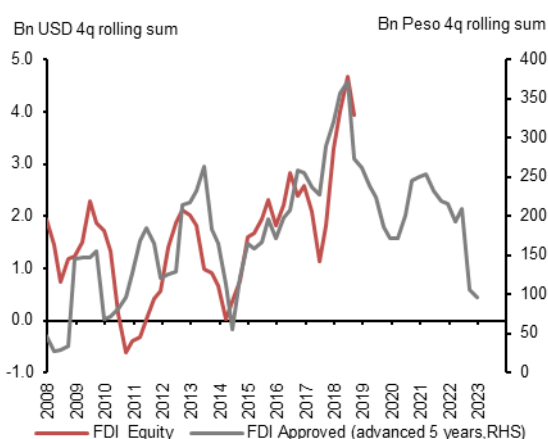
Note: resident flows refer to the net acquisition of financial assets, non-resident flows refers to net incurrence of liabilities.
Source: BSP; AMRO staff calculation

22. **FDI inflows may also slow down markedly.** Given the relative stability and low share of reinvestment of earnings, FDI inflows are largely determined by new equity investment and intercompany lending. Approved FDIs can be taken as a guide for new equity investment. Historically, the completion of an investment project after the FDI approval tends to be spread over five years⁹, thus creating a roughly five-year lead for the approved FDIs to be realized

⁹ According to the Technical Note of Approved FDI on PSA website, capital inflows from approved Foreign Investments are spread or expected to be fully implemented after five years or more, based on the experience of investment promotion agencies.

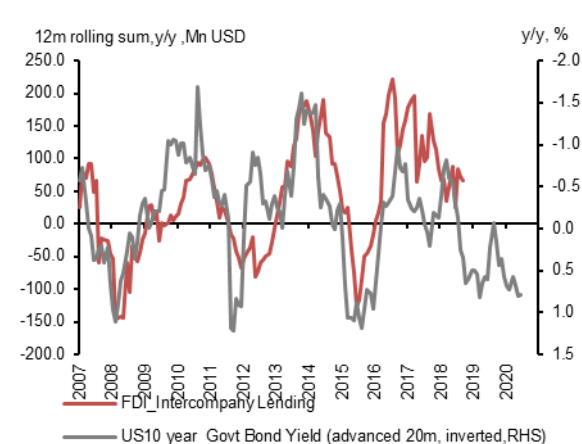
into equity inflows as registered under the balance of payments. The sharp decline of approved FDIs between 3Q 2013 to 1Q 2015 indicates a likely drop of equity inflows from 3Q 2018 to 1Q 2020 (Figure 24). As for intercompany lending, as rising interest rates in the U.S. have been pushing up borrowing costs in the past two years, the dampening impact on the corporates' cross-border lending activities is likely to become increasingly visible (Figure 25). The pace of intercompany loan inflows appears to be cooling off. Overall, FDI inflows are likely to moderate relative to 2018. Still, a sudden tightening of global financial conditions and an escalation of trade tensions are likely to raise borrowing costs and uncertainties sharply. These, in turn, could keep investors cautious and cause them to hold back their investments, thus causing a much deeper decline.

Figure 24 FDI Equity Inflows and Approved FDI



Source: BSP; PSA; AMRO staff calculations

Figure 25 Borrowing Cost and Intercompany Lending



Source: BSP; FED; AMRO staff calculations

B.3 Higher-than-expected Inflation

23. A host of factors could delay inflation from returning to the target range in 2019.

Although inflation is projected to fall back into the target range in 2019, a series of factors can delay the progress. Global oil prices may spike or even reverse the declining trend exhibited since October 2018, if the U.S. restores sanctions on Iran or other geopolitical developments lead to drastic supply disruptions. Between the time of the U.S. threat to restore sanctions on Iran and its granting of temporary exemption to eight major oil importers from Iran, global crude oil price rose by around USD 20 per barrel. Similarly, global oil price could jump, should concerns of a drastic supply disruption occur. Besides, a weak implementation of the rice tariffication law could result a lower-than-expected dampening impact on domestic food prices. Although the Congress has passed the rice tariffication law it will take time for relevant government agencies, importers and distributors to arrange new contracts. Given that delays in domestic food imports and distribution system are not a rare occurrence, the real impact of the rice tariffication law on food price remains to be tested. If combined with weather disruptions, food prices may remain elevated. In addition, government employees are expecting another round of salary hikes in 2019 and workers are asking for higher minimum wage hikes. The broad wage increase may induce cost-push inflation pressures, fuel domestic

demand and worsen inflation expectations. These developments are likely to create the conditions for strong second-round effects.

B.4 Potential Financial Vulnerabilities

24. **Rapid credit growth over the past several years may have increased potential financial vulnerabilities.** The banking system has generally remained sound, with adequate capital buffers, high liquidity and solid profitability. Nonetheless, a prolonged period of rapid credit expansion has led to rising corporate leverage and concentration risk, and expansion of non-banking activities, where the lack of critical data prevents a comprehensive assessment of the financial system. Foreign investors seem to have contributed to robust demand in the property sector, and a sudden reversal of their investment due to any policy change could bring corrections to the real estate market, impairing developers' balance sheets and repayment ability (see Selected Issue 1 for more details). In addition, rising borrowing costs will weigh on SMEs and other financially-weak borrowers and may result to higher non-performing loans, which may hurt banks' profitability. Having said these, banks have continued to set aside adequate provisioning for credit losses and higher interest rates may lend some support to net interest margins.

Authorities' Views

25. The authorities generally agree with AMRO's assessment of risks, especially external risks. The authorities pointed out that the BSP has approved the implementation of enhanced macroprudential measures to strengthen its oversight of the lending activity of banks, in addition to existing bank supervision and examination which are being conducted on a regular basis. Meanwhile, the government's accelerated infrastructure spending, along with the expected full swing of the "Build, Build, Build" program to help address the country's long-standing infrastructure bottlenecks, is expected to generate gains to the economy in the long run. The resulting expansion in productive capacity of the economy is also seen to moderate current inflationary pressures.

C. Policy Discussion and Recommendations

26. Given the Philippines' robust economic conditions amid uncertainties in the external environment, the authorities should strive to maintain the overall policy direction, while recalibrating the policy mix to maintain stability and guard against risks.

C.1 Fiscal Policy

27. **Fiscal policy should be calibrated to help contain inflation pressures and support the external position, through reprioritization of expenditure.** Efforts by the government to speed up fiscal spending, particularly in infrastructure projects, while pushing hard on tax reforms to create additional fiscal space are commendable. However, given inflation pressures, the bottlenecks in some sectors, and weakening external position, a neutral fiscal stance is recommended. The government could streamline current expenditures as it continues to improve the implementation capacity and spending efficiency of government agencies in-charge of the infrastructure projects. Moreover, the pace of implementation could be adjusted to be in line with the absorptive capacity of the economy.

28. **As the government continues to push the Tax Reform for Attracting Better and High-Quality Opportunities (TRABAHO bill), the design and implementation should be carefully calibrated to avoid the potential negative impact on investment and employment (see Selected Issue 2).** Despite the relatively smooth passage of the TRAIN law, the progress of the TRABAHO bill has been facing growing concerns and oppositions. Between the two pillars of the TRABAHO bill, namely corporate income tax cut and rationalization of the current tax incentive system, resistance and oppositions are mainly on the latter with concerns of losing current incentives and facing more bureaucracy. The sharp slowdown of approved FDI inflows since 2017 may indicate that investors have become cautious, possibly arising from the uncertainties related to this pending reform. Although the government should remain committed to push forward with tax reforms to continue to improve its fiscal system, it is important to consider concerns which are reasonable and make necessary adjustments to ensure a smooth implementation of the bill. It is also important that the tax reform is not revenue negative, to ensure that the fiscal deficit is capped within the medium-term target of 3 percent.

Authorities' Views

29. The authorities highlighted the importance to accelerate infrastructure investment for the long-term growth and development needs. Fiscal reforms need to keep up with the growing need from the ambitious infrastructure initiative. The authority stressed that there is no need to worry about the reforms on tax incentive. The proposed reforms will offer better and more attractive incentives through a performance-based, time-bound, transparent and targeted incentive system. The government has made some adjustments to reflect the feedbacks and comments from other agencies and business associations, etc. Currently the TRABAHO bill is under deliberation in the Senate. Once this tax reform is approved and enacted into law, the tax incentives would be available for new projects starting 2019. Moreover, the recently enacted Ease of Doing Business Law will help reduce red tape in the bureaucracy as it stands to boost investor confidence in the domestic economy as well.

C.2 Monetary Policy

30. **Monetary policy should be set appropriately to anchor inflation expectations and curb second-round effects.** The BSP has increased the policy rate five times in 2018 for a total of 175 basis points and reiterated its strong commitment and readiness to take all necessary policy actions to address the threat of high inflation. The staff welcome BSP's vigilance and commitment to safeguard price stability and financial stability. Going forward, the direction of the policy stance should be conditional on domestic and external developments. As domestic demand remains resilient, the economy can accommodate a further tightening of monetary policy if needed, especially if inflation fails to return to the target range in 2019. Moreover, government agencies would have to coordinate more closely in implementing timely non-monetary measures to further mitigate the impact of supply-side factors on inflation. A swift implementation of the rice tariffication law and enhanced price monitoring to ensure compliance will help dampen inflation pressure. Although inflation has started to trend

downward, it would be prudent to keep monetary policy on hold for now until inflation is firmly within the official inflation target band.

Box A. An Updated Taylor Rule Model for the Philippines

The Taylor rule is a simple equation that could describe a central bank's rate-setting behavior.

The standard Taylor rule sets the monetary policy rate as a function of the output gap and inflation relative to a target rate (Taylor, 1993). Since then, variants have been proposed to improve the model's fit. One is the addition of a lagged policy rate variable on the right-hand side of the equation to reflect the sticky, gradualist nature of policy rates (Kozicki, 1999). The standard Taylor rule has been further augmented to include other variables such as exchange rate, asset prices and foreign interest rate to capture their influence in policy decisions (Clarida et al., 1998; Taylor, 2001; Chadha et al., 2004; Bhar and Malliaris, 2016, among many other studies).

