AMRO

ASEAN +3 MACROECONOMIC RESEARCH OFFICE

AMRO Annual Consultation Report

Philippines - 2017

The ASEAN+3 Macroeconomic Research Office (AMRO)

March 2018

Acknowledgment

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 the relevant risks and vulnerabilities, and assist them in the timely formulation of policy recommendation to mitigate such risks (Article 3(a) and (b) of AMRO Agreement).

2. This Report is drafted on the basis of the Annual Consultation Visit of AMRO to the Philippines from 19 to 26 September 2017 (Article 5(b) of AMRO Agreement). The AMRO Mission team was headed by Dr Sumio Ishikawa, Group Head and Lead Economist. Members include Ms Diana del Rosario (Country Economist for the Philippines), Dr Ruperto Majuca (Senior Specialist and Back-up Economist for the Philippines), Mr Paolo Hernando (Senior Economist), Ms Wanwisa Vorranikulkij (Specialist), Mr Edmond Choo Chiang Yong (Research Analyst) and Mr Xinke Tang (Researcher). 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 2017 was prepared by Dr Sumio Ishikawa, Ms Diana del Rosario, Dr Ruperto Majuca, Ms Wanwisa Vorranikulkij and Mr Paolo Hernando; peer reviewed by Dr Chaipat Poonpatpibul (Group Head and Lead Economist) and Dr Jinho Choi (Specialist); and approved by Dr Hoe Ee Khor (AMRO Chief Economist).

3. The analysis in this Report is based on information available up to 27 February 2018.

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 judgements 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 logistical support and hospitality during our visit.

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Executive Summary

The November 2016 Annual Consultation Report pointed out that the Philippine economy was accelerating as election spending, improved budget execution and upbeat business sentiment boosted domestic demand, while low oil prices kept inflation below the government's target. Since then, growth has moderated owing to a deceleration in investment, while inflation has risen to within the target band, and the current account balance has posted a small deficit. Although recent developments continue to support strong macro fundamentals, risk pockets warrant close monitoring. Amidst the softening of private investment, an ambitious 'Build, Build, Build' infrastructure program is expected to lift growth momentum. However, the progress of the infrastructure program may be constrained by the weak implementation capacity of the government and private sector participants. Meanwhile, monetary policy should be on guard against price pressures. While the peso has depreciated, reflecting the deterioration of the current account balance, a flexible exchange rate policy should be maintained to preserve external buffers. Reforms to stimulate private investment and address the labor market mismatch would complement the infrastructure push, and pave the way for an improvement in the economy's productive capacity.

Recent Developments and Outlook

Growth remains robust, although it eased slightly following last year's elections. Growth eased from 6.9 percent in 2016 to 6.7 percent in 2017 as fixed investments decelerated. Private consumption also slowed but generally held up throughout the year, supported by gains in employment and sustained remittance inflows. After a weak first quarter, government disbursement improved in the succeeding three quarters to guide public spending higher. Net exports also improved in 2017 as exports outpaced imports. The Philippine economy is forecast to grow by 6.8 percent in 2018, as exports are expected to remain buoyant, while hurdles to budget execution are gradually being overcome.

Headline inflation has risen and is expected to trend higher in 2018. Higher food and energy prices pushed inflation to within the 3.0±1 percent target range in 2017. Core inflation also inched higher on firm domestic demand. The excise tax increases in the recently approved tax reform as well as higher crude oil prices and the modest pass-through from the sustained depreciation of the peso are expected to guide headline inflation slightly above the 4.0 percent upper-end of the band in 2018.

External buffers are ample despite continued balance-of-payments (BOP) deficits. From a deficit of USD420.1 million in 2016, the BOP deficit widened to USD862.8 million in 2017 and USD531.0 million in January 2018. However, gross reserves—amounting to USD81.2 billion as of end-January 2018—are adequate as it can cover 8.2 months' worth of imports of goods and payments of services and primary income. It is also equivalent to 5.9 times the country's short-term external debt based on original maturity and 4.2 times based on residual maturity.

Risks, Vulnerabilities and Challenges

On the external front, protectionist policies in the U.S. place the country's two main growth drivers at risk. Remittances and BPO revenues face a potential slowdown from U.S. protectionist policies, among other headwinds. The clampdown on undocumented migrants in the U.S. place an estimated 300,000 Filipinos at risk of deportation. Also, approved BPO

investments between in 2017 dropped by 30.9 percent from a year ago, contributing to the 51.8 percent decline in total approved FDI within the same period.

On the domestic front, the economy's weak implementation capacity poses a constraint to the infrastructure push. Government agencies lack skilled manpower to implement an increasing number of complex projects which would require international expertise. Also, not enough local private contractors have the technical competence, experience and financial capacity to handle the long list of large-scale projects. Moreover, despite abundant labor supply, there is a shortage of skilled labor in specific occupations and industries such as in construction.

On the other hand, a strong pick-up in public infrastructure spending accompanied by a crowding-in of private investment poses risks of overheating and a widening of the external imbalance. As brisk fiscal spending adds to the already buoyant domestic demand, rapid credit growth and elevated price pressures, inflation could soar and dampen growth. The pick-up in infrastructure spending also implies stronger import demand, thereby potentially causing the current account deficit to widen and the peso to weaken.

Policy Recommendations

Budgetary, governance and tax reforms should facilitate the execution of a robust fiscal spending plan anchored on medium-term debt sustainability. The imposition of the one-year effectivity of the annual budget and its institutionalization with the Budget Reform Bill have the potential to considerably improve budget utilization. Likewise, measures to streamline the investment-approval process help to speed up project execution. But these will have to be complemented by the sustained progress of the comprehensive tax reform program to keep the deficit within the ceiling and maintain the downward trend of the debt-to-GDP ratio.

While the policy stance remains appropriate, monetary policy must be vigilant against elevated price pressures. Even though upside risks to the inflation outlook are mostly supply-driven, the BSP should be on guard against an intensification of demand-induced pressures with core inflation having trended upwards in recent months.

A flexible exchange rate policy should be maintained as a buffer against external shocks with the BSP intervening to smooth excessive volatilities in the peso. That is, the exchange rate should continue to be determined by market forces, in line with developments in the external account.

Continued enhancements in the BSP's financial surveillance framework will help to contain rapid credit expansion. Sound underwriting standards have to be maintained among banks in order to address pockets of credit risk in real estate and auto loan segments.

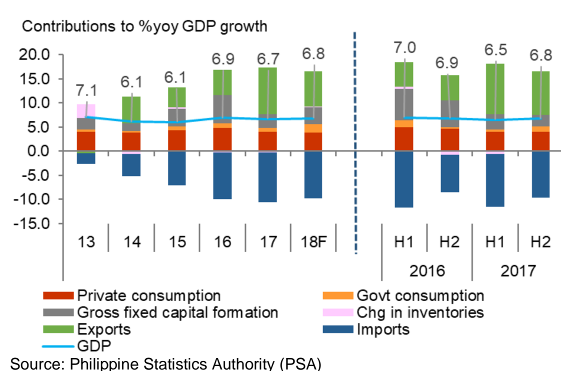
Reforms to attract foreign investments will help to counter the risk of a rising external imbalance while also facilitate a higher growth potential. Advancing efforts to improve the country's business climate and investing in human capital to address the labor mismatch will raise the economy's absorptive capacity and complement the drive to accelerate infrastructure investment.

Recent Developments and Outlook

A.1 Real Sector

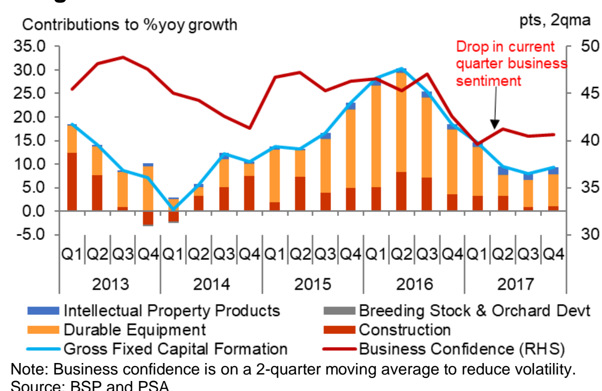
1. **The Philippine economy sustained its robust expansion in 2017 as exports rebounded, even as investments decelerated.** From a three-year high of 6.9 percent in 2016, the pace of economic expansion moderated to 6.7 percent in 2017 (Figure 1). Fixed capital formation led the slowdown as the pace of construction and durable equipment purchases decelerated, in part due to a high base from the May 2016 election spending but also owing to challenges to fiscal disbursements. This is consistent with the modest declines in business confidence (Figure 2).[1] After an anemic first quarter, government disbursements improved in the succeeding three quarters to guide public spending higher, including on construction. However, private sector construction activity weakened after the first quarter of 2017. Private consumption also moderated but generally held up to grow above 5.5 percent in 2017, supported by gains in employment and sustained remittance inflows. Overall, as the pace of domestic demand softened, the strong and broad-based rebound in merchandise exports kept growth buoyant in 2017.[2]

Figure 1. Real GDP Growth, Expenditure Side



Source: Philippine Statistics Authority (PSA)

Figure 2. Investment and Business Confidence



Note: Business confidence is on a 2-quarter moving average to reduce volatility.
Source: BSP and PSA

2. **On the production side, the services sector continued to be the primary growth driver, while manufacturing and agriculture provided additional support in 2017.** Economic growth continued to be driven by services (Figure 4), which accounted for nearly 60.0 percent of the growth. However, the services sector slowed down in 2017, particularly in

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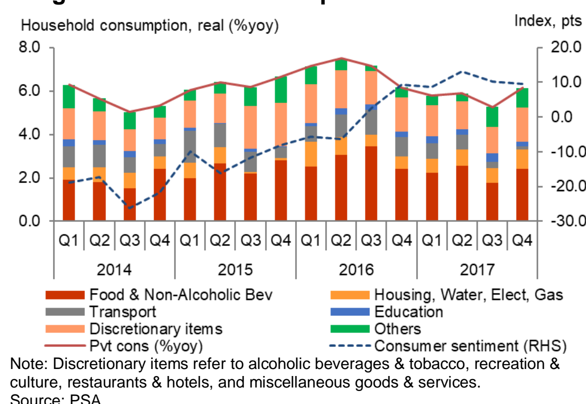
[1] The business outlook particularly turned less optimistic between Q3 2016 and Q1 2017. The decline in business sentiment within this period, according to the BSP survey, was attributed to: (a) perceived concerns over the direction of foreign policies and economic reforms in the country, (b) weakening global demand, (c) foreign exchange losses of imports due to peso depreciation, (d) increase in oil prices and higher cost of raw materials in part due to lack of supply, (e) wait-and see attitude of investors with regard to the economic policy of the Trump administration, and (f) stiff competition. The Marawi crisis and the declaration of martial law in Mindanao, and the damages and outages caused by natural calamities also added to the concerns post Q1 2017. While the outlook for the global economy has turned brighter, it is possible that the decline in FDI commitments, as shown in Figure 6, may be due to a mix of concerns on domestic policies (such as the drug war, Marawi crisis and martial declaration in Mindanao) and the protectionist policies under the Trump administration in the U.S.

[2] After posting negative growth in 2015 (-5.3 percent) and 2016 (-2.4 percent), merchandise exports rebounded to grow 10.8 percent year-on-year in the first 11 months of 2017. The positive turnaround was primarily driven by stronger export earnings from electronic products, and complemented by better returns from exports of agro, forest, and mineral products. By destination, the exports recovery came from the markets of the European Union, Southeast and East Asia, and to a certain extent, the U.S. These trends are consistent with the improvement in economic activity in the European Union, the U.S. and several economies in Southeast and East Asia.

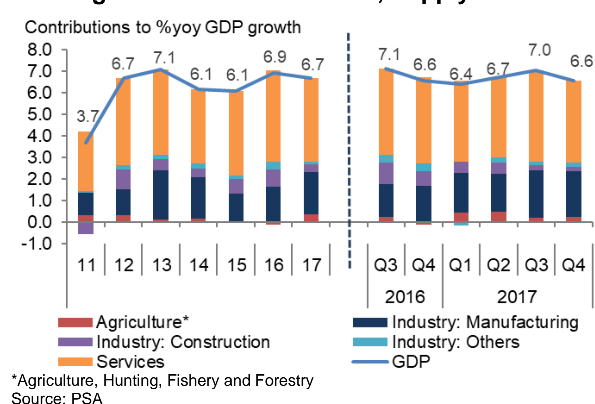
transport storage and communication; real estate, renting, and business activities; and other services. In line with the slowdown in real estate and related activities, construction also weakened, posting growth of 5.4 percent in 2017 as against 13.7 percent in 2016. On the other hand, manufacturing production gained pace following the export rebound, while the agricultural sector recovered from the El Niño-induced drought last year.

Figure 3. Private Consumption and Confidence



Note: Discretionary items refer to alcoholic beverages & tobacco, recreation & culture, restaurants & hotels, and miscellaneous goods & services.
Source: PSA

Figure 4. Real GDP Growth, Supply Side



*Agriculture, Hunting, Fishery and Forestry
Source: PSA

3. **The strong economic growth over the past six years has led to modest gains in employment and poverty reduction.** In line with the faster pace of economic expansion in 2012-2017 (6.6 percent average GDP growth vs. 4.9 percent in the 2002-2011 decade), the country's unemployment rate fell to 5.7 percent in 2017 from 7.0 percent in 2012 (Figure 5).[3] This translated to 2.7 million jobs created in five years, mainly in the construction (1.3 million), wholesale and retail (1.0 million), and BPO-related admin and support service activities (0.5 million), as against the nearly 2.4 million increase in the labor force (Figure 6).[4] On the other hand, the agriculture sector shed 1.8 million jobs between 2012 and 2017 owing in part to the aging of the sector's labor force, although the larger declines in 2016 and 2017 can also be attributed to the effects of the typhoons that hit major agricultural areas of the country. In total, out of the 40.3 million Filipinos employed as of 2017, 6.5 million were still in search of additional hours of work. The fact that the underemployment rate remained elevated at 16.1 percent in 2017, albeit down from 20.0 percent in October 2012, reflects the persistent lack of quality jobs in the country and also a mismatch between business demands and the existing talent pool.

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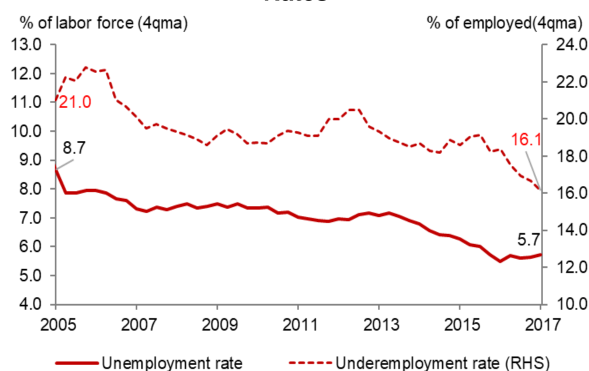
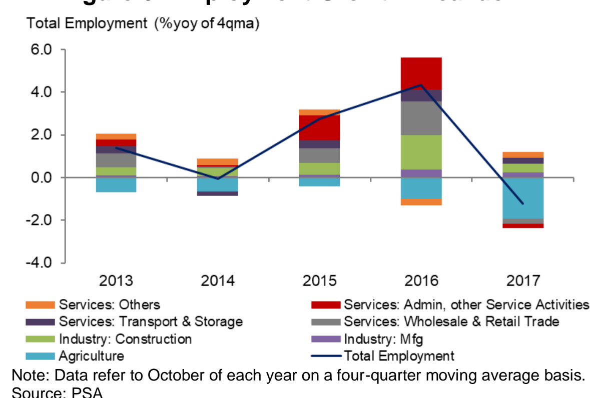
[3] A four-quarter moving average was taken to adjust for seasonality.
[4] The increase in employment within the said period occurred even as the deployment of overseas Filipino workers and emigration of Filipinos slowed down, from an average of 11.3 percent per annum in 2008-2011 to 2.3 percent in 2012-2015.

Figure 5. Unemployment and Underemployment Rates



Source: PSA

Figure 6. Employment Growth Breakdown



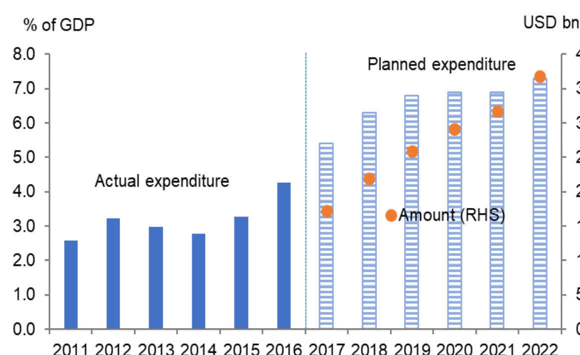
Note: Data refer to October of each year on a four-quarter moving average basis.
Source: PSA

4. **The Duterte administration is embarking on reforms to accelerate infrastructure development and raise the economy's growth potential.** The government has committed to accelerate infrastructure development around the country under the 'Build, Build, Build' program, with planned infrastructure spending steadily rising from 5.4 percent of GDP (USD17.2 billion) as programmed in 2017, to 7.3 percent in 2022 (USD36.9 billion, see Figure 7).[5] Accordingly, the budget deficit limit has been widened to 3.0 percent of GDP for the 2017-2022 period from 2.0 percent in 2013-2015. Aside from the increase in the budget deficit limit, the boost in government expenditure will be financed by additional revenue from the comprehensive tax reform program, of which the first package—estimated by the Department of Finance (DOF) to add 0.5–0.7 percent of GDP on its first year of implementation—is targeted to be implemented by January 2018 (see Box A). These reforms could raise the economy's productive capacity as they crowd-in investments and generate quality employment for the country's young, large and growing labor force.

5. **Looking ahead, buoyant exports and sustained improvements in the pace of public sector infrastructure spending are likely to support growth of 6.8 percent in 2018.** Improvements in budget execution, alongside the double-digit increase in the 2018 government budget, are expected to counter the continued softness in private sector investment activity, as could be indicated by the decline in FDI commitments (Figure 8). Moreover, the external sector recovery is expected to be sustained in 2018, thereby countering buoyant import demand and containing the trade deficit.

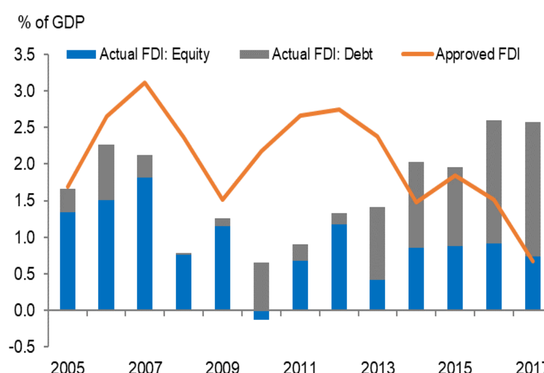
[5] The figures in USD have been converted from the official estimates in Philippine peso (PHP): PHP858.1 billion in 2017 and PHP1,840.2 billion in 2022, converted into USD at PHP49.923/1 USD (as of 29 December 2017, sourced from Bloomberg). In total, the 'Build, Build, Build' program would amount to PHP8.1 trillion (USD162.2 billion) from 2017 to 2022.

Figure 7. Infrastructure Expenditure by the Government



Note: Projections are consistent with the medium-term fiscal targets and growth assumptions approved during the DBCC meeting on 9 June 2017. Actual figures refer to infra and other capital outlays.
Source: Department of Budget and Management

Figure 8. Actual and Approved FDI[6]



Note: For actual FDI, 2017 figure refers to the first three quarters of the year.
Source: BSP and PSA

Authorities' views

6. **The authorities have a more optimistic growth outlook for 2018.** The Philippine authorities expected growth to settle within the 6.5-7.5 percent range in 2017. And as the 'Build, Build, Build' initiative advances, growth is projected to increase to between 7.0-8.0 percent from 2018 through 2022.

Box A. Tax Reform Update: The TRAIN is moving

The President signed into law the first package of the comprehensive tax reform program on 19 December 2017. It is expected to enhance the efficiency and improve the equity of the tax system. At the same time, it is expected to generate sufficient revenues for the government's education, health and infrastructure programs. The signing paves the way for the implementation of the new tax system by January 2018.

The first package, termed the Tax Reform for Acceleration and Inclusion (TRAIN), is a combination of revenue-eroding and enhancing measures as well as tax administration reforms, with an overall net positive impact on the fiscal position of around PHP89.9 billion (0.5 percent of GDP) for 2018. This is equivalent to around two-thirds of the original DOF proposal. To raise the additional revenues of PHP38.9 billion (0.2 percent of GDP) for the first year of implementation, the DOF plans to initiate in Q1 2018 an estate tax amnesty, general tax amnesty, adjustments to the Motor Vehicle Users Charge and amendments to the bank secrecy law and automatic exchange of information.[7]

[6] Approved FIs refer to foreign investment commitments and pledges approved by the investment promotion agencies. In contrast, actual FDIs refer to realized investments that have been compiled and released in the BSP's Balance of Payments report. FDI for the first eleven months of 2017 recorded net inflows of US$8.7 billion, exceeding the US$8 billion projection for 2017. The sustained FDI inflows reflected investor confidence given the Philippine economy's solid macroeconomic fundamentals and growth prospects. Net FDI rose by 20.1 percent year-on-year, driven largely by the 9 percent growth in net placements in debt instruments to US$5.2 billion. Net investments in equity capital reached US$2.8 billion from US$1.8 billion in the comparable period in 2016, on account of the combined effect of higher equity capital placements (US$3.3 billion from US$2.4 billion) and lower withdrawals (US$483 million from US$555 million). Equity capital infusions during the period were sourced mainly from the Netherlands, the United States, Singapore, Japan, and Hong Kong. The said placements were invested largely in gas, steam and air-conditioning supply; manufacturing; real estate; construction; and wholesale and retail trade activities. Reinvestment of earnings reached US$717 million.
[7] There is no direct revenue impact from the amendment of the bank secrecy law, but this may help provide an overall picture of an individual's overall assets and income that can be used as a reference in case of tax evasion charges.

TRAIN Revenue-eroding Measures

The revenue-eroding measures include the reduction of the personal income tax (PIT), value-added tax (VAT) exemption for businesses with sales below PHP3 million, and the simplification of the estate tax and donor's tax.

The PIT aims to adjust tax brackets to inflation to correct for bracket creep.[8] PIT rates are also reduced, except for the highest-income earners. Taxpayers who have net taxable annual incomes of PHP250,000 (USD5,008) and below will be exempted from the PIT. The new threshold is intended to remove the distortions arising from the current tax code which imposes a 5.0 percent tax on individuals earning annual incomes of PHP10,000 and below. As such, under the 1997 tax code, minimum-wage earners are discouraged to accept higher wages as this actually results in lower net income due to the tax structure. Meanwhile, self-employed and professionals with gross sales below PHP3 million will be provided the option to pay either an 8.0 percent flat tax based on gross sales in lieu of the PIT and percentage tax, or based on the new tax table provided in the legislation.

In the case of estate and donor's taxes, a single flat rate of 6.0 percent based on the value of the estate, with the standard deduction being increased to PHP5 million, and a flat rate of 6.0 percent on annual donations above PHP250,000 are imposed. These provisions aim to move away from the complicated regime of multiple rates and numerous eligibility requirements.

TRAIN Revenue-enhancing Measures

The expansion of the VAT base; increase in excise taxes for petroleum and petroleum products, automobile, tobacco, coal and mining; the imposition of new taxes for sugar-sweetened beverages and cosmetic procedures; and the increase in documentary stamp taxes comprise the revenue-enhancing measures. These measures serve to cover for the revenue losses primarily from the PIT reductions.

The expansion of the VAT base entails the removal of numerous exemptions, in order to augment revenues while also keeping the VAT system simpler, fairer, and more efficient. According to the DOF, the Philippines has the highest number of VAT exemptions in Southeast Asia. As a result, despite having the highest VAT rate of 12.0 percent in the region, the government is only able to collect the same amount of VAT revenues as a percentage of its GDP as that of Thailand where the VAT rate is only 7.0 percent. The VAT reform intends to reserve exemptions only to essential consumption items of low-income households and inputs of small enterprises.

Last amended in 1997, the increase in the excise tax of petroleum products is long overdue. The adjustment translates into a yearly incremental increase for identified petroleum products, with increases to be frozen in case the price for Dubai crude oil exceeds USD80 per barrel. Excise taxes for diesel will increase by PHP2.5, PHP2.0 and PHP1.5 per liter for 2018, 2019 and 2020. As for liquefied petroleum gas, rates will increase by PHP1.0 per liter every year from 2018 until 2020.

Meanwhile, the automobile excise tax has been increased but simplified. Lower-priced cars will continue to be taxed at lower rates while expensive cars are taxed at higher rates.[9] Also, increases in the excise taxes for tobacco, coal and mining form part of the tax package. The tobacco excise tax will increase from PHP30.0 per pack to PHP32.5 from January to June 2018, PHP35.0 from July 2018 to December 2019, PHP37.5 from 2020-2021, PHP40.0 from 2022-2023 and by 4.0 percent every year thereafter. The coal excise tax will increase from PHP10 per metric ton (MT) to PHP50 per MT, PHP100 per MT and PHP150 per MT for 2018, 2019 and 2020, respectively. As for the

[8] Bracket creep is the phenomenon wherein inflation pushes income into higher tax brackets. The CPI index has doubled from the time the brackets were enacted into law in 1998, pushing income earners into higher tax brackets.

[9] Excise taxes on brand new cars are imposed depending on the net manufacturing price or importer's price (before the margins of the dealer and importer are added). For example, lower-priced cars of up to PHP600,000 will be taxed at 4.0 percent from the former effective rate of 2.0 percent; while higher-priced cars over PHP4.0 million will be taxed at 50.0 percent compared to the old effective rate of 22.0 percent. Pick-up trucks are not subject to the ad valorem tax on automobiles while half and zero excise tax rates will be imposed on hybrid electric and purely electric vehicles, respectively.

mining of metallic, non-metallic and quarry resources, excise tax imposed on companies will be doubled to 4.0 percent.

TRAIN also introduces a tax for sugar-sweetened beverages and cosmetic procedures. Beverages with caloric and non-caloric sweeteners are imposed a tax of PHP6 per liter, while products using high-fructose corn syrup are taxed at PHP12 per liter. Milk and pre-packaged powdered coffee products, natural fruit and vegetable juices, meal replacements, and medically-indicated beverages are exempted from the new tax on sweetened beverages. Likewise, cosmetic procedures will be subject to a 5 percent levy. Lastly, documentary stamp taxes for various types of certificates and official documents are will be mostly doubled.

Additional Measures

In addition to the tax measures enumerated above, TRAIN also contains tax administration reforms including a mandatory fuel marking and monitoring program, a system to enable the Bureau of Internal Revenue (BIR) to check real-time the financial submission of large taxpayers, and simplification of tax forms.

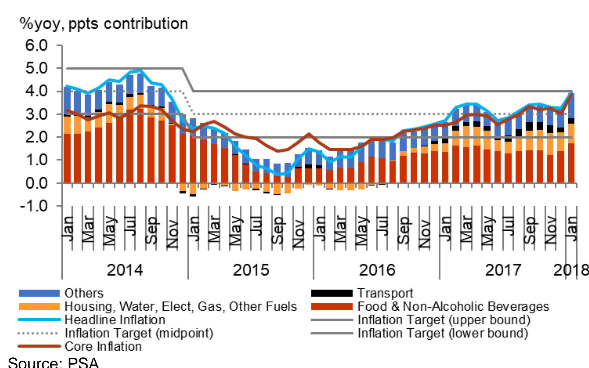
Management of Additional Revenues

To cushion the impact of higher oil excise taxes, 30.0 percent of the incremental revenue from TRAIN will be earmarked over a five-year period for social protection programs to partially mitigate the inflationary impact of the tax hikes on vulnerable groups. The balance will be utilized to fund the government's socio-economic programs including the 'Build, Build, Build' initiative.

A.2 Inflation

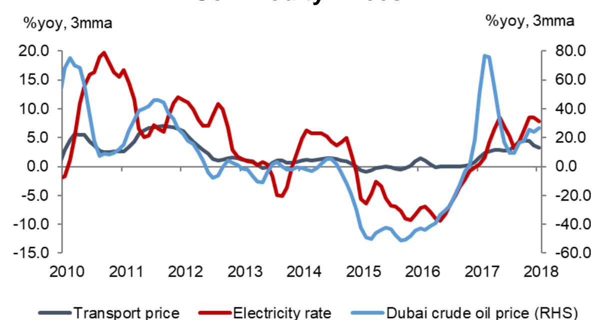
7. **Inflation has increased to within the government's target range on the back of higher food and energy prices.** Faster increases in the costs of food, power generation and transport led headline inflation to rise to within the government's 3.0±1 percent target from September 2016 onwards (Figure 9). From a 1.8 percent average in 2016, headline inflation stood at 3.2 percent in 2017. Core inflation (excluding selected food and energy-related items) likewise inched higher since bottoming out in mid-2016, reflecting firm domestic demand and buoyant domestic liquidity. It rose by 1.0 percentage point (ppt) from the full-year average in 2016 to 2.9 percent in 2017. Both headline and core inflation further rose in January 2018 following the implementation of TRAIN and the increase in global crude oil prices.

Figure 9. Inflation Against the BSP's Target



Source: PSA

Figure 10. Crude Oil Price and Domestic Commodity Prices



Source: Bloomberg Finance LP, PSA

8. **Demand- and supply-side pressures are likely to push headline inflation slightly above the upper end of the target range in 2018.** Excise tax increases for petroleum products, tobacco, and sugar-sweetened beverages—provisions under the recently approved TRAIN—as well as higher global energy prices and the peso's weakness are likely push headline inflation to 4.3 percent in 2018, slightly above the 4.0 percent upper-end of the target range. Higher crude oil prices are expected to cause upward adjustments in transport and electricity rates while the sustained depreciation of the peso, which has weakened by 16.5 percent against the USD between January 2015 and January 2018, is expected to yield a modest pass-through into imported goods prices (Figure 10).[10] Beyond 2018, inflation is seen to ease back within the target range as the impact of the excise tax increases diminishes.

Authorities' views

9. **The authorities have a slightly more benign inflation outlook.** The BSP expects inflation to average 3.4 percent in 2018 before easing to 3.2 percent in 2019. The TRAIN is estimated by the BSP to add up to 1 ppt to inflation in 2018.[11] However, the inflationary impact could also be offset by the plan to liberalize rice imports. The proposed reforms to remove the quantitative restriction on rice imports and replace it with tariffs could reduce inflation. Nonetheless, the BSP continues to see the balance of risk to its inflation outlook tilted to the upside owing to possibly higher crude oil prices. But reflecting the likely transitory impact of the tax reform on inflation, the Development Budget Coordination Committee (DBCC) maintained the 2 to 4 percent inflation target for 2018 to 2020 last December 2017.

A.3 Fiscal Sector

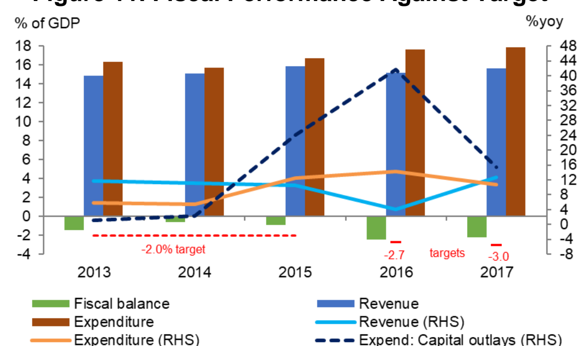
10. **Effective budget execution remains a challenge for the government's expansionary fiscal policy.** In line with the new administration's wider budget deficit ceiling and expanded fiscal policy, actual budget deficits have increased as a share of GDP. From an average of 1.0 percent of GDP in 2013-2015, the budget deficit rose to 2.4 percent in 2016 and 2.2 percent in 2017 as expenditures, particularly capital outlays, grew faster than revenues (Figure 11). But the implementation capacity still leaves room for further improvement; for instance, the fiscal disbursement rate in 2017 is about the same as the previous year and is thus could remain well below 100 percent for another year (Figure 12). As budget execution continues to be challenged by line agencies' weak absorptive capacity, disbursements will likely remain below budget in the medium term. While this outcome would

[10] According to AMRO staff's estimates, a 10.0 percent increase (depreciation) in crude oil price (peso NEER) increases Philippine headline inflation by 1.6ppts over three years or roughly 0.5ppt per year. The VAR system consists of crude oil price growth, food price growth, peso NEER change, output gap, and Philippine CPI inflation, with a 1-quarter lag using 2002-Q3 2017 data.

[11] Following the Monetary Board meeting on 8 February 2018, the BSP has raised its inflation forecast to 4.3 percent for 2018 and 3.5 percent for 2019 to reflect the impact of the first tax reform package and the expected oil price hikes on consumer prices.

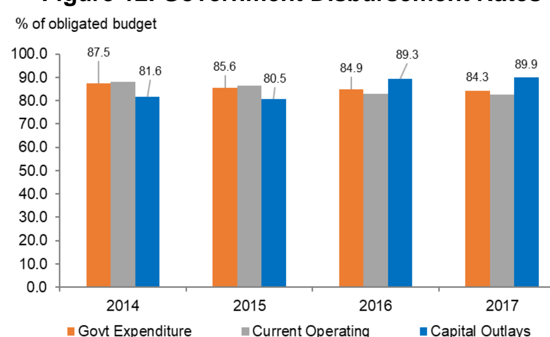
contain the increase in public debt, it will also constrain the drive to accelerate infrastructure spending by the public sector.

Figure 11. Fiscal Performance Against Target



Note: 2015 saw a one-time revenue worth 0.5 percent of GDP from the coco levy fund, without which the deficit would have been 1.4 percent of GDP and revenues lower at 15.3 percent (6.6 percent yoy).
Source: PSA

Figure 12. Government Disbursement Rates



Note: The Philippine General Appropriations Act (GAA), which sets the national budget, is currently on an obligation basis, as opposed to cash basis. This implies that the GAA may not be fully spent in a given year, as a portion of the annual budget will only be utilized in succeeding years. As such, another way to measure the disbursement rate is to compare actual disbursements to programmed expenditures. Using this approach, total disbursement rate would be 97.1 percent in 2017, up from 96.4 percent in 2016.
Source: Department of Budget and Management, PSA

11. **The fiscal deficit is likely to remain below target in 2018 given challenges to budget execution.** Fiscal revenue collection gained pace in 2017 and exceeded the government's revenue-to-GDP target. Similarly, buoyant revenue collection combined with continued challenges in budget execution, albeit to be gradually addressed by ongoing enhancements in public financial management and procurement processes, is likely to keep the deficit below the 3.0-percent-of-GDP target in 2018. On the other hand, concerns over the revenue-generating potential of the tax reform could push the deficit above the ceiling.

12. **The considerable reduction in the debt burden has provided space to pursue a more expansionary fiscal policy to support growth.** The national government debt was unchanged at 42.1 percent of GDP at end-2016 and 2017, down from the peak of 74.4 percent of GDP in 2004. Given strong growth prospects, the government can afford to accelerate spending through a higher budget deficit ceiling while keeping the debt burden sustainable over the medium term (see Box B). The Bond Sinking Fund, amounting to 4.4 percent GDP as of end-2016, is also another source of comfort as it provides cover for the repayment of maturing domestic obligations.[12] Moreover, vulnerability to peso depreciation remains limited given that foreign currency-denominated debt amounts to less than 20 percent of GDP.

[12] The Bond Sinking Fund (BSF) was created under Republic Act 1000 of 1954 to redeem maturing government bonds and to provide cash to offset temporary revenue gaps. From 6.2 percent of GDP in March 2014 (PHP726.3 billion), the size of the BSF fell to 4.4 percent in December 2016 (PHP634 billion). The Bureau of Treasury reduced the size of the BSF to cut down the cost of maintaining the fund, and to encourage the agency to issue more short-term treasury bills. The latter would contribute to the development of a money market and short-term pricing benchmarks. It intends to further reduce the BSF to 2.7 percent of GDP by 2022.

Box B. Assessing debt sustainability

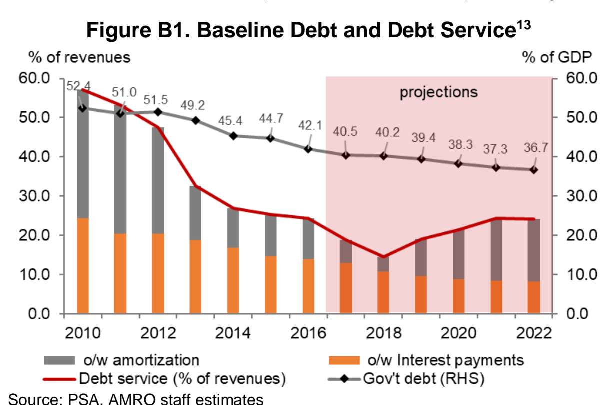
The Duterte administration's drive to ramp up government spending will not come at the expense of debt sustainability. This is shown in our medium-term projections utilizing the IMF framework for debt sustainability.[14] Under a scenario wherein the fiscal deficit ceiling widens from about 2.0 percent of GDP to 3.0 percent, while growth and inflation readings are sustained at about current levels (Table B1), the national government debt will fall from 42.1 percent of GDP in 2016 to 36.7 percent in 2022 (Figure B1). The government debt declines over the medium term notwithstanding the further assumptions of an increase in nominal interest rates and a depreciation of the peso against the USD over the same period. Under such a baseline scenario, the gross financing need (primary deficit plus debt service payments) gradually rises from 4.0 percent of GDP in 2016 to 5.5 percent in 2022, or from 26.7 percent of revenues in 2016 to 31.4 percent in 2022. On the other hand, interest payments, as a share of government revenue, are projected to fall from 13.9 percent in 2016 to 8.2 percent in 2022. This improvement is a result of the expected increase in revenue collections from the implementation of the tax reform.

Table B1. Baseline assumptions

	2016	2017F	2018F	2019-22F
Real GDP growth (%yoy)	6.9	6.7	6.8	6.9
Nominal GDP growth (%yoy)	8.7	9.1	9.5	10.0
GDP deflator (%yoy)	1.7	2.3	2.5	2.9
Primary balance (% of GDP)	-0.3	0.1	-0.8	-1.0
Fiscal balance (% of GDP)	-2.4	-2.0	-2.9	-3.0
PHP/USD (eop)	49.8	49.9	52.5	54.5
10-year yield (%, eop)	4.6	4.8	5.5	6.3

Source: PSA, Bloomberg Finance LP, AMRO staff estimates

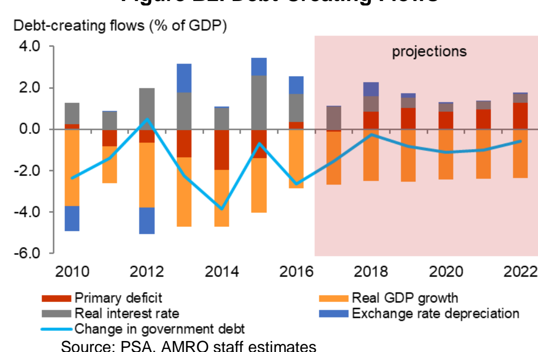
Figure B1. Baseline Debt and Debt Service[13]



Source: PSA, AMRO staff estimates

Decomposing the drivers behind the debt dynamics, the steady decline in the debt-to-GDP ratio is primarily due to the sustained strength in the economy's pace of expansion (Figure B2). On the other hand, the government's expansionary fiscal stance—as reflected in the widening of the primary deficit—and the increase in the cost of borrowing puts upward pressure on the debt ratio. The projected depreciation of the peso puts an upside pressure on the debt, which is manageable given the historical decline in the share of foreign currency liabilities to total government debt, comprising 35.0 percent as of September 2017. The government also intends to limit the share of foreign currency financing to 20 percent of total financing through 2022.

Figure B2. Debt-Creating Flows



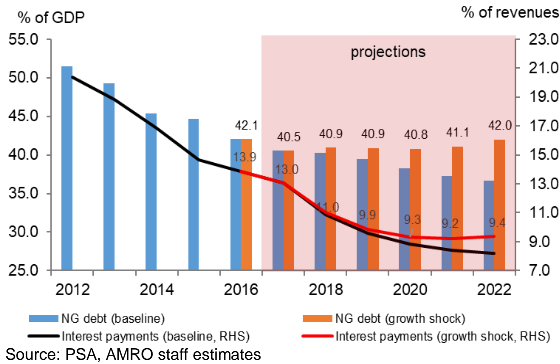
Source: PSA, AMRO staff estimates

Risk scenarios could shed light into the vulnerability of the debt projections at the baseline. In the context of the Philippines, we examine the following shocks.

[13] The government's debt service payments have fallen steadily since 2010 as a result of a pro-active debt management strategy to reduce the debt burden. Under this strategy, the Bureau of Treasury went through debt swaps and exchanges to lengthen the maturity profile of the debt.

[14] This exercise uses the IMF debt sustainability framework for a market-access country. According to this framework, the evolution of the public debt stock is a function of the debt stock from the previous period, the primary fiscal balance, and other one-time factors such as privatization receipts, recognition of contingent liabilities, debt relief, and other specific items such as bank recapitalization. Using the same equation, the change in the debt-to-GDP ratio can be further decomposed to show the contribution of the effective interest rate, real GDP growth, exchange rate, and the primary balance and other factors.

Figure B3. Impact of a Growth Shock

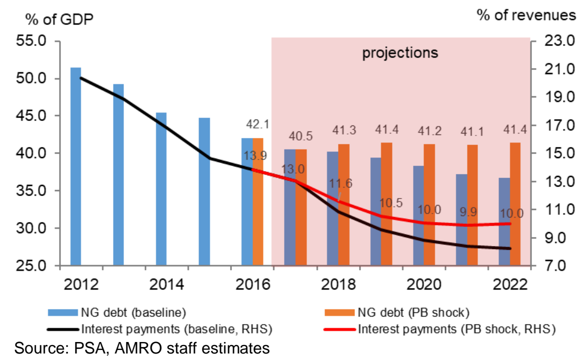


Source: PSA, AMRO staff estimates

1. **Real GDP growth shock.** A case wherein growth eases to a low of 5.8 percent in 2019-2022—for example, as a result of anemic private sector investments—while rising temporarily to 6.0 percent during election years (2018 and 2022), could cause the debt-to-GDP ratio to increase to 42.0 percent by 2022, up 5.3 ppts from the baseline (Figure B3). The moderation in growth dampens inflation and revenues, consequently leading to a deterioration in the primary balance. In turn, the cost of borrowing increases. A growth shock of such magnitude would raise interest payments to 9.4 percent of revenues in 2022, as against 8.2 percent in the baseline.

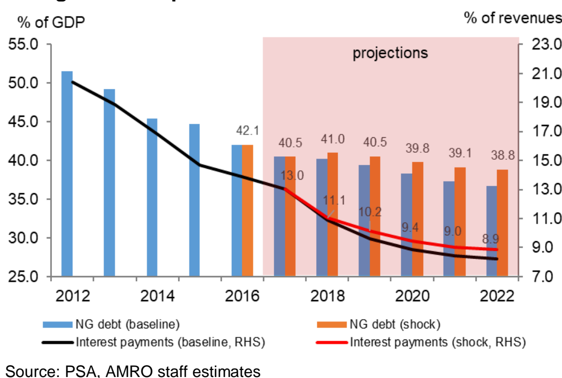
2. **Primary balance shock.** The comprehensive tax reform proposed by the DOF is key to keeping the budget deficit within the ceiling of 3.0 percent of GDP as government expenditure is ramped up. The first package of the tax reform is already being implemented, since the start of 2018. However, the approved version deviates quite markedly from the DOF's version and could thus run short of estimated revenue collections. Against this backdrop, we assume that both the overall and primary balance deteriorates by 1.0ppt per annum from 2018 to 2022. That is, the fiscal deficit could reach 4.0 percent of GDP in the 2018-2022 period. Along with the deterioration in the budget balance, nominal interest rates are also assumed to increase. In this scenario, the debt-to-GDP ratio gradually rises to 41.4 percent in 2022 (Figure B4). The gross financing need would increase from 18.1 percent of revenues in 2017 to 44.6 percent in 2022, as a result of lower revenues and higher interest rates relative to the baseline. Likewise, interest payments are higher in 2018-2022 as against the baseline and relative to the impact of a GDP growth shock.

Figure B4. Impact of a Primary Balance Shock



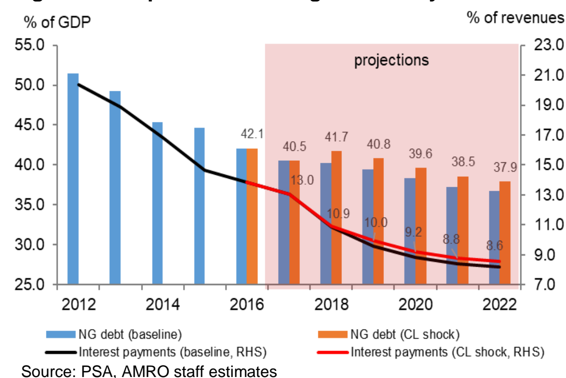
Source: PSA, AMRO staff estimates

Figure B5. Impact of Interest and FX Rate Shocks



Source: PSA, AMRO staff estimates

Figure B6. Impact of a Contingent Liability Shock



Source: PSA, AMRO staff estimates

3. **Interest rate and exchange rate shocks.** Adverse domestic and external developments, such as a faster-than-expected monetary policy tightening in the advanced economies or domestic political instability, could potentially cause a 200-basis-point spike in interest rates and a 10.0 percent depreciation of the peso against the USD in 2018. These, in turn, could cause inflation to rise to 5.0 percent in the same year and dampen growth to 5.8-6.0 percent over the medium term. In such a

case, the debt-to-GDP ratio sustains its downtrend in the next five years (Figure B5), albeit settling at a higher level compared to the baseline.