Taylor rule models have been estimated for the Philippines. Salas (2006), for instance, employed a forward-looking Taylor rule model to show that the BSP had been responding to inflation since its adoption of the inflation-targeting framework in 2002, in contrast to the earlier period when currency stability and money supply growth appeared to be a bigger concern for the central bank. On the other hand, the ASEAN-5 Cluster Report of the IMF (2016) found the coefficients for inflation and the output gap to be insignificant in the case of the Philippines. To a certain extent, this finding is in line with Lim's assertion (2008) of the disconnect between the largely supply-driven inflation in the Philippines and demand-influenced monetary policy. Lim claimed that a lax monetary policy would be unable to spur credit demand and raise inflation given the weak confidence arising from the high public debt burden, lack of financial deepening, and the trauma from the earlier 1997 Asian financial crisis, referring to the prevailing environment of the time. The fiscal burden would be gradually resolved over the next decade, with the country attracting sizeable foreign capital inflows following the ultra-loose monetary policies of the advanced economies in the wake of the 2008 global financial crisis. However, the abundant domestic liquidity that ensued also raised concerns about the effectiveness of the monetary policy transmission (IMF, 2015).

A Taylor rule model is estimated to take into account the BSP's adoption of the interest rate corridor system. The BSP implemented the interest rate corridor (IRC) system in June 2016 in an effort to improve the transmission of monetary policy while emphasizing that the IRC is meant to further support the inflation targeting framework of the central bank. To begin, we follow the augmented Taylor rule specification presented in the ASEAN-5 Cluster Report. That is, measures of the exchange rate, global uncertainty, and the U.S. interest rates are introduced as explanatory variables aside from the output gap, inflation, and the lagged policy rate. But we modify the model by introducing a dummy variable to reflect the adoption of the IRC system. The model is estimated for the period 2005-2018, and compared with a short-term time period for robustness checks.

Table A1. Taylor Rule Model Estimates

POLRATE = C(1) + C(2)*POLRATE(-1) + [1-C(2)] * [C(3)*(INFL - INFLTAR) + C(4)*OUTGAP(-1) + C(5)*UST5Y + C(6)*VIX + C(7)*FX + C(8)*DUMMY]						
Variable	Coefficient Label	Least Squares Estimate				
		Q4 2005 – Q4 2018			Q4 2010 – Q4 2018	
		w/ Dummy	w/o Dummy	w/ GFC Dummy	w/ Dummy	w/o Dummy
Intercept	C(1)	0.714**	0.184	1.012***	2.081***	0.753
Smoothing parameter	C(2)	0.848***	0.943***	0.811***	0.596***	0.844***
Headline CPI Inflation less midpoint of BSP's target	C(3)	0.874**	2.232	0.701***	0.391***	0.624
Output gap (trend obtained from one-sided HP filter with lambda=1600)	C(4)	0.694**	0.852	0.241	0.045	-1.127
U.S. monetary policy gap (5-year Treasury bill less rolling 2-year average)	C(5)	1.060	3.981	0.661	-0.294	2.009
Global uncertainty (VIX index less rolling 2-year average)	C(6)	-0.120*	-0.286	-0.018	-0.007	0.0746
FX rate (USD/PHP deviation from linear trend)	C(7)	-0.121***	0.054	-0.130***	-0.106*	0.108
IRC dummy [Q2 2016 - Q4 2018]	C(8)	-2.974***		-3.031***	-2.259***	
GFC dummy [Q4 2008 - Q2 2009]	C(9)			-4.128**		
Adjusted R-squared		0.961	0.956	0.969	0.874	0.783
No. of Observations		53	53	53	33	33

Note: Deviations of the variables are obtained to address the unit root issue. Model estimates have been adjusted for the presence of heteroscedasticity and serial correlation in the residuals. ***, **, * denotes significance at the 1 percent, 5 percent, and 10 percent levels, respectively.

Source: AMRO

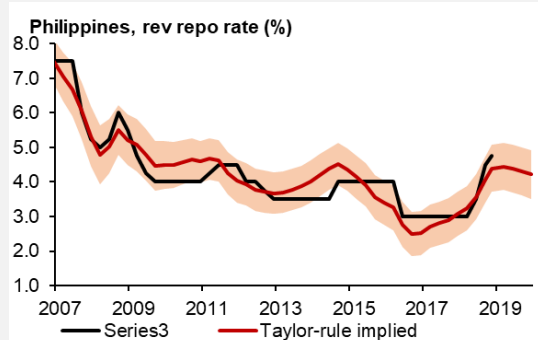
Adding the IRC dummy yields significant coefficients for inflation and output gap. Just as in the IMF report, our least-squares estimates of the augmented Taylor rule fit the data well, with an adjusted

R-squared of 96 percent. A strong preference for interest rate smoothing is also indicated by the model results, given the significant coefficient of over 0.8 for the lagged dependent variable. But in contrast to the IMF report's other results, our estimates indicate the relevance of inflation in guiding the policy rate decisions of the BSP, albeit with a coefficient of less than 1. The coefficient for the output gap is also significant but smaller than inflation's, suggesting that the BSP places greater weight on inflation than growth in adjusting monetary policy. In addition, we find that heightened global uncertainty—as proxied by an increase in the VIX index relative to its rolling 2-year average—and an appreciation of the peso relative to its trend tends to place downward pressure on the policy rate, albeit to a lesser degree given their smaller coefficients as against those for inflation and output gap. As for the former, heightened global uncertainty may prompt a policy rate cut to counter its downside impact on the real economy via weaker investments and exports.

Of the variables in the model, only the U.S. interest rate is not significant. This to us is intuitive given the low foreign investor presence in the country's bond and equity markets. As such, the risk of foreign capital reversals is not sufficiently material to prompt the BSP to hike policy rates in response to U.S. Fed rate hikes, and its impact on the exchange rate can instead be managed by a drawdown of foreign currency reserves. *Once the IRC dummy—which is also significant—is excluded from the model, only the lagged policy variable is left with a significant coefficient.* The addition of a GFC dummy does not alter the results much, except that it would make the output gap no longer significant, though the fit barely improves. Also, the significance of most coefficients would continue to hold, except for the output gap and uncertainty variables, when the data range is shortened.

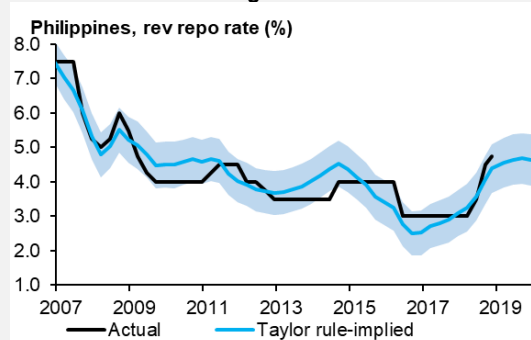
The estimated Taylor rule shows that the BSP has tightened monetary policy in line with higher inflation and strong economic growth. Going forward, the Taylor rule model suggests a slight reduction in the policy rate under our baseline scenario where inflation is expected to ease from 5.2 percent in 2018 to 3.4 percent in 2019 while GDP growth is maintained above 6 percent. However, if inflation settles above 4 percent in 2019, as indicated by the median of Bloomberg-compiled analyst expectations, then the policy rate should stay at around the current level as the Taylor rule model suggests. The baseline and alternative scenarios both assume one 25-basis-point rate hike by the U.S. Fed—as implied by the Fed Funds futures—and a fairly stable PHP/USD rate and VIX index.

Figure A1. Actual Policy vs. Taylor Rule-Implied Policy Rates under Baseline Scenario



Note: The bands denote +/-1 standard error.
Source: AMRO

Figure A2. Actual Policy vs. Taylor Rule-Implied Policy Rates under Higher Inflation Scenario



Note: The bands denote +/-1 standard error.
Source: AMRO

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31. **The staff endorses the BSP's commitment to maintaining a flexible exchange rate as a buffer to absorb external shocks.** While the BSP should intervene in the foreign exchange market to smooth short-term fluctuations, the exchange rate level should continue to be determined by market forces. The BSP has issued, under Circular Nos. 1014 and 1015 dated 24 September and 5 October 2018, respectively, the enhanced guidelines on the Currency Rate Risk Protection Program (CRPP), aimed at easing the demand pressures in the foreign exchange spot market. Against the rapidly changing external environment, the BSP's efforts to strengthen hedging tools in the FX market are welcome. However, the implementation of the CRPP should be carefully managed in order not to hinder price discovery in the FX market.

C.3 Macro-prudential Policy

32. **The staff welcomes the BSP's ongoing efforts to strengthen its macro-financial surveillance and develop various macroprudential toolkits.** The introduction of the countercyclical capital buffer as a pre-emptive move to safeguard the economy's financial stability and collective efforts across agencies to collect information on corporate and household borrowers are very important and necessary for effective financial surveillance. With improved data coverage and toolkit, the authority can conduct comprehensive analyses of the financial sector, to get a better understanding of the interconnectedness and potential weak points in relevant sectors. Such developments will enable the authority to monitor the development of risks and deploy appropriate policy tools in a pre-emptive manner.

C.4 Structural Policy

33. **The government should strengthen the structural reform agenda to continue enhancing the growth potential of the economy.** In addition to further improvements in physical infrastructure, social infrastructure also needs to be enhanced. The staff commends the authorities' continued efforts on improving the ease of doing business. The timely implementation of the Ease of Doing Business and Efficient Government Service Delivery Act of 2018 (Republic Act No. 11032 dated 28 May 2018), will improve the country's ease of doing business and help attract more private investment and FDI inflows. The implementation of the Inclusive Innovation Industrial Strategy (i3S) will enhance productivity growth and support economic diversification. In addition, the government should promote the development of a more productive and resilient agricultural sector over the medium term by providing better infrastructure, conducting more research and development, and providing financial services to the farmers. At the same time, an efficient food stock and distribution system is indispensable to avoid a steep adjustment in prices when natural calamities occur. The achievement of the comprehensive and complex development objectives will require not only a strong push from

the government, but also the close cooperation from the local governments. Therefore it is crucial for the local governments to have the relevant absorptive capacities. The current proposal of the central government to transform the political system into a federal form of government could be taken as a starting point in that direction (Box B).