4. **Contingent liability shock.** The Philippine government's contingent liabilities amounted to 3.2 percent of GDP as of September 2017. Should half of the contingent liabilities were to materialize in 2018, holding other factors constant, the debt-to-GDP ratio would rise modestly in 2018 but would sustain the downtrend thereafter through 2022 (Figure B6). Likewise, the gross financing need would increase from 4.0 percent of GDP in 2016 to 4.6 percent in 2018 and then to 5.8 percent in 2022, or from 26.7 percent of revenues in 2016 to 33.1 percent in 2022. Interest payments, as a share of revenues, would amount to 8.6 percent in 2022, just slightly higher than in the baseline.

From the various scenarios illustrated above, it is evident that strong economic growth is crucial to maintaining debt sustainability. The government must thus safeguard macroeconomic stability so that the economy's robust growth is maintained and even strengthened. However, the primary balance shock scenario also shows that stronger economic growth should not come at the expense of abandoning fiscal rules, such as deviating further from the 3.0-percent-of-GDP budget deficit ceiling. Interest rate, currency, and contingent liability shocks prove to have a benign impact on the debt ratio over the medium term. However, these findings are no reason to be complacent given that such shocks could also occur with a deterioration in macroeconomic fundamentals, which would in turn imperil the fiscal position. As such, notwithstanding the government's projected sound fiscal position over the medium term, the shock scenarios illustrated above should serve as a reminder to continuously implement mitigating measures to preserve debt sustainability.

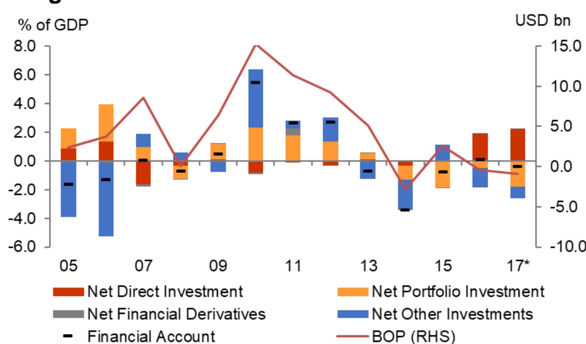
Authorities' views

13. **The Philippine authorities are strongly committed to containing the budget deficit even as expenditures are ramped up.** Government expenditures have been growing at double-digit rates and yet, the authorities admit that structural impediments to stronger fiscal disbursements remain. However, the authorities are optimistic that existing reforms such as the new Right-of-Way Act that is set to ease the acquisition of the right-of-way for the government's infrastructure projects, and pending measures such as the Budget Reform Bill that aims to improve the state's budget process, would lead to more efficient budget and project execution going forward. Moreover, the approval of the first package of the tax reform is seen as only the start of the economic reforms under the Duterte administration. Given that the recently approved TRAIN falls short of revenue expectations, the DOF is pushing the legislature to pass complementary measures in the first quarter of 2018. This and the succeeding tax reforms would fill the revenue gap and ensure that the budget deficit is kept within the ceiling even as expenditures are accelerated.

A.4 External Sector

14. **The country's external buffers remain ample despite continued BOP deficits.** From a deficit of USD420.1 million in 2016, the BOP deficit widened to USD862.8 million in 2017 and USD531.0 million in January 2018. For Q1 2017, the deficit was due to bigger outflows in portfolio investments—more than twice the outflows registered in Q1 2016—as non-residents redeemed debt security holdings and withdrew equity placements, while residents stepped up acquisition of foreign financial assets (Figure 13). Likewise, the current account also contributed to the BOP deficit as it posted the fourth consecutive quarter of shortfall on the back of continued robust import demand despite an acceleration in exports (Figure 14). The BOP recorded net inflows in Q2, as the financial account registered net inflows which outpaced the modest outflows recorded in the current account; but this was again followed by net outflows in Q3, following the reversal of the financial account to net outflows. Despite this volatility in the BOP, gross international reserves were broadly stable in 2017 through early 2018, increasing by USD532.2 million from its level in end-2016. At USD81.2 billion in end-January 2018, reserves are adequate as it can cover 8.2 months' worth of goods imports and payments of services and primary income. It is also equivalent to 5.9 times the country's short-term external debt based on original maturity and 4.2 times based on residual maturity. This indicates that the Philippines has ample buffers against external shocks, and is well-positioned to smooth excessive volatilities of the peso.

Figure 13. Financial Account Balance and BOP



Note: 2017 refers to the average for the first three quarters of the year, except for BOP where data refer to the sum for the full-year 2017. The signs for the Financial Account and its components have been reversed to indicate direction of flows, with negative values indicative of net outflows.
Source: BSP

Figure 14. Current Account Balance and FDI

Note: 2017 refers to the average (of the percent-of-GDP ratios) for the first three quarters of the year.
Source: BSP

15. **The BOP is expected to continue to post a deficit in 2018, reflecting capital outflows and strong imports of capital goods.** A sharper-than-expected rise in US interest rates could lead to asset rebalancing and cause capital outflows from emerging markets including the Philippines, putting pressure on the financial account. The current account could remain in deficit owing to robust import demand as the government ramps up infrastructure spending, although the sustained recovery of the external sector would help to contain the

current account deficit. Remittances, revenues from the business process outsourcing (BPO) industry, and to a limited extent, FDI, are expected to remain as stable sources of foreign exchange. However, their ability to counter the outflows may be limited amid multiple headwinds. For example, a sharp fall in oil prices could reduce foreign labor demand in the Middle East, dampening remittances inflows to the Philippines, while protectionist policies in the U.S. could weaken foreign investment inflows.

Authorities' views

16. **The BSP also expects the current account and the overall BOP to continue to post deficits in the medium term.** It has a relatively benign outlook for the current account, posting a deficit of less than 1.0 percent of GDP in the next five years. The BSP does not consider the deficit a cause for concern given that it would likely be driven by the acceleration of public sector investments in economic and social services which could improve economic productivity over the medium to long term.

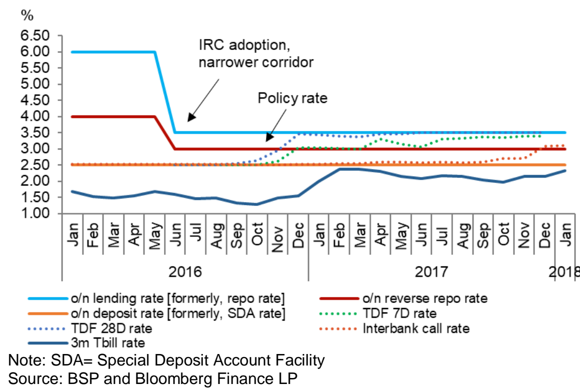
A.5 Monetary and Financial Sector

17. **The BSP has made progress in improving the monetary policy transmission since the adoption of the interest rate corridor (IRC) framework for the setting of monetary policy.** The BSP shifted its monetary operations to an IRC system in June 2016 in an effort to improve the transmission of monetary policy amid excess liquidity in the financial system.[15] Since the IRC adoption, the transaction volumes of the term deposit auction facility (TDF) have increased with TDF rates moving towards the upper-end of the corridor (Figure 15). Short-term rates such as the 3-month Treasury bill yields have crept up closer to the lower bound of the corridor, although the upward moves were also likely facilitated by capital outflows resulting from policy rate hikes by the U.S. Federal Reserve and the spike in long-term yields following the U.S. elections. Since the introduction of the IRC, the yield curve has seen an upward shift across bond tenors (Figure 16). Meanwhile, interbank call loan rates had been settling at the low end of the corridor until they inched higher in the final quarter of 2017 through January 2018. The National Government's decision to increase its debt paper offering by PHP20 billion in the fourth quarter and to sell PHP255 billion worth of five-year

[15] The IRC consists of the overnight lending rate—the rate at which the BSP lends to the banks—as the ceiling; the overnight deposit rate—the rate at which the BSP takes deposits from the banks—as the floor; and the overnight reverse repurchase rate, which serves as the BSP's target or policy rate, at the middle of the corridor. The IRC has a fourth component—the term deposit auction facility (TDF), which absorbs excess liquidity to influence money market rates to move more closely with the policy rate.
To commence IRC operations, placements in the Special Deposit Account (SDA) facility were initially migrated to the overnight deposit facility, and which over the course of one year, were then migrated to the TDF via auction-based operations. As such, with the adoption of the IRC framework, the SDA facility was replaced by the TDF. The BSP also narrowed the width of the corridor from 3.5 percent previously to 1.0 percent—a move emphasized by the BSP to be operational in nature—to limit interest rate volatility and for the central bank to provide clearer guidance to the market.

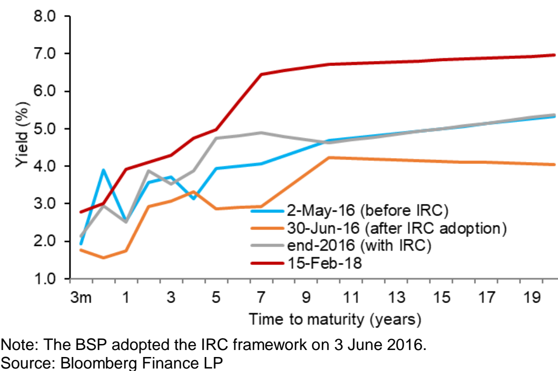
Retail Treasury Bonds in the same period were the main reasons behind the rise in interbank call loan, government securities and TDF rates recently.

Figure 15. Interest Rate Corridor



Note: SDA= Special Deposit Account Facility
Source: BSP and Bloomberg Finance LP

Figure 16. Yield Curve, Pre- and Post-IRC Adoption

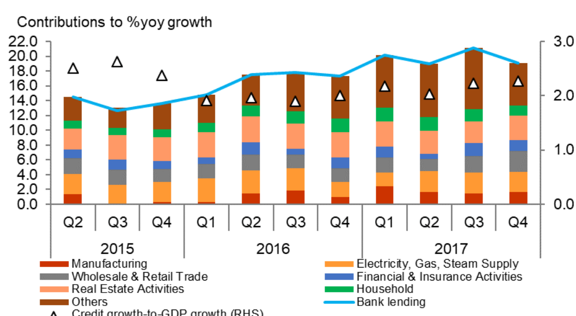


Note: The BSP adopted the IRC framework on 3 June 2016.
Source: Bloomberg Finance LP

18. **While overall credit risk remains low despite rapid credit expansion, relatively elevated NPL ratios in the real estate and auto loan segments may be indicative of risk pockets.** Bank lending further gained pace in 2017, especially in the first three quarters. However, despite easing slightly in the fourth quarter, bank credit continued to grow at over twice the pace of the underlying economy (Figure 17). The expansion in bank lending was channeled to productive sectors such as in manufacturing but also to household (motor vehicle purchases) consumption, alongside smaller items such as agriculture, accommodation & food services, and transportation & storage. Likewise, lending towards other major sectors such as real estate, power generation, and wholesale & repair also remained strong. Despite this rapid credit expansion, asset quality has remained stable. The ratio of non-performing loans (NPL) was broadly unchanged at 1.4 percent of total universal and commercial bank loans from January through November 2017 and then dropped to 1.2 percent in December after having declined steadily over the preceding five years (Figure 18). Still, rapid credit growth—notwithstanding the strength of the banking system—warrants close monitoring especially in certain segments. For example, while they have eased in more recent periods, NPL ratios in the real estate and auto loan segments remain relatively elevated, a warning sign given their continued rapid pace of credit expansion despite having eased over the preceding 1-2 years (see Selected Issue 2 for a broader discussion of this topic). In a country where less than a third of the adult population has a bank account, the rapid growth in bank lending may also be indicative of the aggressive lending behavior of non-bank financial institutions and the informal sector which are beyond the purview of the BSP.[16]

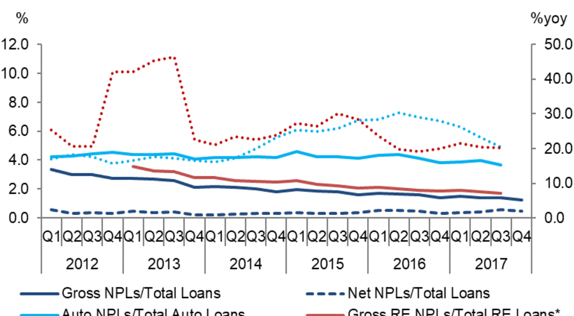
[16] According to the World Bank and the latest Global Findex database, 31 percent of the Philippines' adult population owned bank accounts in 2014, but 70 percent of adults borrowed money within the last 12 months.

Figure 17. Credit Growth, Universal & Commercial Banks



Note: Others refer to Agriculture, Forestry & Fishing, Mining & Quarrying, Water Supply, Sewerage & Remediation Activities, Construction, Accommodation & Food Services, Transportation & Storage, Information & Communication, Professional, Scientific & Technical Activities, Administrative & Support Services Activities, Public Admin & Defense, Compulsory Social Security, Education, Human Health & Social Work Activities, Arts, Entertainment & Recreation, Other Community, Social & Personal Activities, Activities of Households and Non-residents. Loans and lending rate by Universal & Commercial Banks. Household Consumption are further broken down into credit cards, auto loans, salary loans and others.
Source: BSP

Figure 18. Loan Quality and Growth, Universal & Commercial Banks



Note: Universal and Commercial Banks account for over 90.0 percent of Philippine Banking System's assets. *Gross RE NPLs of the Philippine Banking System (Bank Proper & Trust Department).
NPL = non-performing loans; RE refers to residential real estate.
Net NPL refers to Gross NPL less Specific Allowance for Credit Losses.
Source: BSP

19. **While the banking system's asset quality has been good and capitalization remains adequate, rapid credit expansion continues to warrant close monitoring.** Likewise, for the overall banking system, gross NPLs have been steady within 1.9–2.0 percent of the total loan portfolio for the most part of 2017 after declining from 2.8 percent in March 2014 (Table 1). The NPL provisioning coverage ratio is also above 100 percent (120.7 percent as of end-December 2017), indicating that the banking system has made sufficient provisions for credit losses. Moreover, banks are well-capitalized, with capital adequacy ratios well above the BSP regulatory threshold of 10 percent. However, the rapid pace of credit expansion continues to warrant close monitoring, especially as lending could quicken further as financial inclusion advances and the banking system becomes more competitive.

Table 1. Financial Soundness Indicators for the Philippine Banking System

as of end-of-periods indicated	2014				2015				2016				2017			
ratios in percent (%)	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Capital Adequacy Ratio (Solo)	15.6	16.1	16.4	15.6	15.5	15.8	15.8	15.2	15.3	15.6	15.6	14.7	15.3	15.5	15.3	-
Non-Performing Loans, percent of total loans	2.8	2.7	2.6	2.3	2.5	2.4	2.3	2.1	2.2	2.2	2.1	1.9	2.0	1.9	1.9	1.7
Return on Equity (ROE)	9.7	9.5	9.7	10.9	11.1	10.7	10.1	9.8	9.7	9.8	10.0	10.5	10.0	9.8	9.8	10.2
Net Interest Margin	3.5	3.5	3.5	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.2	3.3	3.3	3.4	3.3
Loans to Deposit Ratio	64.9	66.0	67.5	68.4	67.5	68.3	68.6	70.7	69.2	70.4	71.5	72.5	72.1	72.8	74.1	75.6
Cash and Due from Banks to Deposits	31.5	30.6	29.0	29.1	28.1	27.3	27.0	26.8	27.2	26.8	26.0	26.3	26.1	25.0	24.1	23.1
Liquid Assets to Deposits Ratio	58.6	57.1	55.5	55.7	55.3	55.0	55.7	53.6	53.9	53.0	52.4	50.7	51.3	50.4	49.0	47.7
Cost to Income Ratio	64.7	65.0	64.6	62.4	62.1	62.3	63.1	64.5	64.7	64.6	64.3	63.6	64.2	64.2	64.0	63.8

Source: BSP Banking Statistics – Selected Performance Indicators – Philippine Banking System

Authorities' views

20. **The authorities recognize the rapid growth in credit, but cite its broad-based expansion—a reflection of the growing needs of a dynamic economy—and generally good asset quality.** In addition, despite its rapid expansion, credit has room to accommodate further growth. The Philippine's credit-to-GDP ratio (of 63.6 percent as of September 2017)

remains one of the lowest in the region, second only to Indonesia (40.6 percent as of September 2017). Nonetheless, the monetary authority is vigilant against the build-up of financial imbalances; it has, for example, enhanced prudential reporting requirements since September 2017 in order to strengthen its oversight of banks' real estate and project finance exposures, and is collaborating with other financial regulatory authorities to enhance compilation and quality of debt-related data. According to the BSP's assessment, there is no imminent risk with regard to the repricing, repayment and refinancing of loans.

Risks, Vulnerabilities and Challenges

B.1 Risks to the Macroeconomic Outlook

21. **Internal and external headwinds tilt the balance of risk in the growth outlook to the downside.** The drive to accelerate infrastructure development through the 'Build, Build, Build' program continues to be challenged by the weak implementation capacities of the line agencies and private sector participants. Government agencies lack sufficient skilled manpower and have poor institutional memory to effectively implement the growing number of complex projects such as urban subways, complicated road networks, and flood control and urban water systems, which would require international expertise. Similarly, not enough domestic private contractors have the technical competence, experience and financial capacity to handle large-scale projects. Moreover, domestic investments face the risk of contagion from a further slowdown in FDI inflows. That is, while the contribution of FDI to the Philippine economy is small, a sustained drop in committed FDI—as evident in recent quarters—could spill over into domestic investments (Figure 8). Amid these vulnerabilities, the timely passage and implementation of the first package of the comprehensive tax reform program could counter near-term concerns and lift business confidence. However, a tax reform version with a weaker revenue increase relative to the DOF's version could also hold back the infrastructure investment program. All these domestic factors could undermine investment activity and dampen growth prospects.

22. **Notwithstanding the structural impediments, one cannot rule out a strong pick-up in public infrastructure spending accompanied by a crowding-in of private investment, which could cause the economy to overheat.** As brisk fiscal spending adds to the already buoyant domestic demand, rapid credit growth and elevated price pressures, inflation could spike up and dampen growth.[17] The pick-up in infrastructure spending also implies stronger import demand, thereby causing the current account deficit to widen and the peso to weaken sharply. And while the risk to medium-term fiscal sustainability is low, financing big-ticket infrastructure

[17] Moreover, rapid credit growth accompanied by changes in market conditions such as a steady increase in interest rates and depreciation of the peso may also result to a higher debt service burden and cause a sharp disruption in economic activity.

projects with uncertain commercial viability and without accurate assessment under various adverse shocks could lead to a spike in government liabilities and a consequent deterioration of the fiscal health in the long term.

23. **While the first package of the tax reform has raised our 2018 inflation forecast, the balance of risk to the outlook remains tilted to the upside.** The provisions under the TRAIN have raised our 2018 inflation forecast by 0.8 ppt to 4.3 percent. Still, the inflation outlook faces additional upside risks from higher disposable incomes arising from the reduction in personal income tax rates, which could lead to higher food consumption, as well as the pending petitions for electricity rate adjustments. On the other hand, downside risks may stem from a dampened global economic recovery, which in turn could push down global commodity prices, and the proposed deregulation of rice imports, which has the potential to cut down the domestic price of a national staple.

24. **A host of factors could affect the direction of the external balance, raising or reducing medium-term vulnerability.** A disorderly pace of advanced economies' policy normalization and heightened domestic political risks could exacerbate capital outflows and worsen the slowdown in FDI. Moreover, a faster-than-expected pace of infrastructure building, coupled with a material pick-up in commodity prices, could accelerate import demand, worsening the current account imbalance. On the other hand, efforts to attract foreign investments, such as by liberalizing restrictions (refer to Box C) and relaxing FX rules (Box D), could ease the external imbalance and reduce the country's external vulnerability over the medium term.

Authorities' views

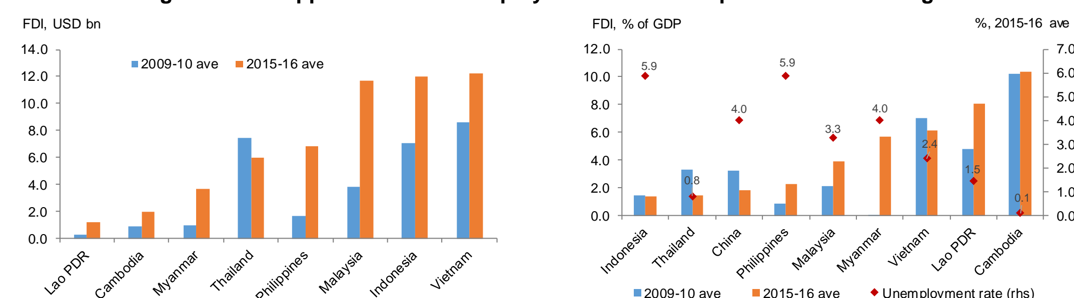
25. **The BSP stresses that it remains vigilant to global headwinds and is ready to deploy measures to guard against risks.** The BSP recognizes that global economic growth faces downside risks from geopolitical tensions and lingering uncertainty over macroeconomic policies in advanced economies. It does not believe that the economy, amid its robust expansion and rapid credit growth, is already in a state of overheating. Nonetheless, the BSP assures that it remains on guard to deploy macro-prudential measures in response to various risks, such as from overheating and a global increase in interest rates. In line with its continued monitoring of the rapid growth of credit, the BSP is soliciting comments to a discussion paper entitled "Credit Growth and the Confluence of Factors". In the process, it is engaging primary stakeholders (fellow regulators and market participants) in discussing the risks to the repayment capacity of borrowers in an environment of rising debt burdens as interest rates rise and the peso depreciates. The comments will be used to improve the analysis of the credit quality of borrowers, the threats to their capacity to pay, and the possible pre-emptive

measures that will be formulated by the BSP. To guard against the upside risks to inflation, it shall consider adjusting its monetary stance in response to second-round effects and demand pressures such as that arising from the tax reform.

Box C. The Need to Catch Up with the Region on FDI Inflows

The amount of FDI that the Philippines received annually between 2010 and 2016 grew more than sevenfold. As a share of GDP, the country also saw its FDI steadily increase from 0.5 percent in 2010 to 2.6 percent in 2016. But notwithstanding these improvements, the country has still lagged behind many of its ASEAN neighbors.

Figure C1. Philippine FDI and unemployment rate as compared to ASEAN neighbors



Source: CEIC (official sources), IMF World Economic Outlook Database (April 2017)

Source: CEIC (official sources), IMF World Economic Outlook Database (April 2017)

As the Philippines continues to have one of the highest unemployment and underemployment rates in the region, the need to attract more FDI inflows is even more critical.[18] There is also a sense of urgency to address hurdles to FDI inflows given a growing external imbalance as the Philippine government embarks on an aggressive infrastructure push.

The new administration under President Duterte recognizes this need and thus aims to liberalize restrictions on foreign investments. For one, the administration is currently reviewing the 10th Foreign Investments Negative List (FINL).[19] After a review in 2015 that left provisions practically intact, the current administration intends to carry out an aggressive liberalization of the FINL. Foreign equity restrictions are reportedly planned to be relaxed in retail trade, practice of professions, education, mass media and public utilities as well as for infrastructure contractors, financing and investment companies, and other wellness centers. However, not all of the restrictions can be lifted administratively via an Executive Order (EO). As such, an EO is also being drafted for concerned government agencies to work on a reform agenda for strategic sectors, and where changes to current rules require legislative action. Over the medium term, the administration also plans to amend the Constitution, particularly the restrictive economic provisions on foreign ownership and participation.

[18] Foreign direct investments (FDI) have been shown in various studies to facilitate the transfer of technology, promote competition in the domestic market, and/or contribute to human capital development in the host country. See Rafaelita Aldaba and Fernando AldabaTHe

[19] The FINL provides a shortlist of investment areas or activities that may be opened, albeit with a specified limited share, to foreign investors and/or reserved to Filipino nationals. It consists of List A and List B, of which amendments are made once every two years. Negative List A refers to foreign investments which are limited or restricted by the Constitution and other specific laws. Negative List B identifies the foreign investments that are limited for reasons of security, defense, risk to health and morals, and protection of small- and medium-scale enterprises. Kindly refer to the 10th FINL in Appendix 1d.

Box D. BSP's Continuing Efforts to Liberalize FX Rules

The BSP initiated to liberalize the FX regulatory framework as early as the 1990s, although this was pursued more vigorously starting in 2007. The latest reforms, issued in December 2017, focus primarily on the following objectives, namely: (a) further ease of access to the banking system's FX resources for legitimate transactions to help sustain the economy's growth trajectory; (b) encourage the shift of more FX transactions from the informal market to the banking system; and (c) maintain the BSP's ability to capture current, reliable and important data or information for policy review and formulation, analysis and monitoring. The reforms are also expected to further deepen the domestic capital market. Moreover, the reforms support the Duterte administration's thrust to encourage foreign investments (see Box C).

Previously, a set of FX liberalization measures were also issued in 2016. These were aimed to: (a) provide Philippine residents greater flexibility in managing cash flows and transacting in FX; (b) further ease access to FX resources of banks for trade, non-trade current account and foreign investments, as well as enhance BSP capture of data; and (c) facilitate funding of projects and activities supportive of economic growth.

Table D1. Foreign exchange liberalization measures adopted in 2016-2017

Circular No./Date	Measures
No. 984 22 December 2017 (Effectivity: 15 January 2018)	(a) Lifted the requirement for prior BSP approval for purely private sector foreign loans/borrowings (i.e., those without guarantee from/exposure of any public sector entity), including those in the form of bonds/notes/other debt instruments issued offshore; loans will only need to be registered with the BSP to allow use of the banking system's FX resources for loan repayments; and (b) Streamlined and simplified requirements to support applications for registration and purchase of FX from the banking system.
No. 985 22 December 2017 (Effectivity: 15 January 2018)	Opened a temporary 6-month window starting from the effectivity date of Circular No. 985 during which unregistered purely private sector loans/borrowings obtained without the prior BSP approval that are outstanding and booked in the borrower's records as of 22 December 2017 may be applied for registration following the guidelines set for the purpose. Once the accounts are registered with the BSP, the outstanding balances (including interest and fees, if any) of the obligations can be paid using FX resources of the banking system.
No. 925 13 September 2016 (Effectivity: 15 September 2016)	(a) Allowed the sale of FX to Philippine residents up to USD500,000 (for individuals) and USD1 million (for corporates/other entities) without documentation for settlement of trade transactions (except intercompany netting obligations); (b) Increased the amount of FX that Philippine residents may freely purchase from the banking system without supporting documents for non-trade current account transactions (from USD120,000 for all to: USD500,000 for individuals, and USD1 million for corporates/other entities); (c) Allowed residents to deposit FX purchased from banks for certain underlying transactions (such as for travel abroad and payment of certain obligations to non-residents) into their onshore foreign currency accounts, prior to remittance to the intended beneficiaries; (d) Allowed the sale of FX by banks and their forex corporations for resident-to-resident FX transactions [such as investment in FX instruments issued by Philippine residents (e.g., ROP bonds and notes)]; and (e) Lifted the prior BSP approval and registration requirements for: (a) private sector loans to be obtained from banks operating in the Philippines; and (b) loans to be obtained by private non-banks with quasi-banking functions (NBQBs) from offshore sources as well as banks operating in the Philippines.
No. 922 23 August 2016 (Effectivity: 15 September 2016)	Increased the amount of legal tender Philippine currency that may be freely brought into/out of the country (from PHP10,000 to PHP50,000 per person) without prior BSP approval.
No. 918 18 August 2016 (Effectivity: 1 September 2016)	Provided one-year grace period (from 1 September 2016 to 1 September 2017) for filing of applications with the BSP for registration of foreign direct investments, regardless of the date when funding for the investment was transferred to the Philippines.

Circular No./Date	Measures
No. 909 30 March 2016 (Effectivity: 21 April 2016)	Lifted the prohibition on notarization of documents covering foreign loans, deferred payment and any other agreements which give rise to a foreign or foreign currency denominated obligations of the private sector that are not guaranteed by the public sector.

Source: BSP

Complementing the FX reforms, the BSP is further pushing for financial sector reforms such as in the development of the local currency debt market.[20] It has, for example, relaxed and streamlined the requirements of banks and quasi-banks (QBs) intending to issue bonds and commercial papers. It has also rolled out the repurchase agreement facility in November 2017 and is finalizing the guidelines for the overnight index swap (OIS) system, measures that are aimed to boost liquidity as well as encourage the expansion of the domestic bond market.

Nonetheless, the easing of FX rules and the advancement of broader reforms in the financial sector need to be complemented with prudence and vigilance to guard against heightened financial market volatility especially as the U.S. Fed continues with its normalization of monetary policy and the Philippines' current account remains in deficit.

B.2 Other Structural Challenges

26. **The jobs mismatch in the country can be a major constraint in raising the economy's growth potential.** Despite the Philippines' abundant labor supply and high unemployment rate, studies sponsored by the Department of Labor and Employment (DOLE) in 2010 already indicate labor shortages in specific occupations and industries.[21] The shortage stems from both quantity and quality of the labor supply: in part from a skills drain to overseas companies which are able to offer higher wages, but also because school curricula are not responsive to industry needs. In 2013, DOLE identified 275 in-demand occupations and 102 hard-to-fill occupations in the country. When combined, it forms a list of 43 in-demand and hard-to-fill occupations per industry, some of which are listed in Table 2. A pressing concern would be the insufficient supply of construction-related skilled workers which may delay the implementation of the government's infrastructure program.

27. **The country's vulnerability to natural disasters, violent outbreaks and political unrest pose a challenge to authorities goal of achieving strong sustainable growth and country-wide economic reforms.** Without sufficient mitigating measures, concerns about such risks have the potential to hold back the progress of proposed economic reforms. Even more worrisome, their materialization could derail the government from its economic agenda, in turn undermining long-term economic prospects and increasing income disparity, as fiscal resources are diverted to other pressing areas of concern.

[20] Speech delivered by the BSP Governor during the Fellows Meeting of the Foundation of Economic Freedom on 26 July 2017.
[21] Project JobsFit DOLE 2020 Vision: Summary of Findings and Recommendations, published in 2010.

Table 2. Selected in-demand and hard-to-fill occupations per industry

Occupation	Industry
Accountant	IT-BPM; Wholesale & Retail; Hotel, Restaurant, & Real Estate; Banking & Finance; Agribusiness; Manufacturing; Education
Carpenter	Agribusiness; Construction
Chemical Engineer	Renewable Energy; Power & Utilities; Manufacturing
Electrical Engineer	Renewable Energy; Ownership, Dwellings & Real Estate; Agribusiness; Manufacturing; Mining; Wholesale & Retail
Heavy Equipment Operator	Manufacturing; Mining; Power & Utilities; Construction
Mason	Ownership, Dwellings & Real Estate; Construction
Plumber	Construction
Welder	Agribusiness; Construction; Mining; Shipbuilding; Manufacturing

Note: Selected out of 43 occupations in the list
Source: JobsFit Labor Market Information Report 2013-2020 (Department of Labor and Employment)

Authorities' views

28. **The authorities recognize the challenges in raising the economy's growth potential.** The current administration strongly believes that a crucial way to ease the constraint to higher growth is to invest in physical infrastructure through the 'Build, Build, Build' initiative and in the people through better health, education, life-long training, and social protection. ,The government has been facing difficulties in attracting sufficient manpower (such as engineers for Department of Public Works and Highways) due to the significant pay differential with the private sector as well as a shortage of specific skills within the local talent pool. Authorities also recognize the weak absorptive capacity of the private sector with regard to the proposed major infrastructure projects. In this regard, the government has started offering licenses to foreign contractors.

Policy Recommendations

C.1 Fiscal Policy

29. **The initiative to accelerate fiscal spending in strategic areas is a welcome development in order to pave the way for inclusive and sustainable economic growth.** In particular, higher spending to improve the country's infrastructure services and human capital could crowd-in private investments and create more employment opportunities for the large and young Filipino population, in turn boosting the economy's productive capacity.

30. **Budgetary, governance, and tax reforms should gradually facilitate the efficient execution of a fiscal spending plan that is anchored on medium-term debt**

sustainability. For example, the imposition of the one-year effectivity of the annual budget and its institutionalization with the Budget Reform Bill have the potential to improve budget utilization considerably.[22] Likewise, the administrative order that was signed in October 2017 to streamline the composition of the National Economic and Development Authority (NEDA) Board—the country's social and economic development planning and policy coordinating body—as well as the proposed Rightsizing Program in the government could fast-track the decision-making process, including on infrastructure project approvals, and in turn facilitate efficient delivery of public service.[23] The new Right-of-Way (ROW) law also serves to cut dispute times on the value of the property for national government infrastructure, although a system to address other long-standing ROW issues such as disputes among government agencies and relocation also has to be pursued, Ultimately. these budgetary and governance reforms would have to be complemented by the passage of the comprehensive tax reform program to preserve fiscal space amid robust spending. Therefore, a temporary breach in the 3.0 percent of GDP budget deficit ceiling as the infrastructure spending gains pace should be acceptable so long as the ceiling is observed over the medium term.

Authorities' views

31. **The government is strongly committed to fiscal reforms.** The first package of the comprehensive tax reform proposal has been approved and is on track for implementation in January 2018. In addition, the DOF is pushing the legislature to approve in the first quarter of 2018 the additional provisions in the first package (tax amnesty program, adjustments in the Motor Vehicle Users Charge, and amendments to the Bank Secrecy Law) in order to fill the revenue shortfall from the recently approved tax measures. Moreover, the DOF is gearing up to submit to lawmakers the second package of the tax reform proposal, which seeks to reduce corporate income taxes and modernize fiscal incentives. The progress of these proposed tax reform measures complements government efforts to ramp up expenditure, and demonstrate firm commitment to keep the fiscal deficit within the ceiling.

C.2 Monetary Policy

32. **The current monetary policy stance is appropriate given within-target inflation, but the BSP needs to be vigilant against elevated inflationary pressures.** Even though

[22] The Philippine General Appropriations Act (GAA), which sets the national budget, is currently on an obligation basis, as opposed to cash basis. This implies that the GAA may not be fully spent in a given year, as a portion of the annual budget will only be utilized in succeeding years.
[23] With the administrative order (AO), the members of the NEDA Board have been reduced from 22 to 12, with the President as Chairperson and the NEDA Secretary as vice chairperson. The same AO also reactivated and reorganized the NEDA Board Executive Committee as well as reconstituted the Investment Coordinating Council (ICC). The Executive Committee is tasked, among others, to provide policy direction and resolve certain policy issues without the necessity of convening the entire NEDA Board in accordance with existing laws, rules, and regulations. As for the ICC, it evaluates the fiscal, monetary, and balance-of-payments implications of major national projects, and recommends to the President the timetable of their implementation. Meanwhile, the proposed Rightsizing Program aims to remove redundancies and overlapping functions in the executive branch in order to improve public service delivery.

the expected increase in inflation in 2018 and the upside risks to the outlook are mostly supply-driven, the BSP should be ready to tighten monetary policy in response to growing demand pressures. Core inflation, for instance, has been generally trending upwards since mid-2017 and higher disposable incomes from the personal income tax reductions risk further stoking price increases. A tightening of monetary policy would help to contain risks to macro stability in view of a pick-up in growth momentum and rising inflation. Adjustments in existing macro-prudential measures may also complement the outright increase in policy rates.

33. **A flexible exchange rate policy should be maintained as a buffer against external shocks.** While the BSP may intervene to smoothen excessive volatilities in the peso, the currency should continue to be determined by market forces and allowed to move in line with the developments in the external account.

34. **Continued enhancements in the BSP's financial surveillance framework are needed to safeguard against the build-up of financial imbalances.** Against the backdrop of rapid credit expansion, both macro- and micro-prudential measures have to be constantly reviewed and enhanced in order to help manage systemic risks which, in turn, will help support and maintain financial stability in the economy. Sound underwriting standards have to be maintained among banks in order to address pockets of credit risk in real estate and auto loan segments. For example, the Monetary Board's decision in September 2017 to enhance banks' disclosure requirements with regard to their real estate and project finance exposures—a move to supplement the existing regulatory framework—is a step in the right direction, as it would help to sharpen the BSP's assessment of the banking system's exposure to the property sector.[24] As for the potentially sizable lending from non-bank financial institutions and the informal sector, the BSP's collaboration with other financial regulatory authorities could be maximized to enhance compilation and quality of debt-related information. Such collaboration would serve as an interim measure before the BSP's regulatory and supervisory functions are broadened with the passage of the amendment to the BSP charter.

Authorities' views

35. **The BSP notes that current monetary settings remain appropriate.** It reiterated that future monetary policy decisions are data-dependent. Any change in the key policy rate depends on the outlook for inflation over the policy horizon, as embodied by the BSP's inflation forecast, along with the assessment of various macroeconomic variables that may indicate a build-up in demand pressures (e.g. liquidity growth, consumption growth, wages, employment,

[24] The new directive, set to take effect on 30 June 2018, would require banks to report granular information on their real estate loans to mid- and high-end housing units, in addition to socialized and low-cost housing; the underlying commercial project being financed by commercial real estate loans; and their project finance exposures which shall include information in terms of type of infrastructure project and project phase.

capacity utilization, etc.) and second-round effects of supply shocks (e.g. wage increases, transport fare hikes). Nevertheless, the BSP assures that it would remain vigilant against any risks to the inflation outlook and will adjust its policy settings as needed to ensure that future inflation stays aligned with the medium-term target while being supportive of sustainable economic growth.

36. **The BSP also recognizes the need to further strengthen its macro-financial surveillance framework.** The BSP recognizes that its current database does not capture borrowings outside the banking system. Thus, the BSP has taken steps to address data issues related to borrowings of corporates and the real estate sector. Aside from the BSP's collaboration with other government agencies through the Financial Stability Coordination Council and the Financial Sector Forum, the Philippines has also become a BIS-reporting country; this status will allow the BSP to access detailed information on cross-border exposures of other countries to the Philippines. However, notwithstanding the progress achieved by the BSP in mainstreaming financial stability in its core mandate and in strengthening its prudential regulations, there is a need to strengthen the macro-financial surveillance in order to enhance existing macro-prudential regulations and develop new ones that aim to safeguard the economy against attendant system-wide risks and financial imbalances.

C.3 Structural Policy

37. **Reforms to improve the country's business climate and attract investments across sectors are urgently needed.** Given the Philippines' high unemployment and underemployment rates, there is a strong need to create jobs by stimulating domestic investments across sectors (from agriculture to manufacturing and services). Alongside the drive to improve infrastructure, which could enhance the ease of doing business in the country, the business climate needs to be improved as well. Plans to implement a "single window" approach to fast-track the processing of business permits and to liberalize restrictions on foreign investments should help to support an environment that is conducive to domestic and foreign investments. Similarly, BSP's measures to liberalize the entry of foreign banks in the country and the phased-in liberalization of FX regulations, alongside impending capital market reforms, are steps in the right direction. Such an environment would facilitate greater FDI inflows, where the Philippines has one of the lowest in ASEAN, and over time, support the move up in the production value chain, in turn paving the way for higher wages. Indeed, studies show the importance of the host economy's business environment and quality of governance

as policy determinants of FDI in Asia and in particular, in the Philippines.[25] Moreover, a sense of urgency in attracting FDI inflows and increasing the value-added of the country's exports can mitigate the concern over the expected widening of the current account deficit in the medium term.

38. **Investing in human capital to address the labor mismatch would support moves to ease the cost of doing business in the country.** While the government should recognize every Filipino's right to work overseas, it can also persuade its labor force to stay in the country by increasing the supply of quality jobs. In this line, greater efforts are needed to stimulate private sector investments—both foreign and domestic, improve the quality of education across levels including technical vocation, and prepare for the impact of potentially disruptive technologies. While the budget for education has been increased, from 3.5 percent of GDP in 2016 to 4.0 percent for 2018, it is still lower than the allocations in Malaysia and Thailand of 4.5-5.0 percent (2017) and above 5 percent in the Eurozone and the United States. Moreover, projects funded by the national budget for education have to be evaluated to ensure that resources are utilized effectively.

39. **Given its high exposure to natural disasters, the country needs to strengthen its capacity for disaster preparedness, resilience, and response.** Recognizing the country's vulnerability to typhoons, earthquakes, and other natural disasters, which can be exacerbated by climate change, the government's climate change-related expenditures were expanded to PHP276.1 billion in 2018 from PHP204.6 billion in the previous year. Bulk of the expense is for adaptation—meant to maintain and increase adaptive capacity and resilience, comprising 97.4 percent in 2018. Separately, a budget of PHP25.5 billion for 2018—up from PHP15.8 billion in 2017—has been allocated to fund the reconstruction, rehabilitation, repair, aid, relief and other works or services brought about by natural calamities, terrorism, and armed conflicts, among others, which have occurred during the budget year or the preceding two years. However, given the broad scope of the funds, there is clearly a need to expand the safety net against natural and man-made calamities.

Authorities' views

40. **The government recognizes the need for broad-based structural reforms.** NEDA stresses the need to improve the delivery of business-related government services and to create an enabling environment that fosters innovation in order to attract investments—such as in sectors with high employment potential like manufacturing—and reinvestments in the

[25] For determinants of FDI in Asia, kindly refer to the Box: *Outward Investments from Selected Asian Economies,* Asian Economic Integration Report 2017 (ADB, 2017), pp. 33-36. For a country-specific study on the Philippines, kindly refer to Rafaelita A. Mercado-Aldaba, *Foreign Direct Investment in the Philippines: A Reassessment*, PIDS Research Paper Series No 94-10 (1994).

country. In line with this, the Department of Trade and Industry, for example, is implementing the Manufacturing Resurgence Program that aims to increase the contribution of the sector to at least 25 percent of GDP by 2022 from a 23.4 percent average in 2016-2017, by improving the competitiveness of existing industries and strengthening new ones. Efforts are also being taken to address the labor mismatch through education and skills upgrading. In November 2017, for instance, the Philippines and Japan agreed to develop the Philippines' construction manpower sector. Under this agreement, Japanese experts will be sent to the Philippines to train construction workers. The Philippine government will also work with established local construction companies to facilitate integration of returning overseas workers.

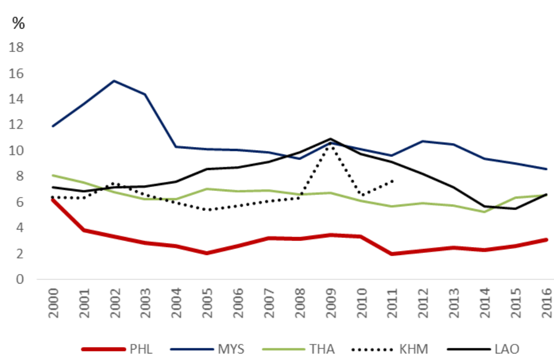
Annexes: Selected Issues

Issue 1. Economic Impact of the Philippines' 'Build, Build, Build' Program

Overview

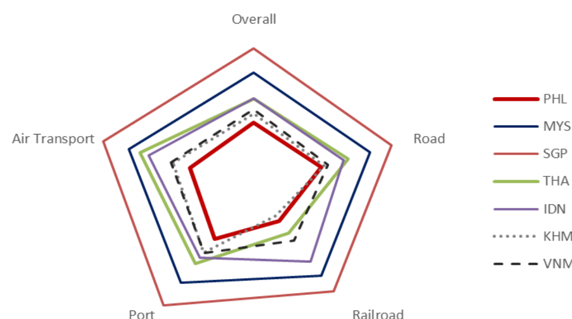
1. **Philippine public sector infrastructure spending has lagged behind its ASEAN neighbors.** During the past 15 years, for example, public investment averaged only around 2.7 percent of GDP. In comparison, Thailand and Malaysia spent about 6.3 percent and 10.5 percent of GDP, respectively, during the same period (Figure A1.1). Overall, total investment (public and private) has only averaged around 20 percent during the same period, in comparison to 22-23 percent for Brunei and Malaysia, 25 percent for Thailand, 26 percent for Singapore and Lao, and 28-29 percent for Indonesia and Vietnam. It is thus not surprising that in the World Economic Forum's Global Competitiveness Report 2017-2018, the Philippines ranked second to last in the ASEAN region in railroad and port infrastructure quality, and last in in road, air transport, and overall infrastructure quality (Figure A1.2).