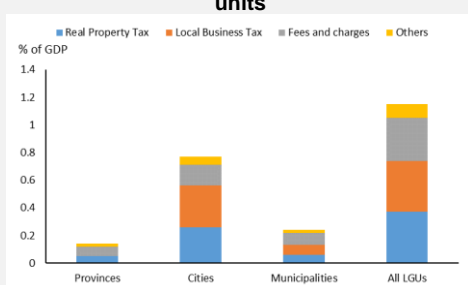
Box B. National Government-Local Government Relations in the Philippines

Currently, the government has initiated debate to transform the political system into a federal form of government. There are several proposals, and with the ongoing debate the potential changes could have far-reaching implications for the country. In particular, the changes in the fiscal accounts will depend on the chosen federal model. In this regard, the form of government, responsibilities, and revenue raising ability of the Federal and Regional governments need to be carefully considered, particularly the impact on various fiscal indicators and fiscal sustainability. Understanding the current inter-governmental fiscal relations is an essential step towards evaluating the proposed reform. Currently, the revenue raising ability of local governments and devolved responsibilities have been limited, suggesting significant capacity building and institutional reform at the local level to achieve effective decentralization.

The current framework for the devolution of duties to the local government is enshrined in the 1991 Local Government Code (LGC). Under the 1991 LGC, functional assignments are detailed at the provincial, municipality and barangay level with devolved functions ranging from agriculture, health, local infrastructure, social welfare, housing and other services. However, due to a lack of capacity and unfunded mandates at the local level, the full implementation of these devolved functions never took off, with the national government still providing the bulk of such services or facilities directly.

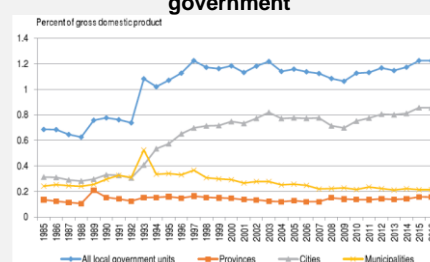
The weak ability of the local government to perform its expenditure mandate can also be attributed to their ability to raise revenue. Revenues raised by local governments mainly relate to real estate property tax, local business tax and other fees and charges (Figure B1). Revenues generated by the local government is quite low, hovering only around 1.2 percent of GDP. Since the 1991 LGC was enacted, it was mainly cities that were able to increase revenue from their own sources, while the revenue-raising ability of provinces and municipalities have remained relatively flat (Figure B2), as many LGUs have not fully maximized their own revenue-raising powers under the Local Government Code.

Figure B1. Own-source revenue of local government units



Source: Manasan (2017)

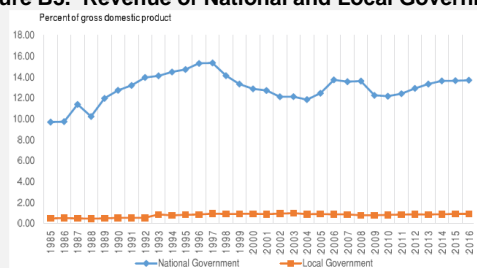
Figure B2. Revenue across different levels of local government



Source: Manasan (2017)

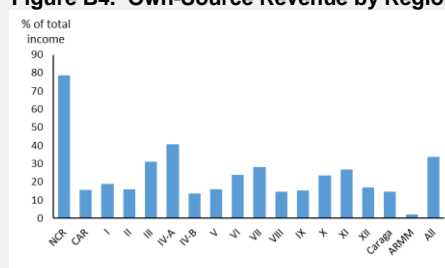
Local governments are highly dependent on the national government for generating revenue. National government tax revenue hover around 12-13 percent of GDP, while local government revenues are very low (Figure B3). Looking on a per region basis, only NCR can be considered to have sufficient ability to raise its own revenue, with own-source revenue accounting for almost 80 percent of local government income.¹⁰ Meanwhile, the rest of the region have their own source revenue at much lower levels, with the average at 34 percent of income (Figure B4). The low level of own source revenue means local governments are highly dependent on fiscal transfers from the National Government, particularly the Internal Revenue Allotment (IRA), which account for around 13 percent of total expenditure.

Figure B3. Revenue of National and Local Government



Source: Manasan (2017)

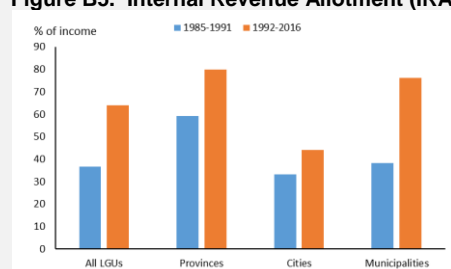
Figure B4. Own-Source Revenue by Region



Source: Bureau of Local Government Finance (BLGF)

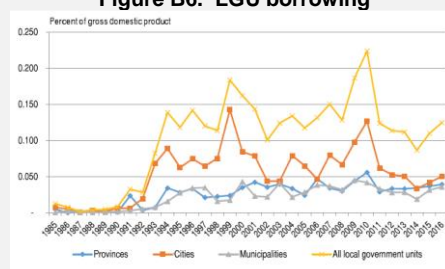
The bulk of local government incomes are derived from the IRA. The IRA accounts for a significant share of local government income, and has increased markedly since the 1991 LGC was enacted (Figure B5). This is mainly due to the legislative mandate under the LGC to increase the IRA from 20 percent to 40 percent of national tax collection. The IRA is automatically appropriated based on a formula of expenditure needs, which is based on population and land area.

Figure B5. Internal Revenue Allotment (IRA)



Source: BLGF

Figure B6. LGU borrowing



Source: BLGF

Borrowing framework for local government is limited. Despite the ability provided by the 1991 LGC for local government to borrow from banks and issue bonds, the complicated and numerous approval process has limited the growth of LGU borrowing (Figure B6). This has held back the ability of local governments to invest in capital expenditure, as limited borrowing forces them to save significant amounts of their IRA first, before they are able to sustainably finance a project.

References

1. Diokno, B. 2012. "Fiscal decentralization after 20 years: What have we learned? Where do we go from here?" *The Philippines Review of Economics* XLIX(1):9–26c
2. Hill, H. 2008. "Globalization, Inequality, and Local-Level Dynamics: Indonesia and the Philippines." *Asian Economic Policy Review*. 3 (1). pp. 42–61.
3. Manasan, R. 2017. "Designing the Fiscal Features of a Federal System of Government: Autonomy, Accountability, and Equity Considerations." *Philippine Institute for Development Studies Third Annual Public Policy Conference*.

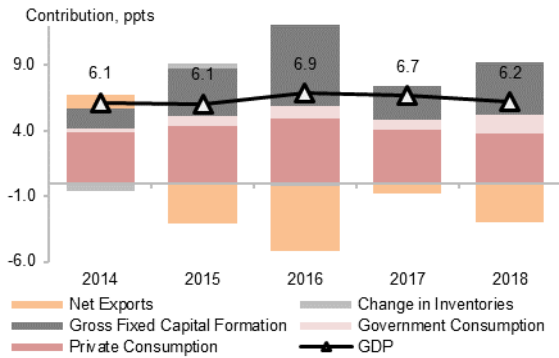
¹⁰ Local government income consist of own-source revenue (mainly property taxes and business permits) and transfers from the National Government (Internal Revenue Allotment).

Appendix

Appendix 1. Selected Figures for Major Economic Indicators

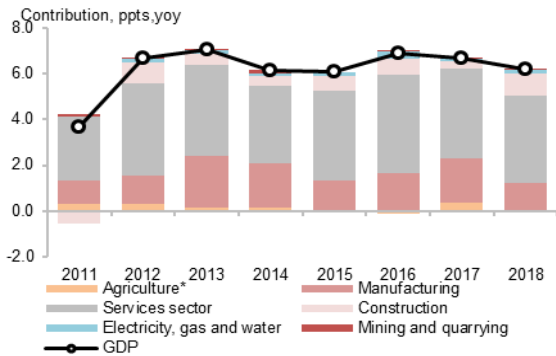
Figure 1.1. Real Sector

Economic growth moderated in 1Q-3Q 2018, as private consumption growth decelerated and net exports drags increased.



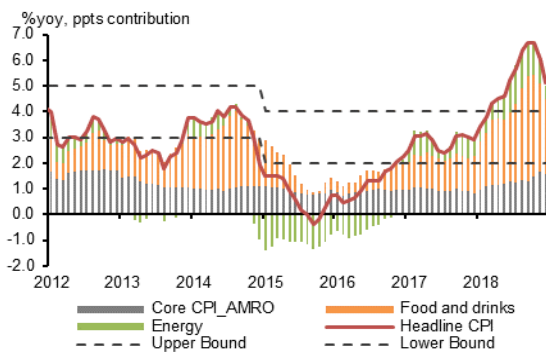
Source: PSA

Service sectors continued to hold up well, while manufacturing output growth decelerated.



Source: PSA.

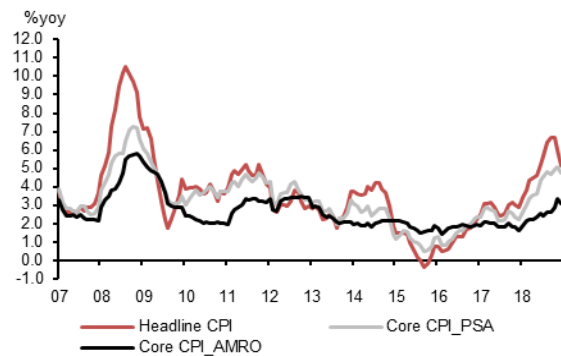
Inflation accelerated to above the upper bound of target, largely due to supply shocks...