Figure A1.1. Public Investment (% of GDP)



Source: World Bank WDI

Figure A1.2. Infrastructure Quality



Source: World Economic Forum, Global Competitiveness Report 2017-2018

2. **Recognizing the country's large need for infrastructure, the Philippine government is embarking on an ambitious infrastructure program in the next six years.** Dubbed the 'Build, Build, Build' infrastructure strategy, the government plans to spend PHP8.1 trillion (USD162.2 billion) in infrastructure projects from 2017 to 2022, and in the process, increase the share of public infrastructure spending from 5.4 percent of GDP in 2017 to 7.3 percent in 2022 (Figure A1.3). The 'Build, Build, Build' infrastructure plan has been further threshed out with details of specific projects, timelines and funding sources in 'The Public Investment Program 2017-2022', which also includes projects conceived or approved under the previous administration, and implemented under the present administration. The list of the major ongoing and planned infrastructure projects is listed on Table A1.1.

Table A1.1. List of selected big-ticket infrastructure projects under the 'Build, Build, Build' program

No.	Project Title	Total Cost (bn)		Funding Source	Feasibility Study	Date – NEDA Board Approval	Status
		PhP	USD				
1	Metro Manila Subway	355.6	7.1	Japan	Ongoing	12-Sep-17	to start construction in Q3 2018
2	North-South Commuter Railway (Phase 1, Malolos-Tutuban)	117.3	2.3	Japan	Completed	16-Feb-15	to start construction in H1 2019, clearing operations have begun
3	PNR North 2 (Malolos-Clark Railway Project)	211.4	4.2	Japan	Completed	27-Jun-17	construction to start in Q2 2019
4	PNR South Commuter Railway	134.0	2.7	Japan	Completed	12-Sep-17	
5	PNR-South Long Haul	175.0	3.5	China	Completed	12-Sep-17	
6	Improvement, Operations, Maintenance of regional airports (Iloilo, Bacolod and Davao)	91.2	1.8	GAA	Completed	12-Oct-14, 14-Nov-16	Groundbreaking started in 2017
7	Mindanao Railway (Tagum-Davao-Digos segment)	35.3	0.7	GAA	Completed	27-Jun-17	Construction to start in Q3 2018
8	MRT Line 7 Project	62.7	1.3	PPP	NA	21-Nov-13	Under construction
9	LRT Line 1 South Extension	64.9	1.3	PPP	Completed	22-Mar-12, 19-Jun-14	pre-construction (ROW, relocation), construction to start early 2018
10	Cavite-Laguna Expressway	35.4	0.7	PPP	Completed	21-Nov-13	pre-construction stage (e.g., ROW)
11	NLEX-SLEX Connector	23.2	0.5	PPP	Completed	18-Jan-13, 16-Dec-15	pre-construction, construction to start May 2019
12	TPLex (Ultimate Stage)	24.4	0.5	PPP	NA	16-Feb-15	Under construction
	TOTAL	**1,330.5**	**26.7**	**~8% of 2018 GDP**			

Source: NEDA, DPWH, various media reports (as of 11 January 2018)

3. **This short note analyzes the economic impact of the 'Build, Build, Build' program on the Philippine economy in the short and long term. It also suggests policy recommendations towards the successful implementation of the infrastructure program.** Following established literature,[26] vector regression (VAR) analysis using quarterly data has been employed to measure the short-term impact of infrastructure spending on quarterly GDP.[27] In addition, policy scenario simulations on a small-scale structural macroeconomic model with supply and demand-side dynamics have been conducted, in order to quantify the impact of the 'Build, Build, Build' initiative on the country's long-term economic potential (see Annex 1 for a description of the methodology). The simulation results also include the calculation of the potential private investment crowd-in in case the historical relationship between the public-investment-to-GDP ratio and the private-investment-to-GDP ratio holds during the implementation of the government's infrastructure program. Finally, in making policy recommendations, we take into account the country's past experiences with infrastructure projects under various financing schemes as well as the current state of the

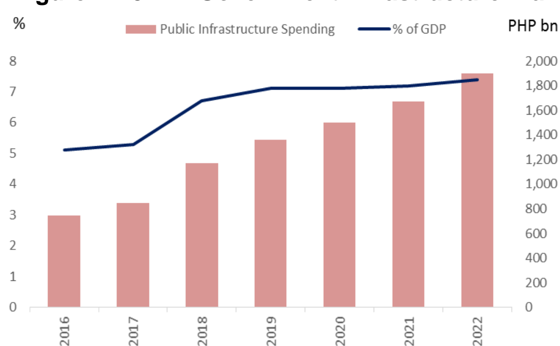
[26] See, for example, Alfredo M. Pereira and Jorge M. Andraz, *Public Investment in Transportation Infrastructures and Industry Performance in Portugal*, College of William and Mary Department of Economics Working Paper 45 (April 2007); Alfredo M. Pereira, *Is All Public Capital Created Equal?*, The Review of Economics and Statistics 82:3 (2000); Sylvain Broyer and Johannes Gareis, *How Large Is the Infrastructure Multiplier in the Euro Area*, Natixis Economics Research No 227 (22 March 2013).
[27] The ordering of the VAR variables is as follows: public construction growth rate, total gross fixed capital formation growth rate, real GDP growth rate, and the unemployment rate. Seasonally-adjusted data for the period Q1 2000 to Q2 2017 were used for the VAR.

country's institutional capacity for planning, programming, and executing large-scale infrastructure projects.

Short-Term Impact on the Real Sector

4. **AMRO staff estimates that the economic impact of the 'Build, Build, Build' program can be quite substantial.** VAR analysis indicates that a typical shock to the real public construction is 19.8 percent initially, which then increases to 24.3 percent after a year and a half. In response to the positive shock to real public construction, Philippine real GDP increases by 0.3 percent initially and then gradually rises to a peak of 1.2 percent after one and a half years (Figure A1.4). Thus, the response of GDP growth is about 6 percent of the originating shock after a year and a half. As such, if public infrastructure spending grows by an average of 16 percent between 2018 and 2022 as planned under the 'Build, Build, Build' initiative, GDP growth could increase by 1 ppt after 6 quarters.

Figure A1.3. PH Government Infrastructure Plan



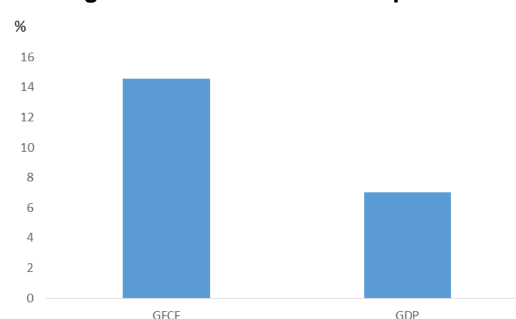
Source: DBM presentation

Figure A1.4. Public Construction Impact on GDP

Note: Accumulated response of real GDP to a 1std shock to public construction. The band refers to ±1se.
Source: AMRO staff calculations

5. **Variance decomposition analysis suggests that, overall, around 7.0 percent of the movement in the Philippines' economic growth can be explained by fluctuations in public construction spending[28] (Figure A1.5).** As to the impact on total investment, the movement of public construction explains about 14.6 percent of the variations in total gross fixed capital formation (public and private construction, and durable equipment expenditures).

Figure A1.5. Variance Decomposition



Note: The figures indicate the proportion of the movements of GFCF and GDP that is explained by the movements in public construction.
Source: AMRO staff calculations

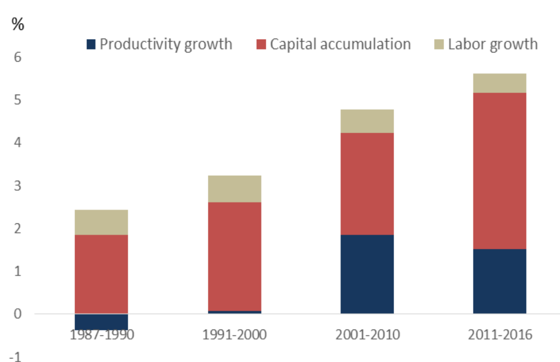
[28] Average for variance decomposition of ten quarters, starting from the current quarter.

Long-term Effect on Productive Capacity

6. In order to boost its long-term potential growth, the Philippines will have to increase the productivity of its factors of production. As mentioned in the Overview above, infrastructure is one obvious candidate to increase productivity. Here, we employed a dynamic macroeconomic model to estimate the Philippines' potential growth, as well as calculate the growth dividends associated with the government's infrastructure program.

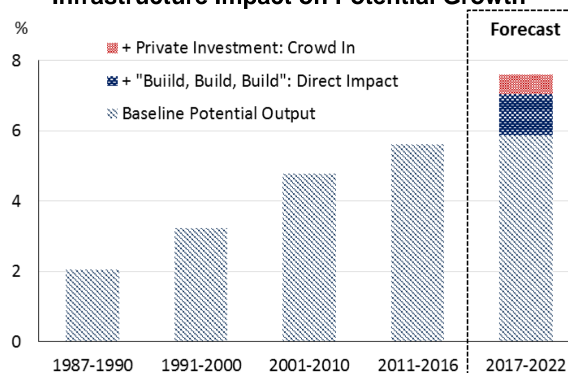
7. **Our estimates suggest that the Philippines' potential growth increased steadily to almost 6.0 percent during 2011-2016 (Figure A1.7).** Growth accounting suggests that investment contributed around 2.4 ppts to potential growth from 1987 to 2010, and then picked up to 3.6 ppts from 2011 to 2016. The contribution of productivity growth was slightly negative from 1987 to 1990 in the aftermath of the political and debt crises in the early 1980s, but turned slightly positive from 1991 to 2000, notwithstanding the power crisis as well as the Asian Financial Crisis during the period. After 2000, productivity growth contributed more than 1.5ppts to the overall growth. (Figure A1.7).

Figure A1.7. Drivers of Potential Growth



Source: AMRO staff calculations

Figure A1.8. Model Simulations – Public Infrastructure Impact on Potential Growth



Source: AMRO staff calculations

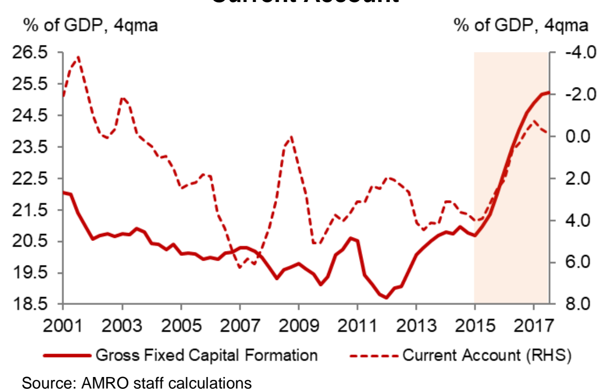
8. **How much will the 'Build, Build, Build' program boost the Philippines' potential growth?** Our model simulations indicate that, if implemented according to the plan and its timetable, the government's 'Build, Build, Build' initiative can yield substantial dividends to potential growth. The model predicts that the planned infrastructure program can increase potential growth by an average of 1.2 ppts from 2017 to 2022 (Figure A1.8). In addition, historically, a 1.0 percent increase in the public investment to GDP ratio had been associated with a 0.64 percent increase in the private investment-to-GDP ratio during 1980-2016. If this historical statistical relationship between public and private investment to GDP ratio holds during the implementation of the government's infrastructure program, then with the private

investment crowded-in, the 'Build, Build, Build' program could increase the potential growth by 1.7 ppts during the plan period (Figure A1.8).

9. **Overall, if the government's infrastructure program is implemented as planned, potential growth can reach an average of 8.0 percent by 2020-2022**. The model simulations indicate that the joint impact of the planned public investment and private investment crowded-in can translate to potential GDP of 6.8 percent in 2017, 6.9 percent in 2018, 7.9 percent in 2019, and an average of 8.0 percent in 2020-2022.

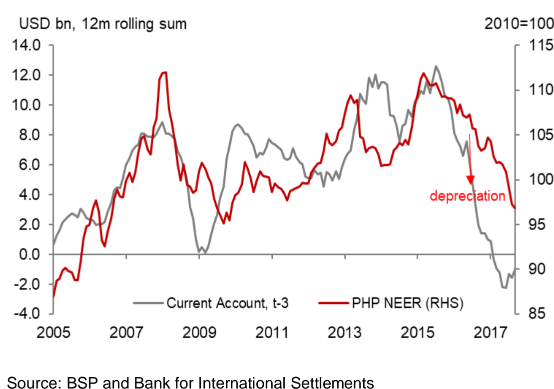
10. **On the flipside, the 'Build, Build, Build' initiative could lead to a widening of the current account deficit in the medium term, which in turn could place the exchange rate under pressure.** The current account surplus has already narrowed since 2015, and even shifted into a small deficit in the first three quarters of 2017, as domestic investments accelerated (Figure A1.9). This is because the higher investment entailed stronger importation of construction-related materials such as iron and steel, machinery and transport vehicles. As such, the public sector's drive to ramp up infrastructure investments is likely to widen the current account deficit over the medium term. And just as the Philippines' current account surpluses had supported the peso's relative strength in the past, wider current account deficits are likely to keep the peso under depreciating pressure going forward (Figure A1.10).

Figure A1.9. Gross Fixed Capital Formation and the Current Account



Source: AMRO staff calculations

Figure A1.10. Current Account and PHP NEER



Source: BSP and Bank for International Settlements

Policy Recommendations

11. **Given the large infrastructure needs and the economic impact of the planned infrastructure program, the country should guard against execution risks and implementation delays.** Overall, the Philippines needs to strengthen its institutional capacity to plan, program, and execute large projects of the scale envisioned in the 'Build, Build, Build' initiative. Both the scale and volume of the projects envisioned are unprecedented, and it remains to be seen if the government can implement them fully and on time. Although the NEDA Board under the new administration has approved projects much faster than the previous administration, yet as we point out below, there are still several areas in project

planning, programming and implementation in which capacity can be significantly strengthened.

12. **First, the capacity of the implementing agencies to develop, plan, and execute projects needs to be significantly strengthened.** For example, many observers are still unsure about the capacity of some implementing agencies to deliver on the key projects in the list. Thus far, implementing agencies' disbursement rates continue to fall short of their targets. Also, since in the past some agencies had not shown full capacity to implement simpler projects on time, many observers wonder about their ability to fully execute the significantly more complex projects envisioned by the government. Many of the projects still do not have feasibility studies, and the procurement process (including the hiring of consultants) in some agencies is slow relative to the target time period. It would also help to have a master infrastructure plan for long-term and medium-term infrastructure planning, and to minimize the risks of the program containing a hodgepodge of projects. These institutional weaknesses can lead to poor project prioritization, screening and execution, and the government needs to make sure that the big budget it allocates to these mega infrastructure projects does not go to waste.

13. **Ability of local construction companies to perform on the large-scale projects envisioned remains to be seen.** As previously mentioned, the country has not seen large infrastructure projects of the scale planned in this ambitious infrastructure program. Thus, the private sector's capacity to undertake the construction and completion of these mega projects remains to be seen. Because of this, it seems that opening the projects to both PPP and ODA modalities would be a step in the right direction.

14. **Notwithstanding the new right of way (ROW) law, long-standing ROW issues still need to be addressed.** Although the legal change of payment requirement from assessed value to fair market value of the property is a step in the right direction, and promises to help expedite some disagreements between property owners and the government, several cases illustrate ROW issues remain non-trivial. Over the longer term, the government should execute laws that prevent squatting on government or public property in the first place; the resettlement of informal settlers will require time to negotiate and build resettlement areas for them.

15. **The availability of raw materials (for example, cement and steel) and labor (skilled and semi-skilled) should be worked out.** The scale of infrastructure projects planned will require extraordinary input requirements from sectors that are not used to such huge demand. Also, many skilled and semi-skilled Philippine construction workers have gone to work abroad especially in the Middle East. Towards this end, TESDA and the K-12 reforms can work with the other government agencies to help alleviate the labor demand issues.

16. **Local government processes should be streamlined.** In several cases in the past, local governments hampered project execution, and they continue to have the ability to do so.

17. **In addition to the implementation of the 'Build, Build, Build' program, efforts should also be advanced to boost productivity growth.** Not being able to address the possible challenges mentioned above may dilute the increase in potential GDP associated with the 'Build, Build, Build' program. On the other hand, if the productivity growth were to increase by 1 ppt, model simulations suggest that the boost to average potential output growth could be as much as 1.2 ppts, even without the Build, Build, Build infrastructure program. Thus, as mentioned in the main text of this Report, efforts towards increasing FDI, manufacturing, and exports; reducing the cost of doing business and enhancing the business climate and competitiveness; as well as reducing corruption and enhancing the rule of law can be additional engines to Philippine economic growth going forward.

Annex I: Estimating Short-Term and Long-Term Effects of PH's Infrastructure Program

We employed two methods in estimating the impact of the Philippines' infrastructure program.

First, to estimate the short-term impact of public construction spending on quarterly GDP growth, total investment growth, and the unemployment rate, we estimated a VAR model with Cholesky decomposition. The ordering of the VAR variables is as follows: public construction growth rate, total gross fixed capital formation growth rate, real GDP growth rate, and the unemployment rate. The base data contain seasonal-adjusted data from Q1 2000 to Q2 2017.

Second, to estimate the 'Build, Build, Build' infrastructure program's impact to the Philippines' long-term productive capacity, we employed a small-scale dynamic macroeconomic model with supply and demand side dynamics. We first estimate the parameters of the model using Bayesian estimation, and then use the estimated coefficient to perform a "what if" type of policy simulations, the scenario being the government's planned infrastructure spending under the "Build, Build, Build" initiative.

The model we employed is a slightly modified version of Rungcharoenkitkul's (2012)[29] model (see Box A1 for the model equations)**.** We performed the Bayesian estimation using IRIS Toolbox[30] to estimate and simulate the model equations above. The data involves historical annual Philippine data from 1986 to 2016, while the forecast period is from 2017 to 2022, the period covered by the government's "Build, Build, Build" program. The observation

[29] Phurichai Rungcharoenkitkul, *Modeling with Limited Data: Estimating Potential Growth in Cambodia*, IMF Working Paper WP/12/96 (April 2012).
[30] https://iristoolbox.codeplex.com/.

variables are Y_t, L_t, i_t, AM_t, AG_t, GAP_t, π_t, and π_t^{OIL}. The data sources are detailed in Table A1.2 and the model's prior and posterior mode estimates in Table A1.3.

Box A1. Potential Growth Simulations: Model Equations

On the supply-side, the long-term potential output of the economy, $\bar{Y}_t$, is determined by the factors of production, capital and labor, as well as total factor productivity (TFP), thus:

(1) $\bar{Y}_t = A_t K_t^{\alpha} L_t^{1-\alpha}$,

where $\log L_t = l + \log L_{t-1} + \varepsilon_t^L$.

Capital accumulation is governed by

(2) $K_t = (1-\delta)K_{t-1} + I_t$,

where $I_t = i_t Y_t$, and $i_t = \rho i_{t-1} + (1-\rho)\bar{\iota} + \varepsilon_t^i$,

while the TFP, A_t, is a composite of the agriculture, industry, and other sectors' productivities,

(3) $A_t = AG_t^{b_G} AM_t^{b_M} AO_t^{b_o}$,

where $\log AG_t = c_G + \log AG_{t-1} + \varepsilon_t^{AG}$; $\log AM_t = c_G + \log AM_{t-1} + \varepsilon_t^{AM}$; $\log AO_t = c_G + \log AO_{t-1} + \varepsilon_t^{AO}$.

The short-run fluctuations of the economy is governed by the demand side equations, involving the output gap,

(4) $GAP_t = \log(Y_t/\bar{Y}_t)$, and

a Phillips curve augmented by oil-price dynamics,

(5) $\pi_t = \gamma\pi_{t-1} + (1-\gamma)[\theta(GAP_t + \bar{\pi}) + (1-\theta)\pi_t^{OIL}] + \varepsilon_t^{\pi}$,

where $\pi_t^{OIL} = \bar{\pi}_t^{OIL} + \varepsilon_t^{OIL}$; and $GAP_t = \beta GAP_{t-1} - \beta_a(\pi_{t-1} - \bar{\pi}) + \varepsilon_t^{GAP}$.

Table A1.2. Data Definitions and Sources

Variables	Data	Definition/Sources
AM_t	GVA per worker (industry)	GVA Industry ÷ (Employment x % Employed in industry)
	Gross value added: industry (2010 USD prices) Employment % Employed in industry	WB IMF WB
AG_t	Agriculture value added per worker	WB
i_t	Gross fixed capital formation (% of GDP)	PSA
L_t	Labor force	IMF
π_t	Inflation, consumer prices (annual %)	PSA
Y_t	GDP (constant LCU 2000=100)	PSA
GAP_t	Output gap (from HP filter)	Author's calculations
π_t^{OIL}	Brent (inflation)	IMF

Table A1.3. Prior Mode and Distribution and Posterior Mode Estimates

Parameters	Prior Mode	Lower Bound	Upper Bound	Prior Distribution	Posterior Mode
α	0.75	0.01	0.9999	Normal(0.75,0.05)	0.746
δ	0.1	0.01	0.9999	Normal (0.1,0.05)	0.033
l	0.02	0.01	0.999	Normal (0.02,0.05)	0.021
b_O	0.1	0.00001	0.9999	Normal (0.05,0.05)	0.103
b_G	0.1	0.00001	0.9999	Normal (0.1,0.02)	0.057
b_M	0.1	0.00001	0.9999	Normal (0.1,0.02)	0.053
c_G	0.04	0.01	0.9999	Normal (0.04,0.05)	0.034
c_M	0.05	0.01	0.9999	Normal (0.05,0.05)	0.043
c_O	0.05	0.01	0.9999	Normal (0.05,0.05)	0.012
β	0.5	0.01	0.9999	Beta(0.5,0.1)	0.607
β_a	0.2	0.01	0.9999	Beta (0.2,0.05)	0.166
γ	0.95	0.01	0.9999	Beta (0.95,0.1)	0.940
θ	0.4	0.01	0.9999	Beta (0.4,0.1)	0.429
$\bar{\pi}$	0.62	0.01	0.999	Normal (0.62,0.05)	0.620
ρ	0.95	0.01	0.9999	Beta (0.95,0.05)	0.937
σ_{ε^L}	0.05	-0.1	5	Inverse gamma(0.05,1)	0.006
$\sigma_{\varepsilon^{AG}}$	0.05	-0.1	5	Inverse gamma (0.05,1)	0.033
$\sigma_{\varepsilon^{AM}}$	0.05	-0.1	5	Inverse gamma (0.05,1)	0.032
$\sigma_{\varepsilon^{AO}}$	0.05	-0.1	5	Inverse gamma (0.05,1)	0.063
$\sigma_{\varepsilon^{GAP}}$	0.03	-0.1	5	Inverse gamma (0.03,1)	0.008
$\sigma_{\varepsilon^{\pi}}$	0.03	-0.1	5	Inverse gamma (0.03,1)	0.015
$\sigma_{\varepsilon^{OIL}}$	0.3	-0.1	5	Inverse gamma (0.3,1)	0.111
$\sigma_{\varepsilon^{i}}$	0.01	-0.1	5	Inverse gamma (0.01,1)	0.003

Issue 2. Time to Revise Prudential Policies for Real Estate and Motor Vehicle Lending?