Note: energy includes electricity, gas and other fuels under housing items and fuel and lubricant under transportation; food and drinks include all food and drinks and tobacco. The remains are used to calculate AMRO's Core inflation.

Source: PSA; AMRO staff calculations.

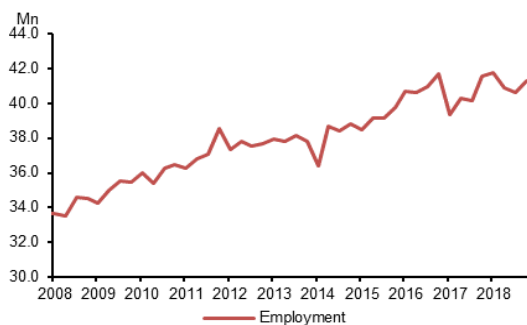
...as resilient demand also played a role.



Note: energy includes electricity, gas and other fuels under housing items and fuel and lubricant under transportation; food and drinks include all food and drinks and tobacco. The remains are used to calculate AMRO's Core inflation.

Source: PSA; AMRO staff calculations.

Employment declined in Q2 and Q3 in part due to tighter labor contractual practices and weather disturbances, and it reverted back in Q4.



Source: PSA.

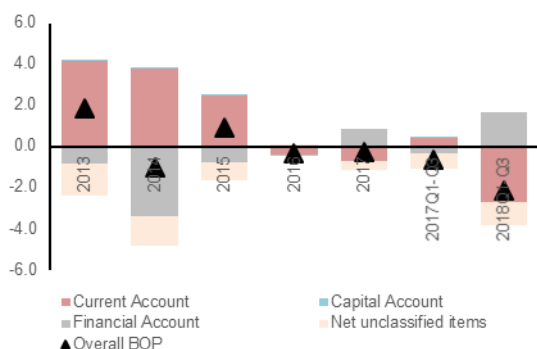
Unemployment rate largely stayed on a mildly declining trend.



Source: PSA.

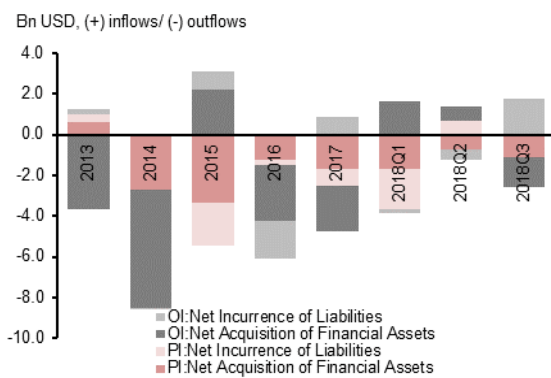
Figure 1.2. External Sector

The BOP has worsened as the current account deficit widened and short-term capital outflows intensified.



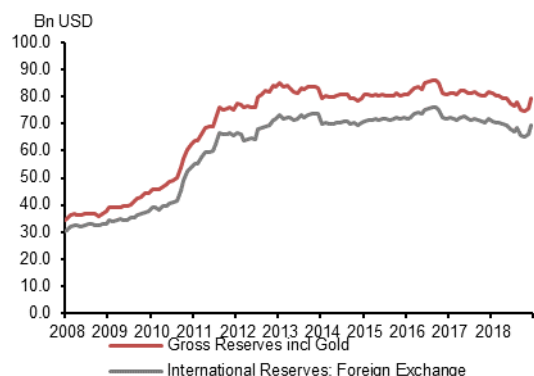
Source: BSP.

Capital outflows were largely driven by residents, while non-residents unwinding of their investment position appeared to be subdued.



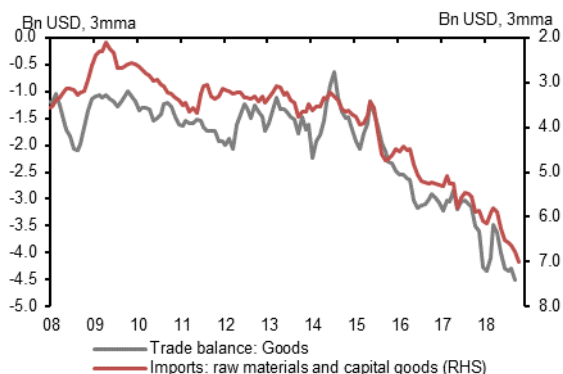
Source: BSP.

Worsening external position eroded external buffers...



Source: BSP

Current account deficit was mainly driven by strong imports demand for capital goods and raw materials.



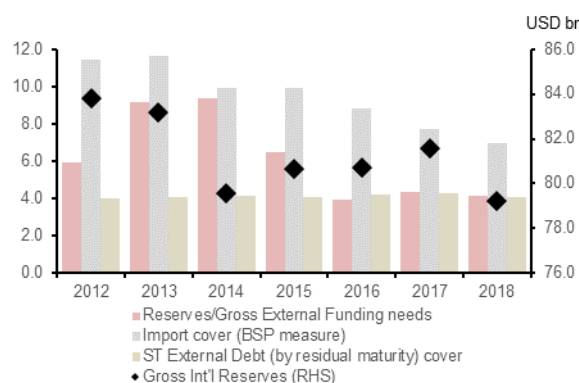
Source: BSP

Worsening external position continued to weigh on peso.



Source: BSP.

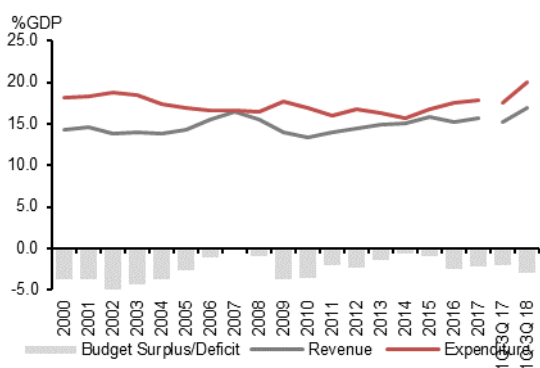
...but international reserves remain adequate.



Note: Import cover refers to number of months of average imports of goods and payment of services and primary income.
Source: BSP

Figure 3. Fiscal Sector

Fiscal strength has been enhanced by tax reforms.



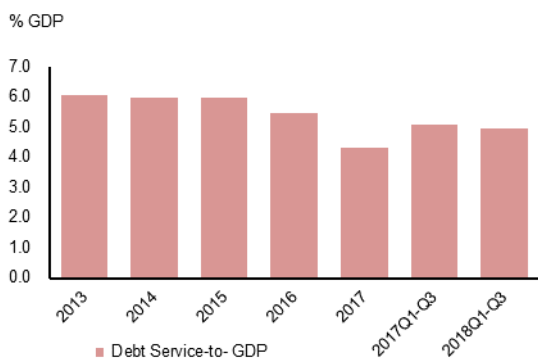
Source: Bureau of Treasury

Fiscal position remained sound with debt staying relatively stable...



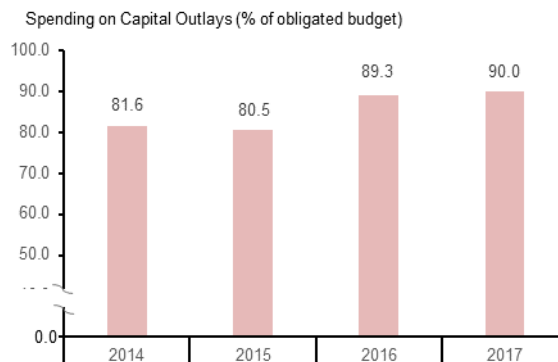
Source: Bureau of Treasury

...with debt service-to-GDP ratio declined mildly



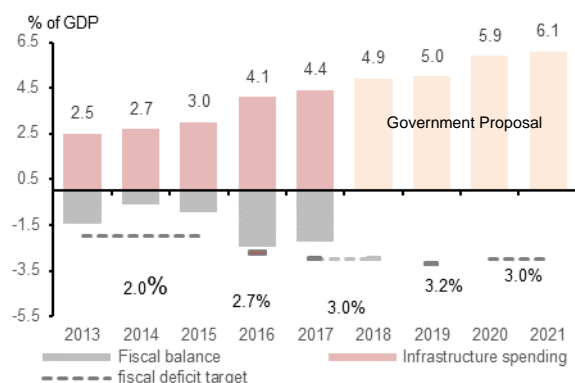
Source: Bureau of Treasury.

Government implementation capacity improved, but more efforts are needed.



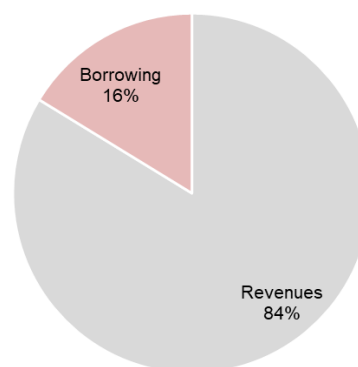
Source: DBM

The government has proposed a higher fiscal deficit ceiling for 2019 on cash basis and more infrastructure spending...



Source: DBM

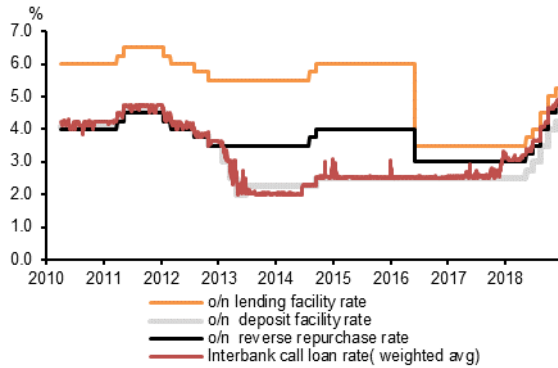
...with most of the disbursement funded by fiscal revenue.



Source: DBM

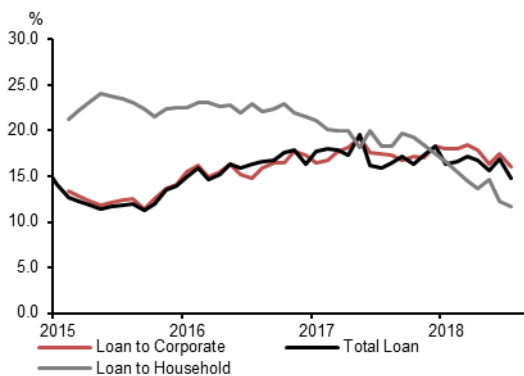
Figure 1.4. Monetary and Financial Conditions

Monetary conditions have tightened as the BSP started hiking its policy rate and short-term capital continued to flow out.



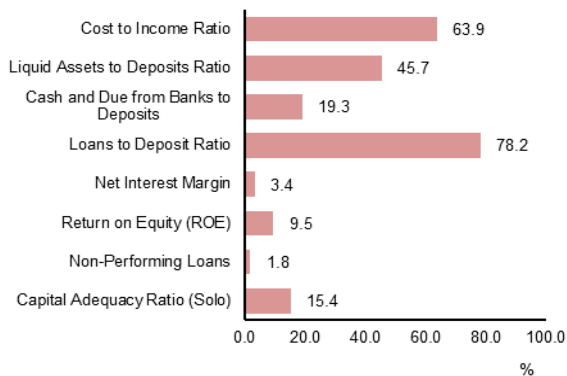
Source: BSP

Credit continued to grow rapidly on the back of strong demand and growing competition.



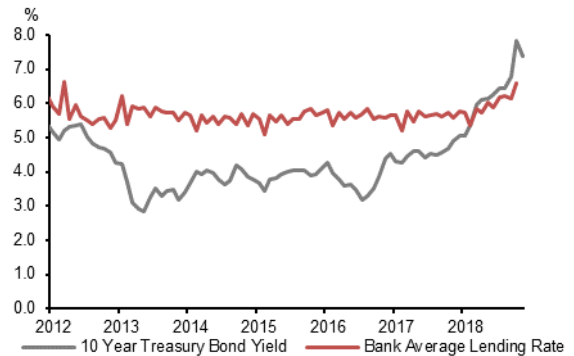
Source: BSP

The banking sector remains generally sound.



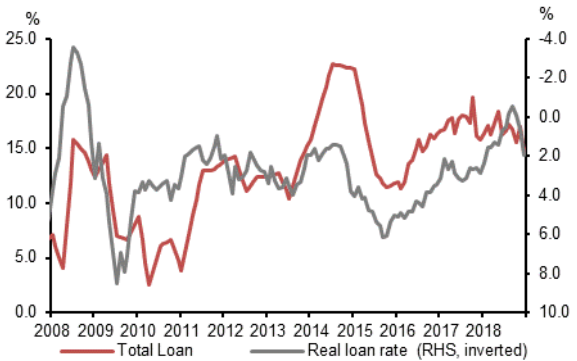
Source: BSP

Funding cost to the real economy rose only moderately, in part due to strong competition among banks.



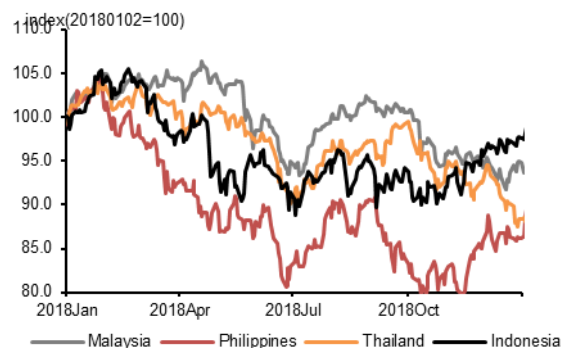
Source: BSP

However, as real borrowing cost has trended higher, credit growth rate is likely to moderate.



Note: Real loan rate is the weighted average of loan rate minus inflation
Source: BSP

The Philippine equity market underperformed ASEAN peers in 2018.



Source: Haver

Appendix 2. Selected Economic Indicators for the Philippines

	2014	2015	2016	2017	Projection	
					2018	2019
Real sector and prices	(in percent change, unless specified)					
Real GDP	6.1	6.1	6.9	6.7	6.2	6.4
Private consumption	5.6	6.3	7.1	5.9	5.6	5.3
Government consumption	3.3	7.6	9.0	7.0	12.8	10.5
Gross fixed capital formation	7.2	16.9	26.1	9.5	14.0	15.4
Exports of goods and services	12.6	8.5	11.6	19.5	11.5	8.6
Imports of goods and services	9.9	14.6	20.2	18.1	14.5	12.2
Prices						
Consumer price inflation (end of period 2012=100)	1.9	0.7	2.2	2.9	5.1	2.9
Consumer price inflation (period average 2012=100)	3.6	0.7	1.3	2.9	5.2	3.0
Core inflation (period average 2012=100)	2.6	1.0	1.6	2.4	4.2	2.9
GDP deflator	3.2	-0.6	1.7	2.3	3.8	2.7
External sector	(in billions of U.S. dollars, unless specified)					
Current account balance	10.8	7.3	-1.2	-2.2	-9.4	-8.3
(in percent of GDP)	3.8	2.5	-0.4	-0.7	-2.9	-2.3
Trade balance	-17.3	-23.3	-35.5	-40.5	-50.6	-55.1
Services balance	4.6	5.5	7.0	9.2	11.0	14.7
Primary income, net	0.7	1.9	2.6	3.0	3.5	4.7
Secondary income, net	22.8	23.3	24.7	26.1	26.6	27.4
Financial account balance	9.6	2.3	0.2	-2.7	-6.3	-6.1
Direct investment, net	1.0	-0.1	-5.9	-6.5	-6.9	-6.4
Portfolio investment, net	2.7	5.5	1.5	2.5	2.6	1.4
Other investment, net	5.9	-3.1	4.6	1.4	-1.9	-1.1
Error and omission	-4.1	-2.4	0.3	-1.4	-2.1	0.0
Overall balance	-2.9	2.6	-1.0	-0.9	-5.6	-2.2
Gross international reserves (end-period)	79.5	80.7	80.7	81.6	76.0	73.8
Total external debt (percent of GDP)	27.3	26.5	24.5	23.3	23.3	21.2
Short-term external debt (percent of total)	20.9	19.5	19.4	19.5	14.3	16.8
Fiscal sector (National Government)	(in percent of GDP)					
Government revenue	15.1	15.8	15.2	15.6	16.3	16.5
Government expenditure	15.7	16.7	17.6	17.9	19.3	19.5
Fiscal balance	-0.6	-0.9	-2.4	-2.2	-3.0	-3.0
Primary balance	2.0	1.4	-0.3	-0.3	-1.0	-0.9
Government debt	45.4	44.7	42.1	42.1	42.1	41.7
Monetary sector	(in percent change, end-period unless specified)					
Domestic credit	17.8	11.5	17.0	13.9	14.2	14.5
Of which: Private sector	19.9	12.1	16.6	16.4	15.5	14.5
Broad money	12.4	9.3	13.4	11.3	8.5	9.0
Memorandum items:						
Exchange rate (peso per USD, average)	44.4	45.5	47.5	50.4	52.7	53.6
Exchange rate (peso per USD, eop)	44.6	47.2	49.8	49.9	52.7	54.3
Gross domestic product at current price (In trillions of pesos)	12.6	13.3	14.5	15.8	17.4	19.0
Gross domestic product at current price (In billions of U.S. dollar)	284.6	292.8	304.9	313.6	330.8	354.5
GDP per capita (in U.S. dollar)	2,849.3	2,882.7	2,953.1	2,988.9	3,102.8	3,274.0

Source: Philippine authorities; AMRO staff estimates

Appendix 3. Data Adequacy for Surveillance Purposes: a Preliminary Assessment

Surveillance Areas	Data Availability ⁽ⁱ⁾	Reporting Frequency/Timeliness ⁽ⁱⁱ⁾	Data Quality ⁽ⁱⁱⁱ⁾	Consistency ^(iv)	Others, if Any ^(v)
National Accounts	Available	Quarterly data for the expenditure and production approaches are available with a normal time lag (two months after the reference quarter)	-	-	-
Balance of Payments (BOP) and External Position	Available	BoP data are available quarterly with a normal time lag (two months and three weeks after the reference month). External debt data are available with a normal time lag of two months and three weeks after the reference quarter	-	-	-
State Budget and Government/ External Debt	Available	Central government budget and public finance data are available on a monthly basis with a normal time lag (one to two months after the reference month). Date for central government domestic and foreign debt outstanding are available monthly with a normal time lag (one month after the reference month)	-	-	-
Money Supply and Credit Growth	Available	Money supply data are available on a monthly basis with a normal time lag (one month after the reference month). Bank loan data are available quarterly with a normal time lag of two-and-a-half to three months after the reference quarter.	-	-	-
Financial Sector Soundness Indicators	Available	Quarterly indicators are available with a time lag of one quarter	-	-	-
SOE Statistics	SOE statistics have yet to be made available on a frequent basis.	-	-	-	-

Notes:

- (i) Data availability refers to whether the official data are available for public access by any means.
- (ii) Reporting frequency refers to the time interval that the available data are published. Timeliness refers to how up-to-date the published data are relatively with the publication date.
- (iii) Data quality refers to the accuracy and reliability of the available data given the data methodologies are taken into account.
- (iv) Consistency refers to both internal consistency within the data series itself and its horizontal consistency with other data series of either same or different categories.
- (v) Other criteria might also apply, if relevant. Examples include but are not limited to potential areas of improvement for data adequacy.

Source: AMRO staff compilations. This preliminary assessment will form the "Supplementary Data Adequacy Assessment" in the EPRD Matrix.