1. **The BSP has implemented a series of macro-prudential measures to contain systemic and sectoral risks.** It has identified the real estate sector, given its sizable contribution to the banking sector and the economy, as a key source of systemic risk. In this regard, the BSP has expanded the Real Estate Exposure Monitoring in 2012, in addition to imposing concentration limits on loans to finance real estate activities (Table A2.1). Since 2014, the BSP conducted Real Estate Stress Tests on universal and commercial banks and thrift banks to determine whether individual banks have sufficient capital to absorb credit risks related to real estate activities. And to further enhance its monitoring of the sector, it has announced the expansion of the scope and granularity of reporting requirements related to bank real estate loans and project financing, with effect from 2018. These measures are intended to identify potential vulnerabilities arising from banks' exposure to real estate activities and to strengthen the banking system's ability to withstand a systemic shock.

2. **Likewise, the BSP is also looking into risk pockets such as the rapid growth of motor vehicle loans.** Lending for motor vehicle[31] purchases is not considered as a source of systemic risk by the BSP given that this segment only accounts for about 5.5 percent of the total loan portfolio. However, the BSP admits that its rapid growth of over 20 percent for about two years warrants close monitoring. Recognizing this risk pocket, the BSP has enhanced the reporting requirement of motor vehicle loans.

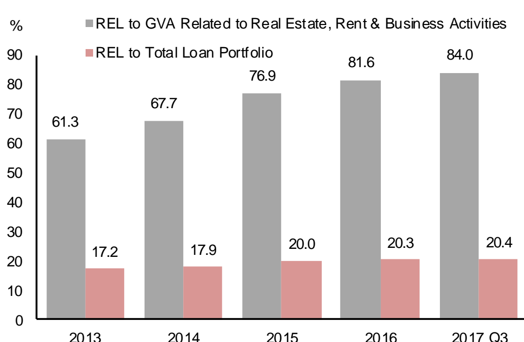
3. **Is there a need to tweak existing macro- and micro-prudential policies?** While prudential policies are currently in place, a timely assessment of the state of real estate and motor vehicle lending is necessary in order to provide appropriate policy recommendations.

Real Estate Loans

4. **Bank real estate loans continued to grow at double-digit rates, even though macro-prudential measures have been in place for some time.** The average growth rates of real estate loans moderated from its record high of 26.2 percent in Q3 2015 to settle at 18.1 percent between Q2 2016 to Q3 2017. [32] However, the growth of real estate lending remained elevated, as it stood at twice of the growth of real estate, rent and business activities in the national income account in the first half of 2017. From the borrowers' side, the ratio of real estate loans to real estate market value-added has steadily increased, indicating rising leverage in the real estate market (Figure A2.1).

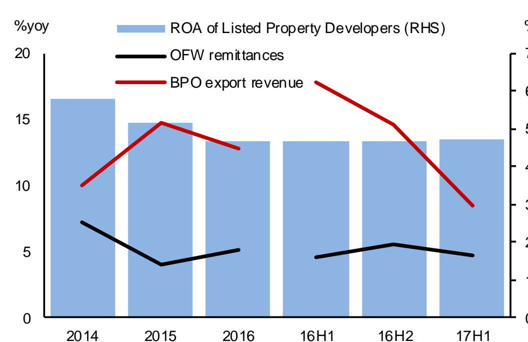
[31] Motor vehicle loans consist of auto loans and motorcycle loans.
[32] The year-on-year growth rate of real estate loans in Q3 2017 was at 17.9 percent.

Figure A2.1. Banks' Exposure to Real Estate Loans (REL) and REL-to-GVA Ratio



Source: BSP, PSA, AMRO Staff Calculations

Figure A2.2. Earnings of Real Estate Loan Borrowers



Source: Bloomberg, BSP, AMRO Staff Calculations

5. **The risk of total lending being concentrated in the real estate sector is limited.** Despite its double-digit growth, real estate lending has been outpaced by the growth of total lending since September 2016.[33] This indicates that bank lending may be gradually diversifying away from real estate loans. Lending to real sector activities has been stable at around 20.0 percent of total bank loan portfolio, net of interbank loans as bank financing is also growing rapidly in other productive sectors. Moreover, the non-performing ratio of real estate loans has fallen (Figure 18). In addition, net profits of property developers continued to expand as real estate demand has remained buoyant. The sustained growth of overseas Filipinos' remittances and the BPO industry, which support the demand for real estate, ensures that borrowers' debt repayment capacity remains healthy (Figure A2.2).

6. **Demand for real estate lending may soften in the period ahead along with weakening private investment, particularly in the BPO industry.** The strong growth in real estate loans seen since 2014 was underpinned by buoyant demand for office and residential property, which was driven by the rapid expansion of the BPO industry, sustained remittance inflows, and strong foreign capital inflows. In the first half of 2017, the real estate market softened as office space demand was dragged down by the slowdown in private investment, particularly in the BPO industry, although it was partly offset by the proliferation of offshore gaming operators.[34] The softening of the property market alongside a sharp increase in property supply over the last few years meant that overall vacancy rates rose.[35] With excess supply, new building construction also slowed down from Q3 2016 into 2017 (Figure A2.4). However, despite the slowdown in the property market, the non-performing loan ratio has declined while banks remain well-capitalized, implying a reduction in risk to the banking sector.

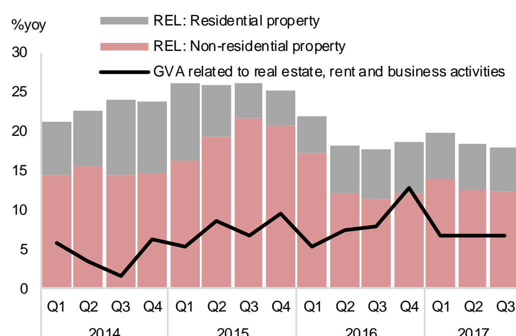
[33] Total lending net of interbank loans and reverse repurchase agreement with the BSP

[34] According to Pronove Tai International Property Consultant, the number of gaming and betting establishments considerably increased from 158 in 2010 to 1,213 in 2017, recording a growth rate of 667.7 percent in four years. As of end-March 2017, approximately 20 percent of office space scheduled for completion in Q2 2017 and pre-leased was expected to be occupied by offshore gaming companies.

[35] Collier International expected that overall vacancy rate of residential real estate in Metro Manila was at around 11.0-11.5 percent in 2017 and would rise to 16.0 percent in 2018. The vacancy rate of office space in Metro Manila was expected to be at 4.5 percent in 2017 and 6.0 percent in 2018.

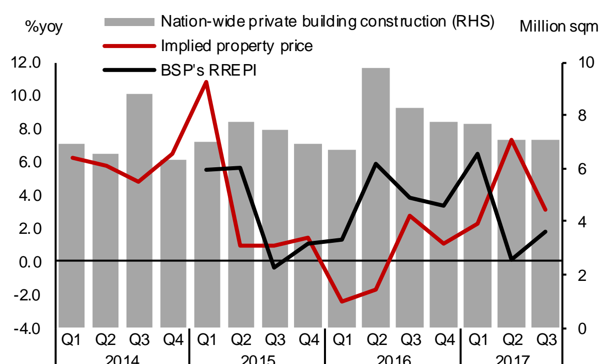
On the other hand, the country's low rate of home ownership and ample supply of credit as well as favourable demographics and economic prospects continue to bode well for the sustained expansion of the real estate sector over the medium term.

Figure A2.3. Real Estate Activities and Real Estate Loans



Source: BSP, PSA, AMRO Staff Calculations

Figure A2.4. Real Estate Price and Construction



Note: 1/ Implied property price is the deflator of gross value added (GVA) of the real estate sector. 2/ RREPI is residential real estate price index (RREPI) constructed by the BSP.
Source: BSP, PSA, AMRO Staff Calculations

Policy Implications

7. **Current real estate market conditions do not point to an immediate need to tweak existing macro-prudential policies.** Tightening macro-prudential policies associated with real estate loans is not immediately necessary, as the pace of lending has eased since Q1 2016 (Figure A2.3). Banks remain well-capitalized and have sufficient financial buffers to cover expected and unexpected losses, according to the BSP's stress test results. However, the double-digit rate of real estate lending and the build-up of outstanding delinquent real estate loans continue to warrant vigilance. Beyond the data from the banking sector, a comprehensive and more granular database on property market activities would enhance macro-financial surveillance and deepen understanding of the real estate sector.[36,37]

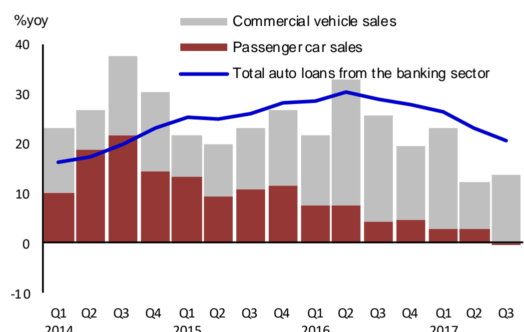
Auto Loans Extended to Households

8. **Auto loans have grown at a rapid pace alongside the robust growth in car purchases.** The annual growth in auto loans reached a peaked of 33.7 percent in Q2 2016. While it has eased since, it continues to grow at more than 20 percent and outpace the expansion in total bank loans (Figure A2.5). Growing middle-income households, the inadequate mass transport system, anticipation of the car excise tax hike under the tax reform, and the rise of ride-sharing platforms (such as Uber and Grab) are underlying factors behind

[36] Desirable property market information would involve data in terms of demand, supply, vacancy and absorption rates and prices, together with data to assess the debt service burdens across income groups.
[37] The BSP through the Financial Stability Coordination Council has initiated to collaborate with the Housing and Land Use Regulatory Board since September 2016 to develop a reportorial template for real estate companies. The level of granularity required by that template allows for a systemic risk perspective in the analysis of individual real estate companies' operations as well as the real estate industry as a whole.

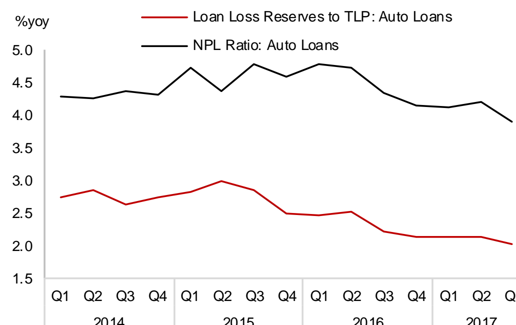
robust passenger car sales in the past few years.[38] In addition, favorable auto loan financing conditions—low lending rates and low down-payments—have also attracted car buyers.

Figure A2.5. Vehicle Sales and Automotive Loans



Source: Chamber of Automotive Manufacturers of the Philippines, BSP, AMRO staff calculations

Figure A2.6. NPL Ratio of Auto Loans and Loan Loss Reserve to Total Auto Loans



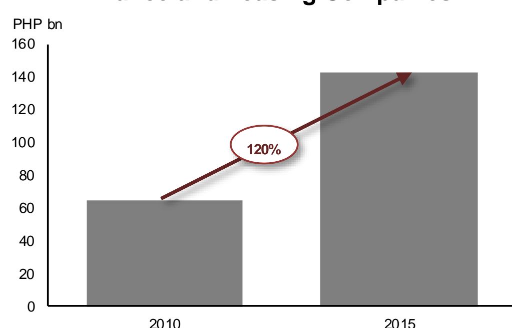
Note: TLP stands for total loan portfolio.
Source: BSP

9. **The rapid growth in auto lending, however, poses limited risk to the banking sector.** Banks' exposure to household loans for vehicle purchases remains low. Auto loans accounted for only 5.5 percent of the banking system's total loan portfolio as of end-September 2017. In addition, growth of auto loans has moderated slightly, following the slowdown in vehicle sales. Bank's underwriting standards have been generally unchanged, according to the latest survey of bank loan officers.

10. **Given limited lending information, a central database on non-banks' lending activities needs to be developed and updated on a timely basis.** While our analysis is based on bank data, unofficial reports cite that a significant portion of households and corporates borrow from non-bank financial institutions and informal lenders**.** According to the Philippine Securities and Exchange Commission (SEC), there were around 600 finance and leasing companies across the country in 2014. Their main business activities are leasing and lending to finance automobiles, transport equipment, construction and heavy equipment, and other industrial and manufacturing equipment. Some companies mainly focus on car and motorcycle loans and non-collateral personal loans to households. According to the Asian Financial Services Association located in the Philippines, the financing and leasing companies have expanded substantially in terms of the number of active players and volume of business since the 1970s (Figures A2.7,8). In addition to these regulated leasing and finance companies, car dealers, well-capitalized equipment dealers and suppliers also offer lending services. However, their lending activities are currently not being captured in the BSP's loan data, as these financial institutions are outside the BSP's oversight. Moreover, publicly available data on these lending activities are outdated and not centralized.

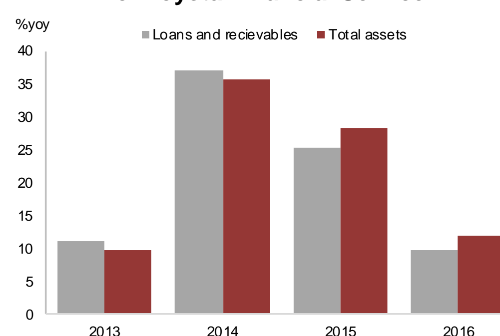
[38] However, loans extended to Uber and Grab are expected to soften going forward as the market become saturated

Figure A2.7. Total Asset Expansion of Top 15 Finance and Leasing Companies



Note: Local financial institutions were ranked based on a size of total assets in 2015. However, data of RCBC and SBM were not included here, since data on their assets in 2010 are not available.
Source: The Asian Financial Services Association, AMRO staff calculations

Figure A2.8. Total Assets, Loans and Receivables of Toyota Financial Service



Note: Toyota Financial Service is the top car leasing company in the industry. Meanwhile, data on household's auto loans extended by other car dealers and leasing companies are not publicly available.
Source: Toyota Financial Services Philippines Corporation, AMRO staff calculations

Policy Implications

11. **Although risk to financial stability is limited, the persistently strong growth in auto loans may warrant a modest tightening of prudential policy.** Given limited risk to financial stability, the strong growth in auto loans does not require macro-prudential measures. Moreover, the increase in excise taxes for petroleum products and automobiles under the TRAIN is likely to temper demand for passenger vehicles, thereby diminishing the urgency to tighten prudential measures. However, if auto loans grow at a rapid pace even after the impact of the new excise tax rates has dissipated, the auto loan portfolio of BSP-supervised financial institutions as well as the debt servicing capacity of borrowers should be closely monitored in order to ensure adequate underwriting standards and to promote prudent lending behavior.[39] Also, to mitigate regulatory gaps between banks and non-banks, the Securities and Exchange Commission (SEC)—as the regulatory authority for leasing and finance companies—in collaboration with the BSP may consider strengthening micro-prudential measures on non-banks as well**.** An initial step, for example, would be to tighten existing CRM guidelines as needed and its coverage broadened to include institutions not currently supervised by the BSP but under the regulation of the SEC. Finally, to gain a better understanding of the changes in auto loans, an expanded, regular and timely data collection to include activities of non-bank financial institutions and dealers—made possible in partnership with other financial regulatory agencies—would greatly enhance risk analysis and policymaking going forward.

[39] AMRO notes that the BSP issued a comprehensive set of guidelines for credit risk management (CRM) for its supervised financial institutions in October 2014. The CRM guidelines emphasize sound credit underwriting practices as well as cash flow analysis or ability-to-pay assessment in determining a borrower's creditworthiness. BSP issuances though can only affect the lending or risk-taking behavior of supervised financial institutions.

Table A2.1. Summary of measures on real estate sector loans

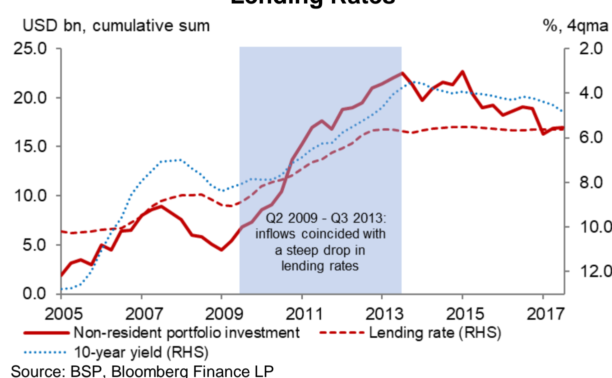
Year to Commence	Regulations
2008	**Loans extended to finance real estate activities are capped at 20 percent of total loan portfolio, net of interbank loans.** • Real estate loans that are subject to this cap are loans granted to retail borrowers, land developers and construction companies. For the developers and construction companies, the loans will be used to finance the construction of residential and commercial real estate. The loans subject to the regulations do not include loans for construction public infrastructure including highways, streets, bridges, tunnels, railways, and other infrastructure for public use. • The regulations are applied to universal banks and commercial banks only. The Trust Departments are exempted from the prescribed limit. [Circular No. 600 Limit on Real Estate Loans of Universal Banks/ Commercial Banks]
2012	**The reportorial requirement on real estate exposures was expanded.** • Real estate exposures included residential real estate loans, commercial real estate loans, investment in debt securities, and investment in equity securities. The real estate exposures subject to this requirement do not include loans and investment in debt and equity securities for construction of public infrastructure. • The expanded reportorial requirement is applied to universal banks, commercial banks and thrift banks, including their trust departments and subsidiaries. [Memorandum No. M-2012-046 Expanded Report on Real Estate Exposures]
2014	**Real Estate Stress Test (REST) limit was imposed for real estate exposures.** • Real estate exposures are those defined in Memorandum No. M-2012-046, effective since 2012, and other real estate property, including those recorded under real and other properties acquired and non-current assets held for sale. But, the regulated exposures do not include loans and investment in debt and equity securities for construction of public infrastructure. • The REST scenario assumes a write off rate at 25 percent. • Under the stress scenarios, universal banks, commercial bank and thrift banks, both stand-alone institutions or bank subsidiaries, are prescribed to maintain 6 percent of Common Equity Tier 1 (CET1) ratio and 10 percent of Capital Adequacy ratio (CAR). [Circular No. 839 Real Estate Stress Test (REST) Limit for Real Estate Exposures]
2018	**The reporting requirement on real estate exposures were expanded.** • Prescribed banks are required to report more granular data on their loans to mid- and high-end residential property, in addition to socialized and low-cost housing required by Memorandum No. M-2012-046. • As for commercial real estate loans, the banks must submit information of underlying projects such as residential property, office buildings, malls, factory and plant facilities besides outstanding loans and collateral value. • Universal banks and commercial banks must submit project finances exposures extended to infrastructure projects including type and progress of underlying projects. [Circular No. 976 Amendments to the Expanded Report on Real Estate Exposure (ERRRE) and the Submission of the Report on Project Finance Exposures]

Source: BSP

Issue 3. Economic and Financial Spillovers from the U.S., Japan and China

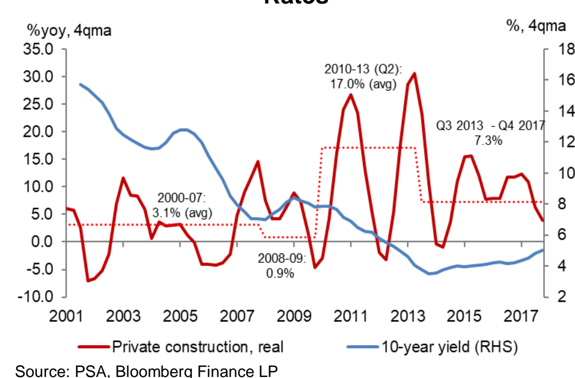
1. **The Philippines, like other emerging market economies, faces the risk of capital outflows from a faster-than-expected pace of monetary policy normalization by the U.S. Federal Reserve.** From late 2008 when the first round of the U.S. Federal Reserve's Quantitative Easing program happened through the first half of 2017, the Philippines attracted net inflows of foreign portfolio investments amounting to USD11.0 billion, which could reverse in a risk aversion scenario such as during the taper tantrum in 2013. Foreign portfolio investment inflows to the country were most intense between April 2009 and September 2013—amounting to USD18.0 billion in total—reflecting the adoption of quantitative easing programs by the U.S. Fed and the European Central Bank (ECB), which in turn led to the decline in global interest rates and domestic lending rates. The latter fell from an average of 9.5 percent in 2003-2008 to 5.6 percent in 2014-2017 (Figure A3.1).

Figure A3.1. Foreign Portfolio Investment and Lending Rates



Source: BSP, Bloomberg Finance LP

Figure A3.2. Private Construction and Lending Rates



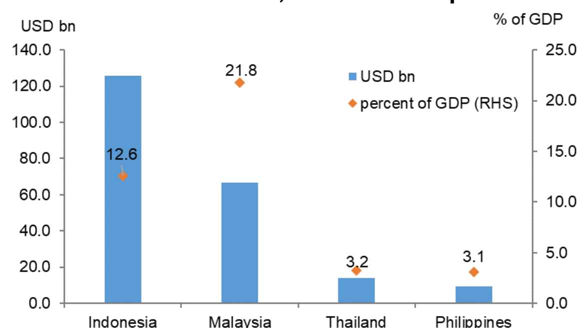
Source: PSA, Bloomberg Finance LP

2. **A reversal of foreign capital inflows could in turn dampen economic activity via private sector construction.** Following the decline in domestic interest rates, private construction activity began to accelerate, gaining pace from an average of 3.1 percent in 2000-2007 to 17.0 percent between March 2010-June 2013 (Figure A3.2). The real estate boom, in turn, contributed 13.4 percent of the GDP growth during the period, which had gained pace to 6.3 percent in the same period from 4.9 percent in 2000-2007. As such, outflows of foreign funds could lead to higher interest rates and dampen domestic economic activity.

3. **Moreover, foreign capital reversals can be compounded by resident portfolio and direct investment outflows as happened between 2014 and 2015.** In those two years, residents' overseas portfolio investments—net of amounts repatriated back to the country—amounted to USD6.0 billion while overseas direct investments amounted to USD12.3 billion. While it is likely for the pace of resident outflows, especially for overseas direct investments, to ease going forward with the current account remaining in deficit, the search for higher returns among domestic financial institutions could sustain resident portfolio investment

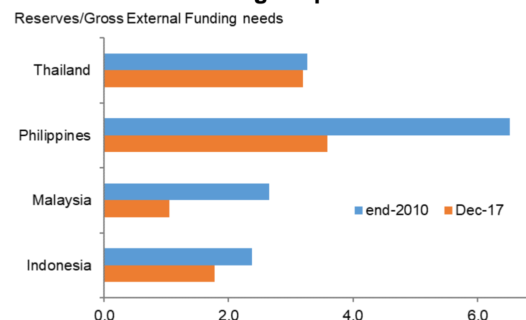
outflows.[40] Fortunately, the Philippines has ample reserves buffer to smoothen a likely depreciation of the currency amid these outflows. When compared to its ASEAN peers, the amount of potential capital outflows from the Philippines is also not as substantial, thereby limiting its overall economic impact (Figures A3.3-4).