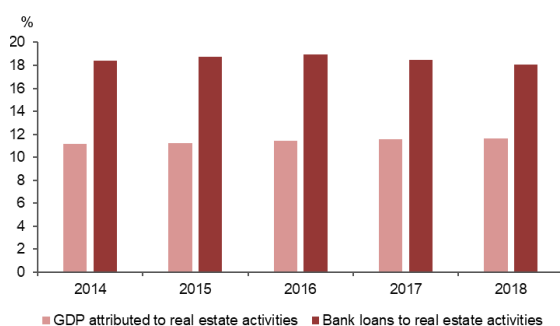
Annexes: Selected Issues

Annex 1. Will the Philippines' Real Estate Sector Stay Resilient to Capital Outflows?— A Firm-Level Stress Test on its Creditworthiness

1. **The Philippines' real estate sector is considered a potential source of systemic risk.** In 2018, real estate activities contributed 11.6 percent to real GDP and comprised 18.1 percent of bank loans, the biggest share across all productive sectors (Figure A1.1).¹¹ To ensure effective surveillance of this sector, authorities have been imposing lending caps and strengthening reporting requirements as well as conducting stress tests on banks' exposures. This selected issue, using firm-level data of 34 publicly-listed real estate developers, studies the creditworthiness of the real estate sector and examines its resilience against stress scenarios of cross-border capital outflows.

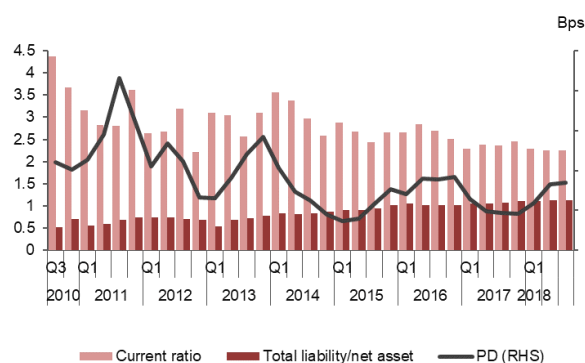
2. **Our study finds no significant credit risk in the sector at this moment, but it points out areas where some stress could surface.** Looking at their financial statements, the real estate developers' financial leverage, defined as book liabilities over net assets, has doubled since 2010 (see Figure A1.2). This heavier borrowing could be attributed to the buoyant demand for properties, low interest rate environment globally, as well as financial deepening in the Philippines. Firms' liquidity, defined as current assets over current liabilities, is abundant, but on the decline. On the one hand, this indicates that developers have been reducing excess liquidity, on their balance sheets, while keeping enough short-term assets to cover their short-term liabilities, as ratio is over 1; but on the other, reduced liquidity has not translated into higher profitability (for example, in terms of return on assets, not shown in the figure), suggesting that the use of excess cash has not been very productive.

Figure A1.1 Contribution of Real Estate Activities to Real GDP and Loan Portfolios



Note: Data on 2018 are till Q3.
Source: BSP; PSA

Figure A1.2 Leverage, Liquidity and Probability of Default (PD) of 34 Real Estate Developers



Note: the numbers presented in the graph are the average liquidity, leverage and probability of default across the 34 real estate developers.
Source: Firms' financial statements; Credit Research Initiative of National University of Singapore; AMRO staff calculations

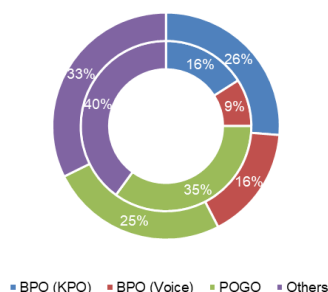
3. **The probability of default (PD) of the real estate developers has inched up in recent quarters, although it is still at modest levels.** PD in this study measures the creditworthiness of a corporate entity, or the likelihood that the entity will not fulfill its debt obligations in a year's time. As a composite index, it incorporates risk drivers not only from firms'

¹¹ Real estate sector loans, in this context, do not include loans extended to home buyers.

fundamentals such as liquidity and leverage ratios, but also from stock market performance and macro-financial conditions. Figure A1.2 shows the average PD of the 34 real estate firms over time. An 8-basis-point (bps) reading for September 2018, the last point in this graph, is roughly equivalent to an S&P A- grade (see Table A1.1).¹² Although it is modest, the PD is upward trending, indicating some stress is building up, likely related to the weak stock market performance this year.

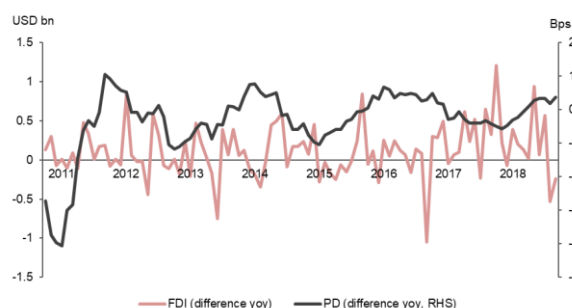
4. Foreign investment has contributed to the demand for properties in the Philippines. The Philippine economy has long enjoyed foreign investment in its manufacturing and services sectors, and naturally, companies receiving these investments demand commercial and residential properties for office space, retail facilities and accommodation. Without much economy-wide information on property demand and its drivers, Figure A1.3 offers a snapshot of the office take-up in Metro Manila by sector, some of which are likely beneficiaries of foreign investment. The BPO sector, including knowledge process outsourcing (KPO) and call centers, currently takes up 42 percent of office space, while Philippine offshore gaming operators (POGO) take up 25 percent. Investors and employees of these businesses consume a decent share of Manila’s condominium sales and rentals as well. According to anecdotal evidence from a couple of real estate developers, foreign nationals own 20-40 percent of their newly launched condominium projects (foreigners are permitted to buy up to 40 percent of the units in a condominium project by law).

Figure A1.3 Office Take-up by Sectors
(Inner Circle 2017 and Outer Circle, Year to Q3 2018)



Note: the take-up share is out of all active buildings as well as pre-leasing of incomplete buildings at the time of reporting.
Source: Colliers International

Figure A1.4 Co-movement of FDI and PD



Source: BSP; Credit Research Initiative of National University of Singapore; AMRO staff calculations

5. The capital inflow appears to be negatively correlated with the PD of the real estate sector. Figure A1.4 uses the year-on-year difference of the FDI and PD series to show their co-movement over time. The negative relationship suggests that when FDI growth slows down, the demand for commercial and residential properties tends to soften too. This may result in the vacancy rate rising and a fall in property prices, subsequently affecting real estate developers’ cash flows and repayment ability, reflected in a heightened PD.

6. Our stress testing model shows that the creditworthiness of the real estate sector is generally sound but can deteriorate significantly if there is a substantial decline in FDI. In the model, we regress PD on its past values as well as contemporary FDI shocks. With the

¹² The PD data is taken from the Credit Research Initiative (CRI) of the National University of Singapore, www.rmcri.org, as of 20 November 2018. Please refer to the CRI Technical Report for a detailed description of its methodology https://rmcri.org/en/technical_document/.

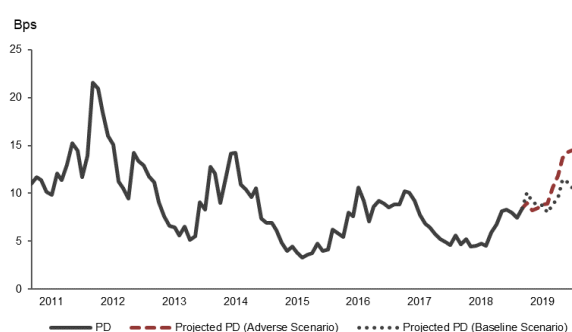
estimated coefficients, we simulate the trajectories of the sector’s PD into September 2019 under two scenarios of future FDI evolution. Under AMRO’s baseline scenario, the PD of the real estate sector will hover around 8-10bps, as shown in Figure A1.5. Under the adverse scenario, where the FDI growth is assumed to decelerate from the current rate to -USD 1.2 billion (or USD 567.8 million outflow in September 2019), resembling the worst decline during the global financial crisis, the PD will trend up and exceed 16 bps, equivalent to the BBB+ grade, the highest since 2012. From the benign scenario to the adverse, the additional credit loss from these firms is estimated to be PHP 2.4 billion, which is about a quarter of the total assets of a median-sized developer.¹³

Table A1.1 Correspondence between CRI PD and major S&P rating grades

S&P Rating Category	Range of CPI PD (Bps)
AA	[1.3,2.5]
A	[5.6,6.9]
A-	[6.9,12.2]
BBB+	[12.2,19.2]
BBB	[19.2,32.4]
BBB-	[32.4,38.9]

Source: ‘Probability of Default implied Rating’ white paper, Credit Research Initiative of National University of Singapore

Figure A1.5 PD and Projected PD



Source: Credit Research Initiative of National University of Singapore; AMRO staff calculations

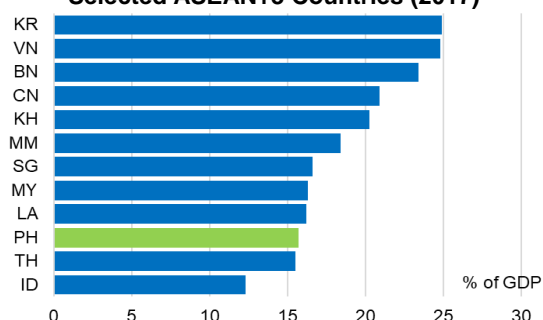
7. Cross-border capital outflows attributable to internal and external factors may add pressure to the creditworthiness of the real estate sector. The ongoing tax reform may invite scrutiny on the competitiveness of the Philippines as an attractive foreign investment destination. Global trade tensions, a looming growth slowdown of the world and monetary policy normalization in the advanced economies may further weigh on the investment momentum in the country too. POGO, relying on overseas demand for online gaming, may be subject to disruption if foreign governments begin regulating the players and facilities or restricting capital flow into this business. Against this backdrop, real estate developers should rationalize their borrowing and diversify their sources of revenues.

¹³ To calculate the expected credit loss from the sector, we multiply its PD with its total liability and a 60 percent loss given default, a common assumption in credit default swap pricing.

Annex 2. Rationalizing Fiscal Incentives and Lowering the Corporate Income Tax in the Philippines

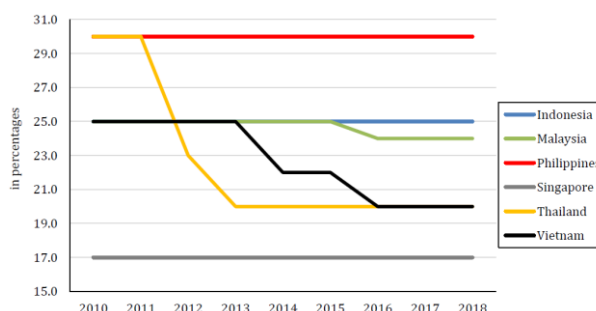
1. **The Philippines is currently striving to raise revenues to finance a massive infrastructure program.** The Philippines has a low revenue to GDP ratio relative to the other countries in the region (Figure A2.1), which it is striving to boost to ensure fiscal sustainability amid a massive push to improve infrastructure in the country with the 'Build, Build, Build' program. Raising tax revenues has been a challenge due to the low tax base, given the large informal economy and sizeable low-wage workers who are exempted from paying personal income tax.

Figure A2.1. Revenue-to-GDP Ratio, Selected ASEAN+3 Countries (2017)



Source: CEIC Ltd.

Figure A2.2. CIT Rates in the Region



Source: Ernst & Young

2. **Revenue goals need to be pursued along with putting in place a competitive and modern tax system.** Alongside the need to raise revenues, the Philippines also need to establish a tax system that is modern and competitive, particularly compared to the rest of the region. In this regard, to attract capital, there have been pressures to lower taxes. Although other factors are considered by multi-national companies (MNCs) in assessing investment options (such as labor skills and costs, ease of doing business, rule of law, electricity costs, law and order situation, security, market size, clustering of customer firms), low taxes compared to other jurisdictions is also one important factor.¹⁴ This phenomenon, known as tax competition, has resulted to a proliferation of tax incentives and exerted downward pressure on corporate income tax (CIT) rates across the world. Among neighboring countries competing for FDI, Malaysia, Thailand and Vietnam have cut CIT rates in recent years, while Singapore, Indonesia and the Philippines (which has the highest) have kept it stable (Figure A2.2).

3. **The Philippines is embarking on a comprehensive tax reform program.** The Department of Finance (DOF) is currently pursuing the second package of a comprehensive tax reform agenda. This package is centred on improving the way fiscal incentives are provided, and also targeting to progressively bring down the CIT rate in the Philippines closer to levels in neighbouring countries.

4. **The proposed reforms to cut the CIT rate and rationalize fiscal incentives are aimed at achieving the two-fold objective of sustainability of investments and fiscal**

¹⁴ Typically investors have minimum requirements with regards to skill and labor cost, rule of law and general ease of doing business; and then compare across broadly similar investment environments for respective countries in choosing where to locate, with the tax cost possibly tilting the choice towards a particular country.

position. Reducing tax rates will give domestic and foreign companies more space to reinvest in their businesses, and potentially draw more foreign companies into the country who will stay even after the initial tax incentives have expired. Despite the relatively high CIT rate of 30 percent in the Philippines, revenues from CIT was only 3.7 percent of GDP, the second lowest among the ASEAN countries (Figure A2.3), suggesting that the tax base for the CIT can be enhanced. On the other hand, reform of the tax incentives is envisioned to lead to improvements in targeting and efficiency, to ensure that recipients of incentives are aligned with the overall development plan of the Philippines. Despite the existing generous tax incentives in the Philippines, FDI has been historically low compared to the region, and has only been on an upward trend since 2013 (Figure A2.4). With no major change in the tax incentive framework since the Special Economic Zone Law was passed in 1995, the recent rise in FDI has been attributed to improvements in the business environment and vibrant leadership of PEZA in enhancing aftercare support to investors to ensure that upon successful start-up, dealings with the government and other institutions continue to be smooth.

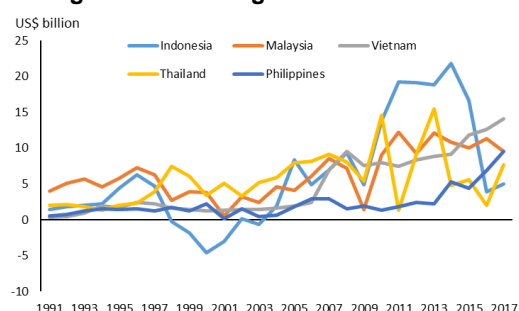
Figure A2.3. CIT Revenue Productivity

	Year	CIT revenues (percent of GDP)	Headline CIT rate (percent)	Revenue productivity (percent)
Vietnam	2016	7.1	20	35.6
Malaysia	2016	6.0	24	25.2
Thailand	2016	4.0	20	20.1
Singapore	2016	3.3	17	19.5
China	2015	3.9	25	15.8
Philippines	2016	3.7	30	12.3
Indonesia	2016	2.5	25	10.0

Note: Tax revenue productivity is computed by dividing the CIT revenue as a percent of GDP by the CIT rate.

Source: DOF

Figure A2.4. Foreign Direct Investment

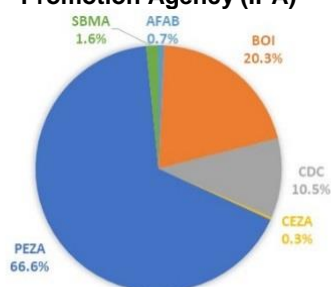


Source: UNCTAD

5. The current fiscal incentive framework in the Philippines is fragmented and complicated, requiring rationalization and reform. Currently, there are 14 separate investment promotion agencies (IPAs) who have the power to provide tax incentives under their respective charters. The largest of this is the Philippine Economic Zone Authority (PEZA), accounting for two-thirds of tax incentives given in 2016, followed by the Board of Investments (BOI) and Clark Development Corporation (CDC) (Figure A2.5). In addition, there are numerous investment and non-investment laws that grant tax incentives.¹⁵ The main fiscal incentive is the Income Tax Holiday (ITH) which can be provided for 4 to 8 years. Upon the expiration of the ITH, companies under the incentive framework are then required to pay a special income tax rate equivalent to 5 percent of the Gross Income Earned (GIE) in lieu of corporate income tax, VAT and other local taxes. This special corporate income tax rate is provided indefinitely, without clear clauses on when such benefits will be terminated. Another set of incentives is the exemptions on customs duties, which account for a third of incentives (Figure A2.6).

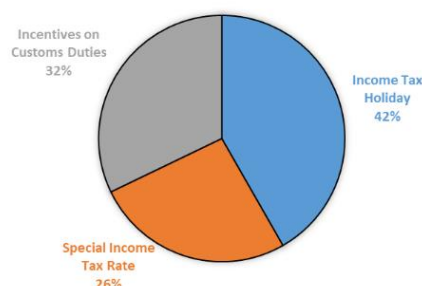
¹⁵ There are 136 investment laws granting tax incentives.

Figure A2.5. Tax Incentive by Investment Promotion Agency (IPA)



Source: Department of Budget and Management (DBM)

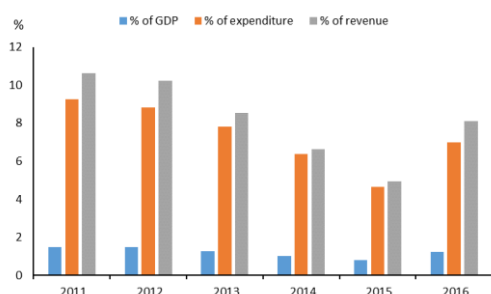
Figure A2.6. Tax Incentive by type (2016)



Source: DBM

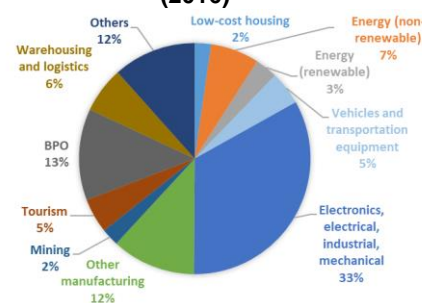
6. **The benefits and costs of incentives need to be re-evaluated on the basis of their fiscal impact, including whether such incentives are achieving their purpose.** A Tax Incentives Management and Transparency Act (TIMTA) was passed in 2015. Data show that tax incentives provided to companies are not trivial, averaging around 7.3 percent of expenditures or 8.2 percent of revenues over the past six years covering the period 2011-2016. In terms of GDP, it averaged 1.2 percent for the same period (Figure A2.7). The sectors that are given tax incentives are broad, ranging from manufacturing and services, with export-oriented sectors such as electronics, electrical, industrial, mechanical, and Business Process Outsourcing (BPO) accounting for 46 percent of the incentives, while the rest cover sectors that mainly service the domestic economy (Figure A2.8).