Figure A3.3. Cumulative Non-Resident Portfolio Investment Inflows, Jan 2010 – Sep 2017



GDP refers to the sum for Q4 2016 – Q3 2017.
Source: BSP, Bank Indonesia, Bank Negara Malaysia, Bank of Thailand, CEIC

Figure A3.4. FX Reserves Against Gross External Financing Requirement



Gross External Financing Requirement refers to the sum of the current account deficit (zero if in surplus such as for Malaysia and Thailand) and short-term external debt by residual maturity. FX reserves strictly refer to foreign currency, excluding IMF reserve position, gold, SDR; for the Philippines, reserves refer to the sum of FX and foreign investments. December 2017 refers to latest FX reserves data, but GEF data are as of September 2017.
Source: BSP, Bank Indonesia, Bank Negara Malaysia, Bank of Thailand, CEIC

4. **Low household and government debt, and a high interest cover among corporates will allow the Philippines to withstand interest rate increases from a tightening of domestic liquidity.** Given private consumption's dominant share in the economy at over 72 percent of GDP, the Philippines' low household debt—at 9.1 percent of GDP as of Q3 2017—is a comforting factor against the risk of higher borrowing costs (Figure A3.5). Also, whereas the data only captures bank lending and not the full extent of household indebtedness in the economy, the informal sector charges considerably higher interest rates relative to bank lending rates and as such, may not be necessarily as sensitive to a global pick-up in yields. Likewise, the considerable reduction in government debt over the past decade has increased fiscal space and enhanced the capacity to maintain an expansionary fiscal policy even with higher interest rates. However, concerns could arise from the high leverage of the non-financial private sector, which rose from 46.5 percent of GDP in 2009 to 54.6 percent in Q2 2017. But a comparison against corporate earnings shows that the sector is generally capable of servicing its debt (Figure A3.6).[41, 42]

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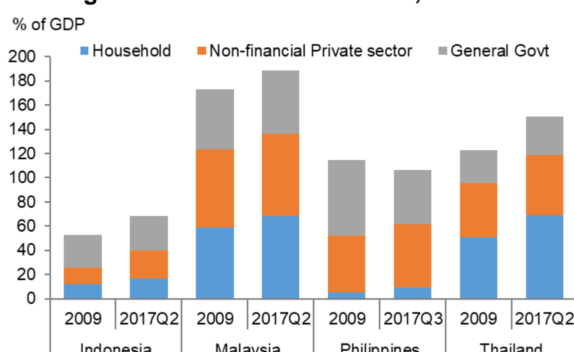
[40] The pick-up in residents' overseas direct investments especially in 2014 and 2015 was likely in response to sustained periods of rising corporate profitability and large current account surpluses. But as the current account deficit persists in the medium term, it is likely for the pace of foreign acquisitions among domestic corporates to moderate as well. Overall, AMRO and the BSP expect that the Financial Account balance would post a net inflow in 2018 on account of a modest increase in the FDI-to-GDP ratio and an easing of foreign portfolio investment outflows.

[41] An IMF study in 2015 using both Philippine publicly-listed and private companies also has the same finding, and thus systemic risk is low. The real estate sector, for instance, has the highest share of debt-at-risk (debt owed by firms with an interest coverage ratio of less than 1.5 according to the IMF), but only amounting to a little over 2.0 percent of total according to 2013 data. Across sectors, "metals and metal products" and "hotels and restaurants" have debt-at-risk of 41-52 percent of the sector's respective total debt. However, either sector's total debt is not large enough to pose systemic risks. Kindly refer to "Are Philippines Nonfinancial Firms Vulnerable to Tighter Financial Conditions?—Firm-Level Analysis and Stress Testing," in *Philippines: Selected Issues*, IMF Country Report No. 15/247 (September 2015).

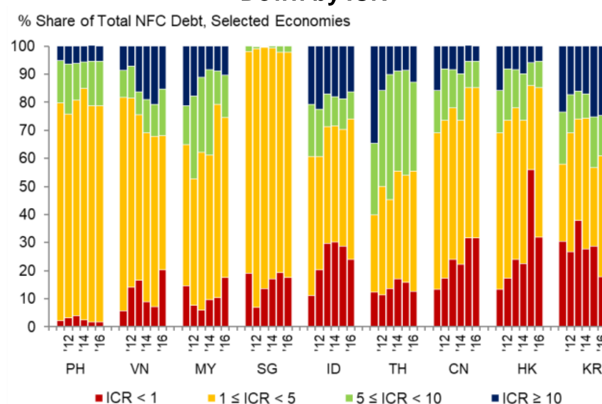
[42] Also in relation to the relatively elevated leverage of the non-financial private sector, the BSP has been closely monitoring this condition to assess potential spillover to the banking system (and subsequently to the real sector) should market conditions worsen. BSP survey/estimates showed that aggregate debt continues to rise in the past 10 years, albeit growing at a slower pace in 2016. The BSP also notes that the rise in borrowing activities

Figure A3.5. Total Debt Burden, ASEAN-4



*Household debt excludes borrowing from non-bank financial institutions. For the Philippines, where debt data are unavailable from the BIS, estimates were obtained mostly from the BSP: Philippine banking system's consumer loans for household debt, the sum of depository corporations' claims on private sector, non-bank private sector external debt, and total domestic debt securities by non-financial corporations (from the BIS) make up the non-financial private sector debt, and government debt from the BTr.
Source: BIS, BSP, Bureau of Treasury, PSA

Figure A3.6. Non-Financial Corporate Debt Broken Down by ICR



ICR = interest coverage ratio or EBIT (earnings before interest and taxes) divided by interest paid. The lower the ICR, the bigger the odds that a corporate would struggle to service its debt. Reuters data only refer to publicly listed firms.
Source: Reuters

5. **Meanwhile, protectionist policies in the U.S. threaten revenues from the BPO industry and overseas Filipinos' remittances—two pillars of the country's buoyant economy.** These two sources of FX, amounting to 16.5 percent of GDP in H1 2017 are primarily behind the country's robust private consumption and upbeat real estate market. However, U.S. President Trump's "America first" policy could adversely affect the BPO industry in the Philippines, with the U.S. accounting for about 70 percent of BPO export revenues. Likewise, the Trump administration's tougher stance on undocumented immigrants could dampen remittance inflows into the Philippines, with the U.S. accounting for at least 30 percent of total land-based cash remittances. The Philippine Embassy in the US estimates that about 9 percent of the 3.4 million Filipinos residing in the U.S. could be undocumented, and thus vulnerable to a tightening of immigration policies.[43]

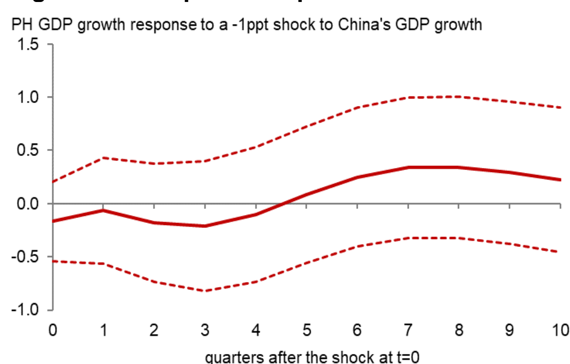
6. **Despite increasing ties with China, the Philippine economy remains strongly influenced by the U.S. and to a certain extent, Japan.** The Philippines is not as open as most other ASEAN economies, with its share of goods and services exports accounting for less than 30 percent of GDP, in contrast to Malaysia or Thailand, where the shares are around 70 percent. However, similar to the rest of the region, the Philippines has increasingly strengthened ties with China over the past decade or so. In terms of merchandise trade, China

was accompanied by improvement in corporates' ability to generate profit. BSP survey/estimates showed that firms showed a steady operational performance with return-on-equity ratios at 15.0 to 16.0 percent for the past four years. The ability of firms to cover short-term borrowing costs, such as payments of interest expenses, appears to be significantly adequate as indicated by firms' aggregate interest coverage ratio (ICR) which remained strong at about five times (5x) their yearly interest expenses. Meanwhile, firms' aggregate current ratio has been generally steady in the last five years although lower than the pre-2012 levels.

[43] These headwinds from the U.S. only add to the existing concerns with regard to the medium-term prospects of the BPO industry and overseas Filipinos' remittance inflows. For one, the BPO industry is also facing the challenge of automation and overall technological advancements as well as the threat to competitiveness from the proposal to rationalize fiscal incentives. Remittances, likewise, face additional headwinds from the prospect of weak foreign worker demand as subdued commodity prices dampen growth in the Middle East, where at least 35.0 percent of land-based cash remittances are sourced. These two reliable sources of foreign fund inflows are thus exposed to risks of a sharp disruption, which in turn could have material socio-economic implications. The country's BPO association, for instance, estimates that the industry employs about 1 million full-time workers and an additional 3.2 million in other sectors such as transportation, hospitality, food, communication, and entertainment, to name some.

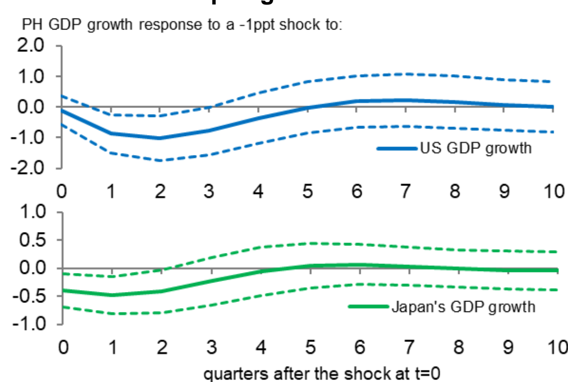
now accounts for over 18 percent of the Philippines' goods imports and at least 10 percent of exports, from less than 3 percent in 2001. The number of Chinese visitors into the Philippines has also grown, comprising 14.6 percent of all visitors in 2017—already the second biggest by country following South Korea (24.3 percent) after displacing the U.S. (14.5 percent)—and up from 5.3 percent in 2010 and less than 2.0 percent in 2001-2004. However, estimates using VAR still show statistically insignificant responses of the Philippine economy from a shock to China's GDP growth (Figure A3.7).[44] In contrast, economic developments in the U.S. and Japan have a statistically significant impact on the Philippine economy in the first 2-3 quarters since the onset of the shock (Figure A3.8). That is, a negative 1.0 ppt growth shock in the U.S. could pull down Philippine growth by the same magnitude two quarters after the shock, while the same shock to Japanese growth could dampen Philippine GDP growth by 0.5 ppt a quarter after the shock.

Figure A3.7: Impulse Response to a China Shock



The impulse responses were estimated from a VAR consisting of US, China, Japan, and Philippine GDP growth with a 2-quarter lag (data period: Q1 2005 – Q3 2017). The impulse responses are averages from the six combinations of the first three growth variables in the VAR ordering. Bands represent 95 percent confidence intervals.
Source: AMRO

Figure A3.8: Impulse Responses to a U.S. and Japan growth Shock



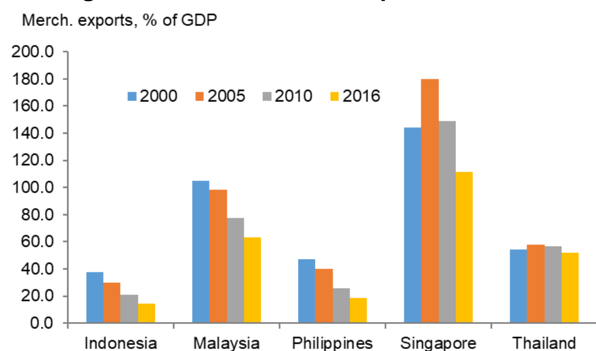
Impulse responses for the 2005-2017 VAR model. Bands represent 95 percent confidence intervals.
Source: AMRO

7. **Notwithstanding the low sensitivity of the Philippine economy to China's growth shocks, the country should prepare itself for the impact of China's economic transformation on its export sector.** The Philippines' merchandise export sector has lagged behind the rest of the Philippine economy, with the share of goods exports falling from 47.0 percent of GDP in 2000 to 25.8 percent in 2010 and further down to 18.8 percent in 2016 (Figure A3.9). While the decline can be largely attributed to the slump in global trade, the Philippines' goods export sector may have also been adversely affected by China's economic rebalancing. The country's exports to China had peaked at 4.0 percent of GDP in 2005, but declined steadily as China's fixed investment-to-GDP ratio started to fall in 2012. The

[44] According to an IMF paper, estimates obtained from a Global VAR (GVAR) model using data from Q1 1981 to Q1 2013 also show statistically insignificant results for the Philippines from a negative GDP shock from China. The authors attribute the finding to "a low signal-to-noise ratio in the Philippines' data because of frequent boom-bust cycles in the past, as well as offsetting commodity price effects and stable remittance flows". See Allan Dizioli and others, *Spillovers from China's Growth Slowdown and Rebalancing to the ASEAN-5 Economies*, IMF Working Paper WP/16/170 (August 2016).

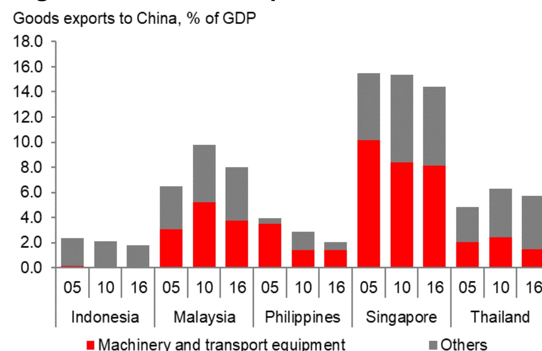
Philippines primarily exports machinery and transport equipment (office machines and automatic data processing machines as well as electrical machinery) to China, which as a share of total exports, has fallen from a peak of 87.9 percent in 2005 to 68.4 percent in 2016 (Figure A3.10).

Figure A3.9. Total Goods Exports, % of GDP



Source: CEIC, IMF Direction of Trade Statistics

Figure A3.10. Good Exports to China, % of GDP



Source: CEIC, United Nations Conference on Trade and Development.

Appendices

1a. Selected Key Economic Indicators and Projections (2012-2018)

	2012	2013	2014	2015	2016	Projection	
						2017	2018
Real sector and prices	(in percent change, unless specified)						
Real GDP	6.7	7.1	6.1	6.1	6.9	6.7	6.8
Private consumption	6.6	5.6	5.6	6.3	7.0	5.8	5.7
Government consumption	15.5	5.0	3.3	7.6	8.4	7.3	16.3
Gross fixed capital formation	10.8	11.8	7.2	16.9	25.2	10.3	11.8
Exports of goods and services	8.6	-1.0	12.6	8.5	10.7	19.2	13.1
Imports of goods and services	5.6	4.4	9.9	14.6	18.5	17.6	15.3
Prices							
Consumer price inflation (end of period)	3.0	4.1	2.7	1.5	2.6	3.3	3.9
Consumer price inflation (period average)	3.2	3.0	4.1	1.4	1.8	3.2	4.3
Core inflation (period average)	3.7	2.9	3.0	2.1	1.9	2.9	3.9
GDP deflator	2.0	2.0	3.2	-0.6	1.7	2.3	2.7
External sector	(in billions of U.S. dollars, unless specified)						
Current account balance	6.9	11.4	10.8	7.3	-1.0	-3.0	-5.1
(in percent of GDP)	2.8	4.2	3.8	2.5	-0.3	-1.0	-1.5
Trade balance	-18.9	-17.7	-17.3	-23.3	-35.5	-41.6	-47.1
Exports, f.o.b.	46.4	44.5	49.8	43.2	42.7	48.6	56.2
Imports, f.o.b.	65.3	62.2	67.2	66.5	78.3	90.1	103.3
Services balance	6.2	7.0	4.6	5.5	7.0	9.1	10.6
Receipts	20.4	23.3	25.5	29.1	31.3	34.6	37.5
Payments	14.3	16.3	20.9	23.6	24.2	25.5	26.9
Primary income, net	0.2	1.0	0.7	1.9	2.6	3.2	3.9
Secondary income, net	19.5	21.1	22.8	23.3	25.0	26.3	27.6
Financial account balance	-6.7	2.2	9.6	2.3	-0.4	0.4	-2.1
Direct investment, net	1.0	-0.1	1.0	-0.1	-5.9	-4.4	-6.8
Overseas direct investment	4.2	3.6	6.8	5.5	2.1	3.1	2.7
Foreign direct investment	3.2	3.7	5.7	5.6	8.0	7.5	9.5
Portfolio investment, net	-3.2	-1.0	2.7	5.5	1.4	4.7	4.2
Net acquisition of financial assets	1.0	-0.6	2.7	3.3	1.2	1.5	1.6
Net incurrence of liabilities	4.2	0.4	0.0	-2.1	-0.3	-3.2	-2.5
Other investment, net	-4.5	3.4	5.9	-3.1	4.1	0.2	0.6
Overall balance	9.2	5.1	-2.9	2.6	-0.4	-0.9	-2.9
Gross international reserves (end-period)	83.8	83.2	79.5	80.7	80.7	80.8	77.9
(in months of goods & services imports)	12.6	12.7	10.8	10.7	9.4	8.4	7.2
Total external debt (percent of GDP)	32.0	28.9	27.3	26.5	24.5	23.4	23.2
Short-term external debt (percent of total)	20.6	21.5	20.9	19.5	19.4	19.6	21.6
Fiscal sector (National Government)	(in percent of GDP)						
Government revenue	14.5	14.9	15.1	15.8	15.2	15.7	16.2
Government expenditure	16.8	16.3	15.7	16.7	17.6	17.9	19.1
Fiscal balance	-2.3	-1.4	-0.6	-0.9	-2.4	-2.2	-2.9
Primary balance	0.7	1.4	2.0	1.4	-0.3	-0.3	-0.8
Government debt	51.5	49.2	45.4	44.7	42.1	42.1	40.2
Government debt, including contingent liabilities	57.5	54.4	49.8	48.8	45.6	45.1	44.3
Monetary sector	(in percent change, end-period unless specified)						
Domestic credit	7.3	10.6	17.8	11.5	17.0	13.4	14.8
Of which: Private sector	14.8	16.5	19.9	12.1	16.6	15.7	17.7
Broad money	7.4	28.8	12.4	9.3	13.4	11.4	14.3
Memorandum items:							
Exchange rate (peso per USD, average)	42.2	42.4	44.4	45.5	47.5	50.4	50.7
Exchange rate (peso per USD, eop)	41.2	44.4	44.6	47.2	49.8	49.9	52.5
Gross domestic product at current price (In trillions of pesos)	10.6	11.5	12.6	13.3	14.5	15.8	17.3
Gross domestic product at current price (In billions of U.S. dollar)	250.1	271.8	284.6	292.8	304.9	313.4	341.0
GDP per capita (in U.S. dollar)	2,591.5	2,768.5	2,849.3	2,882.7	2,953.3	2,987.2	3,198.9

Note: Light grey cells under the 2017 column refer to actual figures.
Source: Philippine authorities and AMRO Staff Estimates

1b. Philippines: Medium-Term Economic Outlook (2017-2022)

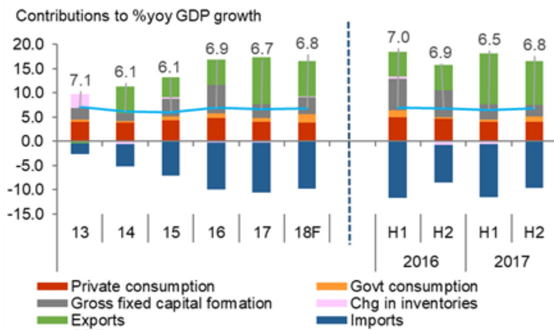
	2014	2015	2016	Projections					
				2017	2018	2019	2020	2021	2022
Real sector and prices	(in percent change, unless specified)								
Real GDP	6.1	6.1	6.9	6.7	6.8	6.9	6.8	6.9	7.0
Private consumption	5.6	6.3	7.0	5.8	5.7	5.8	5.5	5.9	6.2
Government consumption	3.3	7.6	8.4	7.3	16.3	10.0	8.2	8.4	10.0
Gross fixed capital formation	7.2	16.9	25.2	10.3	11.8	14.5	13.5	14.5	15.0
Exports of goods and services	12.6	8.5	10.7	19.2	13.1	11.0	10.6	10.0	9.5
Imports of goods and services	9.9	14.6	18.5	17.6	15.3	13.0	12.0	12.2	12.5
Prices									
Consumer price inflation (end of period)	2.7	1.5	2.6	3.3	3.9	3.4	3.2	3.1	3.1
Consumer price inflation (period average)	4.1	1.4	1.8	3.2	4.3	3.3	3.1	3.2	3.0
Core inflation (period average)	3.0	2.1	1.9	2.9	3.9	2.9	2.8	2.8	2.7
GDP deflator	3.2	-0.6	1.7	2.3	2.7	2.9	3.0	2.9	2.8
External sector	(in billions of U.S. dollars, unless specified)								
Current account balance	10.8	7.3	-1.0	-3.0	-5.1	-4.2	-6.0	-7.5	-7.8
(in percent of GDP)	3.8	2.5	-0.3	-1.0	-1.5	-1.1	-1.5	-1.7	-1.6
Trade balance	-17.3	-23.3	-35.5	-41.6	-47.1	-50.4	-57.5	-64.4	-71.0
Exports, f.o.b.	49.8	43.2	42.7	48.6	56.2	63.4	70.8	79.0	87.8
Imports, f.o.b.	67.2	66.5	78.3	90.1	103.3	113.8	128.3	143.5	158.8
Services balance	4.6	5.5	7.0	9.1	10.6	12.3	14.9	17.8	21.2
Receipts	25.5	29.1	31.3	34.6	37.5	40.3	43.7	47.4	51.4
Payments	20.9	23.6	24.2	25.5	26.9	27.9	28.8	29.7	30.2
Primary income, net	0.7	1.9	2.6	3.2	3.9	4.7	5.7	6.7	7.8
Secondary income, net	22.8	23.3	25.0	26.3	27.6	29.2	30.9	32.5	34.2
Financial account balance	9.6	2.3	-0.4	0.4	-2.1	-4.3	-5.8	-8.1	-9.3
Direct investment, net	1.0	-0.1	-5.9	-4.4	-6.8	-8.1	-9.6	-11.8	-13.9
Overseas direct investment	6.8	5.5	2.1	3.1	2.7	2.9	3.2	3.5	3.8
Foreign direct investment	5.7	5.6	8.0	7.5	9.5	11.0	12.8	15.3	17.7
Portfolio investment, net	2.7	5.5	1.4	4.7	4.2	4.2	4.0	3.7	4.4
Net acquisition of financial assets	2.7	3.3	1.2	1.5	1.6	2.1	1.9	1.7	1.8
Net incurrence of liabilities	0.0	-2.1	-0.3	-3.2	-2.5	-2.1	-2.1	-2.1	-2.6
Other investment, net	5.9	-3.1	4.1	0.2	0.6	-0.5	-0.2	0.0	0.2
Overall balance	-2.9	2.6	-0.4	-0.9	-2.9	0.1	-0.2	0.6	1.5
Gross international reserves (end-period)	79.5	80.7	80.7	80.8	77.9	78.0	77.8	78.5	79.9
(in months of goods & services imports)	10.8	10.7	9.4	8.4	7.2	6.6	5.9	5.4	5.1
Total external debt (percent of GDP)	27.3	26.5	24.5	23.4	23.2	24.1	24.5	24.9	25.7
Short-term external debt (percent of total)	20.9	19.5	19.4	19.6	21.6	21.6	22.5	22.5	21.8
Fiscal sector (National Government)	(in percent of GDP)								
Government revenue	15.1	15.8	15.2	15.7	16.2	16.8	17.3	17.4	17.6
Government expenditure	15.7	16.7	17.6	17.9	19.1	19.9	20.2	20.3	20.8
Fiscal balance	-0.6	-0.9	-2.4	-2.2	-2.9	-3.1	-2.9	-2.9	-3.2
Primary balance	2.0	1.4	-0.3	-0.3	-0.8	-1.0	-0.9	-0.9	-1.3
Government debt	45.4	44.7	42.1	42.1	40.2	39.4	38.3	37.3	36.7
Government debt, including contingent liabilities	49.8	48.8	45.6	45.1	44.3	43.3	42.0	40.9	40.4
Monetary sector	(in percent change, end-period unless specified)								
Domestic credit	17.8	11.5	17.0	13.4	14.8	14.5	14.2	14.8	14.3
Of which: Private sector	19.9	12.1	16.6	15.7	17.7	17.3	15.4	16.4	15.9
Broad money	12.4	9.3	13.4	11.4	14.3	13.7	14.7	12.7	12.8
Memorandum items:									
Exchange rate (peso per USD, average)	44.4	45.5	47.5	50.4	50.7	51.9	52.2	52.6	53.0
Exchange rate (peso per USD, eop)	44.6	47.2	49.8	49.9	52.5	53.4	53.7	54.0	54.5
Gross domestic product at current price (In trillions of pesos)	12.6	13.3	14.5	15.8	17.3	19.0	20.9	23.0	25.3
Gross domestic product at current price (In billions of U.S. dollar)	284.6	292.8	304.9	313.4	341.0	366.4	400.7	438.1	478.1
GDP per capita (in U.S. dollar)	2,849.3	2,882.7	2,953.3	2,987.2	3,198.9	3,384.3	3,644.2	3,925.8	4,220.8