Figure A2.7. Estimates of Tax Incentives



Source: Department of Budget and Management (DBM)

Figure A2.8. Tax Incentive Beneficiaries by Sector (2016)

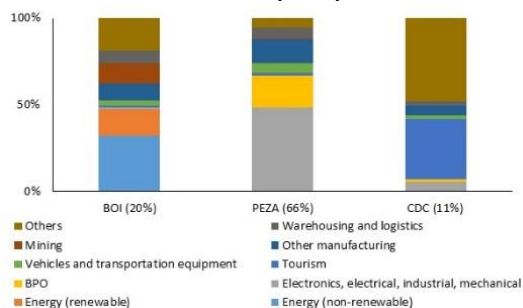


Source: DBM

7. **A framework needs to be put in place to facilitate efficient and targeted provision of fiscal incentives.** The current system of multiple and decentralized agencies providing significant incentives covering a broad range of sectors has resulted in the erosion of the tax base. Monitoring of this decentralized system is difficult and inadequate, setting back the ability to effectively evaluate the usefulness of the incentives. Within the largest IPAs, there is an observed specialization in terms of the types of industry they provide incentives to. PEZA gives most of its incentives to export-oriented manufacturing, especially those related to electronics, electrical, industrial, mechanical, and the BPO sector. Meanwhile, the BOI mostly give incentives to domestic-oriented firms, particularly to the renewable and non-renewable energy sector. For CDC, the largest share of incentives goes to tourism (Figure A2.9). Incentives have also been provided to particular companies for a long period of time, which puts into question the purpose

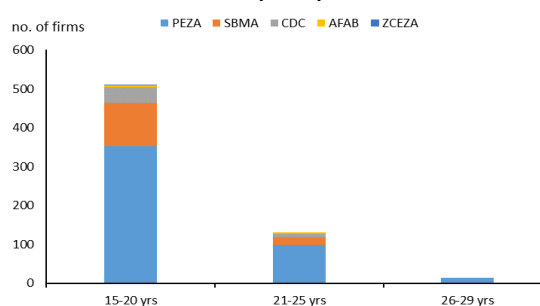
of providing incentives to established firms¹⁶ (Figure A2.10). A more targeted provision of tax incentives will facilitate support to industries that are aligned with the development goals of the country, and at the same time, ensure adequate monitoring and evaluation to check whether such incentives are achieving their purposes.

Figure A2.9 Tax Incentives by IPA and by Sector (2016)



Source: DBM

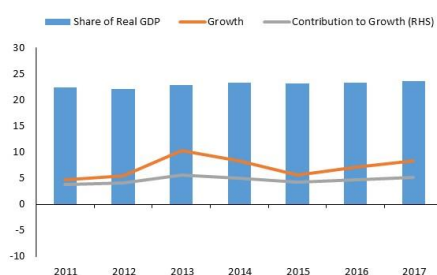
Figure A2.10. Firms with Long Incentive Period (2015)



Source: DOF

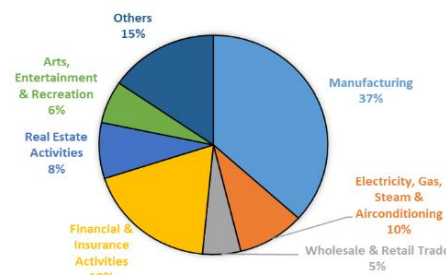
8. Given the need to maintain fiscal stability amid growing expenditure requirements and a challenging external position, the government needs to push for a tax regime that will enable it to keep to its medium-term fiscal deficit target. The government’s reform proposal rightly contains elements that improve the competitiveness of the tax system by cutting the corporate tax rates, and strives to balance this by rationalizing fiscal incentives to make it more efficient and also safeguard revenues. In this regard, the reform of fiscal incentives must keep an eye on eliminating or limiting unnecessary and redundant incentives, particularly those granted to firms that mainly cater to the domestic market or to firms who have been enjoying incentives for quite a long time. However, an adequate transition period will be needed to minimize and mitigate any potential adverse disruptions to the economy. In particular, careful consideration of the manufacturing sector is needed, cognizant of the sector’s economic contributions, accounting for more than a quarter of GDP growth (Figure A2.11) and 37 percent share of FDI from 2011-2017 (Figure A2.12). Careful consideration and an adequate transition period should also be given to the BPO industry given its importance to the economy. Estimates indicate that the Philippines BPO industry accounts for around 10 percent of the global market share, with 1.3 million employees and USD 23 billion revenues in 2017.¹⁷

Figure A2.11. Manufacturing Sector Value Add to GDP



Source: Philippine Statistical Authority

Figure A2.12. FDI by sector (2011-2017)



Source: Bangko Sentral ng Pilipinas

¹⁶ Out of the 5694 registered business entities that receive incentives, 654 companies (11.5 percent of total) have been enjoying incentives for 15 years and longer.

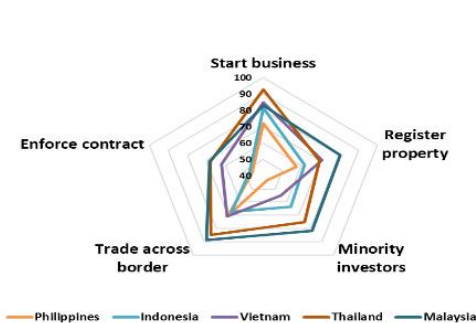
¹⁷ The industry is represented by The Information Technology and Business Process Association of the Philippines (IBPAP), which has over 300 members, consisting not only from the BPO sector itself but also from supporting industries such as telecommunications and real estate.

9. **Improvements in the administration of the incentives will help enhance the efficiency of the system in the future.** To enhance efficiency and transparency of the administration of incentives, there is a need to change the current decentralized structure to a more centralized structure, enabling proper alignment of objectives between the investment promotion agencies and the fiscal authorities as well as effective implementation and monitoring. Putting all incentives into one package instead of being dispersed across many different laws, will also help in making the incentives more understandable, particularly for foreign investors. Furthermore, the provision of incentives need to be aligned with the development plans, so that investments become growth-enhancing, and in line with the objectives of job creation, knowledge transfer, and enhanced economic activity in less developed areas of the country. Finally, an effective monitoring and evaluation process will also help ensure that the companies receiving the incentives deliver on their promises.

10. **Tax incentives should be temporary to allow the tax base room for expansion in the future.** It is imperative that incentives have definite timelines. Tax incentives are needed in the beginning to attract investors into particular industries. However, as the industries become established, then the incentives should be phased out and withdrawn. Unlike in many countries which have a maximum period of years wherein the tax holiday and other incentives can be given¹⁸, in the Philippines, here is no sunset clause for some incentives (particularly the 5 percent of the Gross Income Earned (GIE) tax, which is paid in lieu of all other taxes) or the incentives are continuously renewed, even for firms that are already profitable.

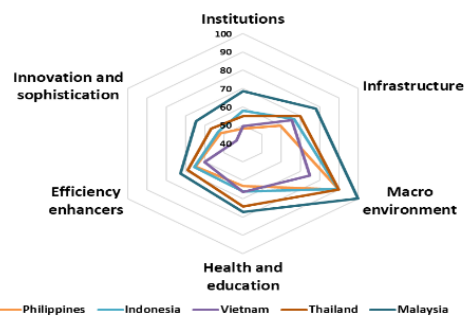
11. **Moving forward, facilitating general improvements in the business climate and establishing an enabling environment for investment will help support future growth of the economy.** According to the latest World Bank Ease of Doing Business (2019), the Philippines' rank fell to 124 for 2018 from 113 in the previous survey, with the indicators on enforcing contracts and protecting minority investors, performing the weakest (Figure A2.13). More generally, the results of the survey suggest that the Philippines needs to continue to build strong institutions, enhance infrastructure, and improve the quality of labor, in order to be more globally competitive. It is also important to intensify efforts towards enhancing the efficiency of the economy through flexible labor markets, financial market development and technological readiness. The ability of the economy to innovate and enter into more sophisticated modes of production also needs to be further developed through better production linkages, greater spending on research and development, and increased quality of scientific research institutions (Figure A2.14).

¹⁸ For example, the maximum years for income tax holidays in Vietnam, Malaysia, Thailand and Indonesia are 4, 10, 13 and 20 years respectively.

Figure A2.13. Ease of Doing Business 2019
(selected indicators)

Source: World Bank

Figure A2.14. Global Competitiveness Index 2018



Source: World Economic Forum

12. **The second package of the tax reform is now going through the legislative process.** The second tax initiative known as “TRABAHO” (Tax Reform for Attracting Better and High-Quality Opportunities) is currently being deliberated by Congress. The lower house of Congress (House of Representatives) version, House Bill 8083 (HB 8083), has been passed on third reading, and as expected, is a compromise from the original DOF proposal. It is important to note that HB 8083 includes an unconditional cut in the corporate income tax rate by 2 percentage points every 2 years beginning 2021 until 2029 when it would be 20 percent.¹⁹ This is a deviation from the revenue-neutral proposal of the DOF which conditioned cuts in the corporate tax rates on the reduction of tax incentives.²⁰ The upper house of Congress (Senate) is currently working on their own version before a bicameral committee can be convened to reconcile conflicting provisions.²¹

13. **The current version of the tax reform is anticipated to negatively affect the fiscal position of the government.** With the current legislation proposing an unconditional cut in the CIT rate, tax revenue is estimated to go down by 0.3 percent of GDP for every two percentage point cut in the CIT rate. This loss in revenue, if not compensated by broadening of the tax base through rationalized tax incentives or by other revenue raising efforts, will push the fiscal deficit above the government’s medium-term target of 3 percent of GDP. Thus, the current version of the tax reform needs to be carefully considered, mindful of the government’s fiscal deficit target of 3 percent of GDP. Keeping to the medium-term fiscal program requires increasing revenues to fund government spending that will help the country to achieve a higher growth path, particularly through the “Build, Build, Build” initiative.

¹⁹ If adopted into law, this translates to a CIT rate of 28% by 2021, 26% by 2023, 24% by 2025, 22% by 2027 and 20% by 2029.

²⁰ The original DOF proposal was to reduce CIT rate by 1 percentage point every year from January 1, 2020, to settle at 25 percent by 2025, conditional on the reduction of investment incentives equivalent to 0.15% of GDP.

²¹ The DOF targets the bill to be passed by the first quarter of 2019, however, the successful passage of the law in the Senate is dampened by the negative perception of lawmakers and the general public on the first tax reform package, which has been partly blamed for the significant rise in inflation during the year. Meanwhile, the possibility of passing a revenue neutral law closer to the DOF proposal is held back by populist tendencies by legislators ahead of a mid-term election in May 2019.