Note: Light grey cells under the 2017 column refer to actual figures.
Source: Philippine authorities and AMRO Staff Estimates

2. Selected Charts

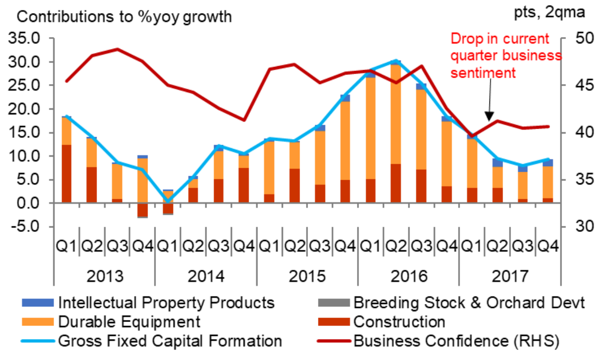
Figure 1. Economic Growth and Real Sector

Growth eased in 2017, reflecting a high base from election spending as fixed investments decelerated.



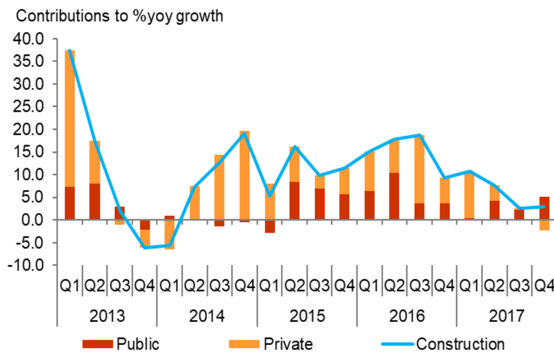
Source: Philippine Statistics Authority (PSA)

Slower durable equipment purchases and construction activity followed the decline in business confidence.



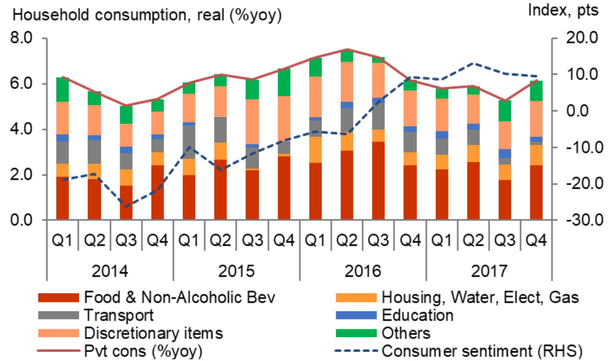
Source: PSA

After gaining pace in 2015 through mid-2016, public sector construction activity cooled post elections.



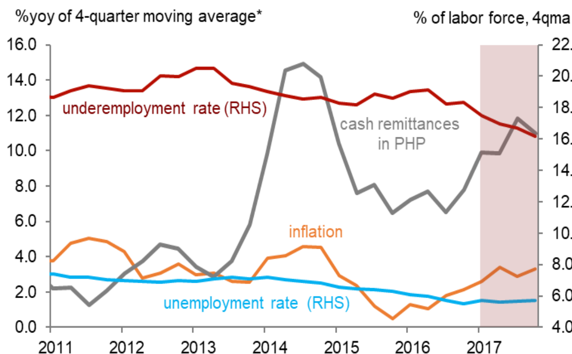
Source: PSA

Slower growth in food and transport spending also dampened the pace of private consumption.



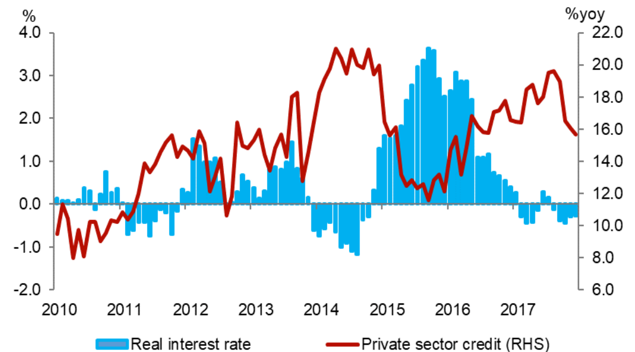
Source: PSA

Modest employment gains, strong remittance inflows and low inflation are supportive of growth.



Note: For remittances, the four-quarter moving sum (not average) was computed before computing for yoy growth.
Source: PSA

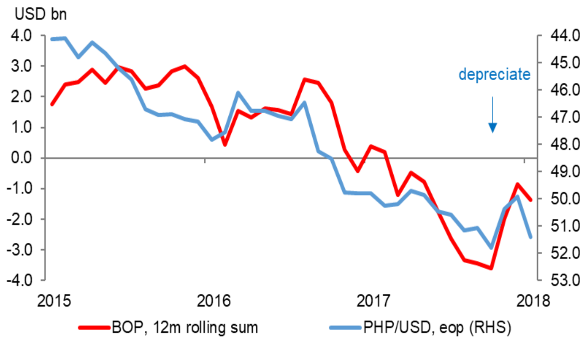
Faster credit growth, despite the softening in recent months, amid low real interest rates is also supportive of domestic demand.



Real interest rate is reverse repo rate minus CPI inflation.
Source: PSA

Figure 2. External Sector

The BOP deficit widened and the peso weakened against the USD in 2017.

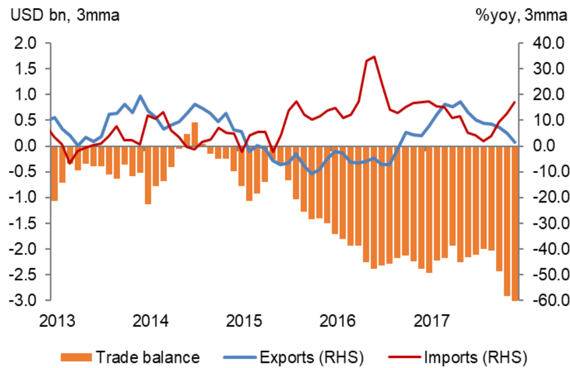


Source: BSP

Wider trade deficits drove the current account into a small deficit despite stronger remittance inflows.

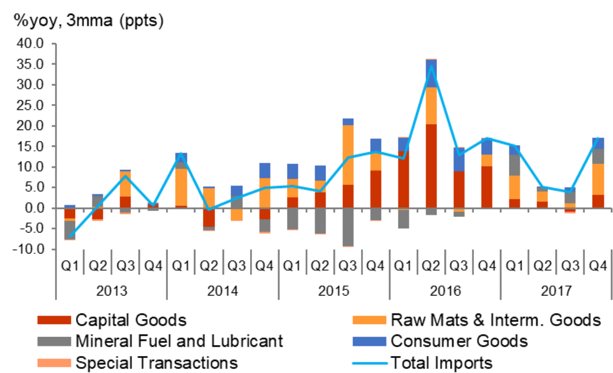
Note: 2017 refers to Jan-Sep period.
Source: BSP

The widening of the trade deficit, which began in 2015 as imports accelerated while exports shrank, had eased in early 2017 but resumed in Oct-Dec.



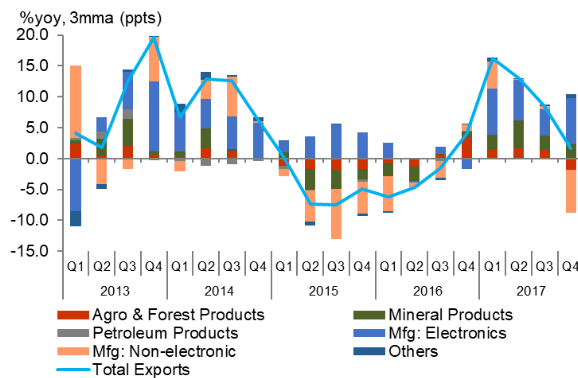
Source: PSA

Import growth eased in the first three quarters of 2017, in line with the deceleration in fixed investments, although it picked up in the final quarter.



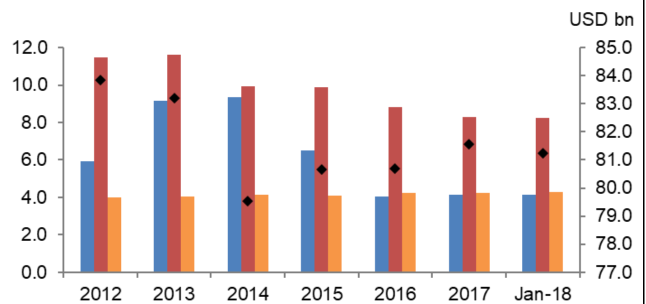
Source: PSA

A broad-based recovery in exports ensued in the first three quarters of 2017, causing a slight improvement in the trade deficit.



Source: BSP

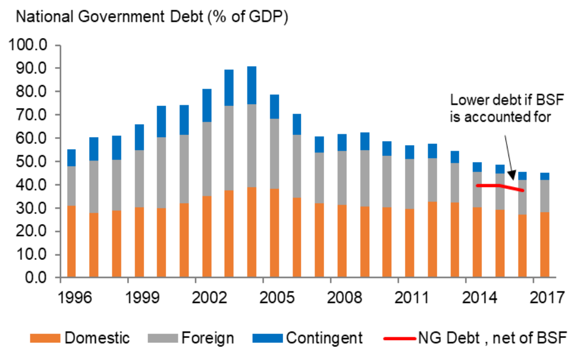
Despite prolonged BOP deficits, FX reserves remain ample, providing sufficient buffer against external shocks.



Note: Gross External Funding needs refer to the sum of ST external debt by residual maturity plus the current account deficit. Import cover refers to no. of months of average imports of goods and payment of services and primary income.
Source: BSP

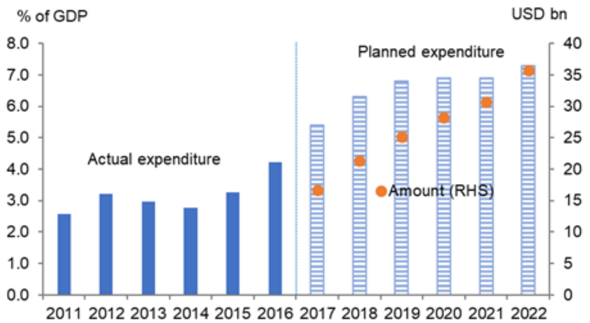
Figure 3. Fiscal Sector

Considerable debt reduction provides space to expand fiscal policy.



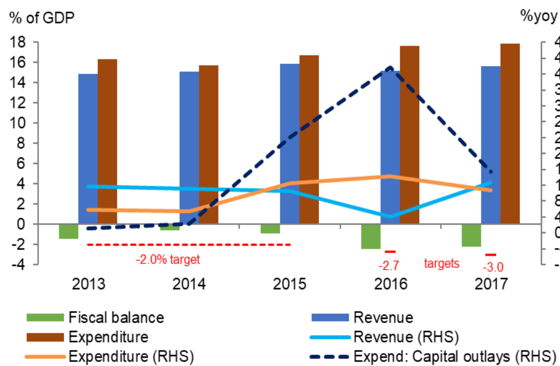
Note: BSF = Bond Sinking Fund, created to cover maturing government bonds.
Source: Bureau of Treasury (BTr), Department of Finance

With decent fiscal space, the Duterte administration aims to ramp up public sector infrastructure spending.



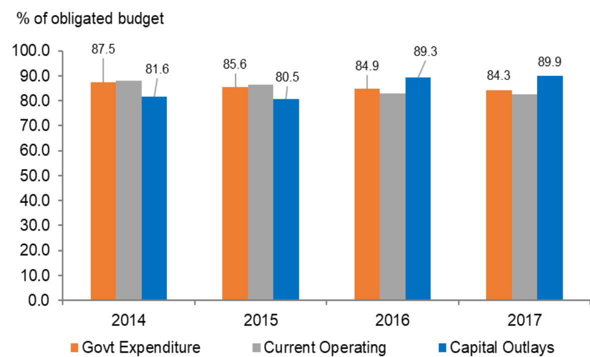
Note: Projections are consistent with the medium-term fiscal targets and growth assumptions approved during the DBCC meeting on 9 June 2017. Actual figures refer to infra and other capital outlays.
Source: Department of Budget and Management (DBM)

Budget deficits remain below the widened limit even as expenditures outpaced revenues.



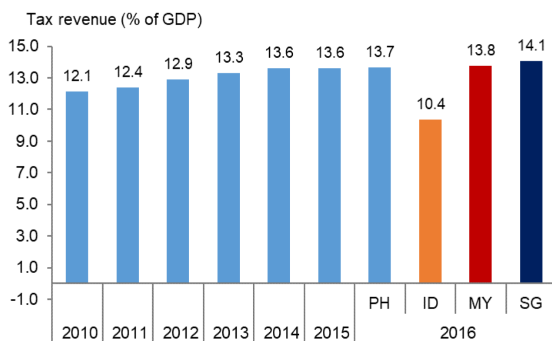
Note: 2015 saw a one-time revenue worth 0.5 percent of GDP from the coco levy fund, without which the deficit would have been 1.4 percent of GDP and revenues lower at 15.3 percent (6.6 percent yoy).
Source: PSA

Disbursements continue to be challenged by line agencies' weak implementation capacity.



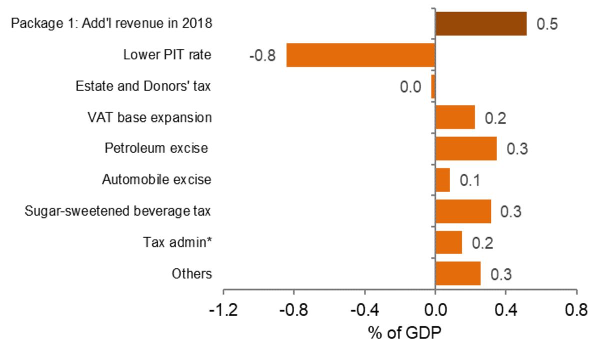
Note: *For 2017 (and latter part of 2016), the improvement in the disbursement rate for Capital Outlays was in part due to the new law (signed in March 2016) on the right of way, which states that owners of the private property taken for public use should be compensated at current market value. On the other hand, the decline in the disbursement rate for Current Operating expenditure was in part due to lower interest payments in the early part of 2017.
Source: Department of Budget and Management, PSA

Tax revenue efforts can improve further…



Source: BTr, PSA, other respective national sources

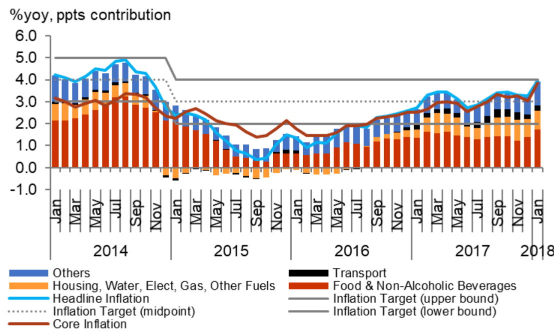
…with the proposed comprehensive tax reform program.



Note: *Tax administrative measures refer to the mandatory fuel marking and monitoring program, a system to enable the BIR to check real-time the financial submission of large taxpayers, and the simplification of tax forms. Others refer to taxes for cosmetic procedures, coal and mining excise tax, and increases in the Documentary Stamp Tax.
Source: Department of Finance (as of December 2017)

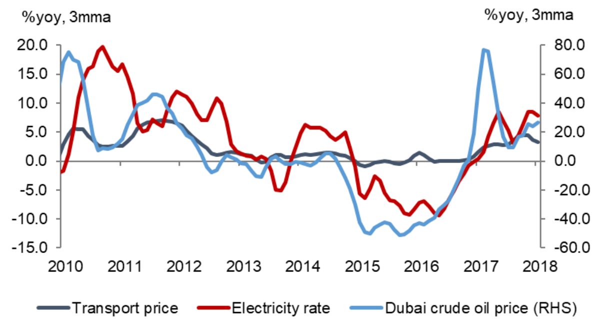
Figure 4. Monetary and Financial Conditions

Inflation has climbed to within the target range on higher food and energy prices.



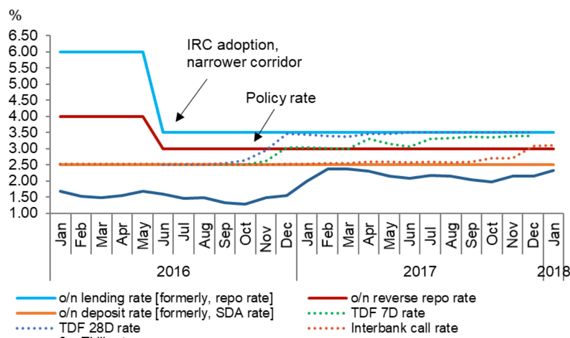
Source: PSA

Global crude oil prices affect domestic electricity rates and transport prices.



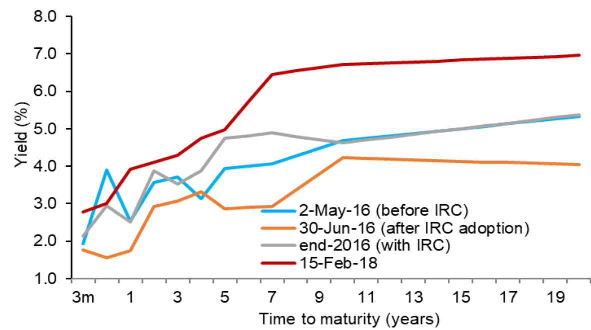
Source: BSP, Bloomberg Finance LP

Monetary policy has been kept steady since the adoption of the IRC framework.



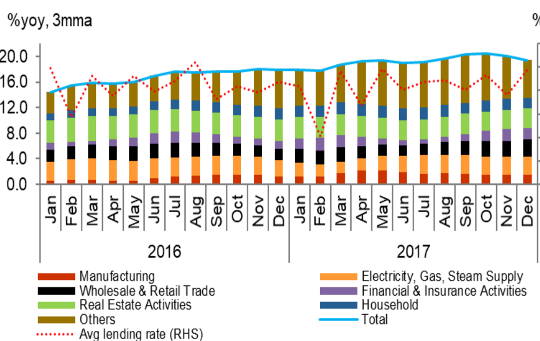
Source: BSP, Bloomberg Finance LP

The yield curve shifted upwards across tenors after the IRC adoption, which also coincided with capital outflows due to monetary developments in the US.



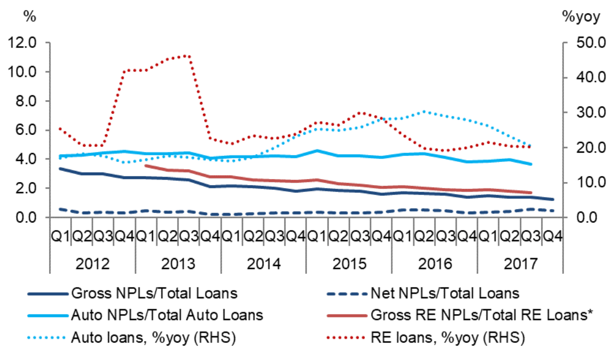
Source: Bloomberg Finance LP

The acceleration in bank lending, facilitated by steady lending rates, is broad-based.



Source: BSP

Overall loan quality continues to improve, including in real estate and auto loan segments, albeit relatively elevated.



Note: Lending by Universal and Commercial Banks (accounting for over 90.0 percent of Philippine Banking System's assets); *Gross RE NPLs of the Philippine Banking System (Bank Proper & Trust Department).
NPL = non-performing loans; RE refers to residential real estate.
Net NPL refers to Gross NPL less Specific Allowance for Credit Losses.
Source: BSP

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). 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 periodicity with which the available data are published. Timeliness refers to how up-to-date the published data are relative to the publication date.
(iii) Data quality refers to the accuracy and reliability of the available data given the data methodologies.
(iv) Consistency refers to both internal consistency within the data series itself and its horizontal consistency with other data series of either the 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.