AMRO Annual Consultation Report

The Philippines - 2016

The ASEAN+3 Macroeconomic Research Office (AMRO)

November 2016

Acknowledgements

1. This Annual Consultation Report on the Philippines has been prepared in accordance with the functions of AMRO to monitor, assess and report to its members on their macroeconomic status and financial soundness and to identify the relevant risks and vulnerabilities, and assist them, if requested, 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 15 to 19 August 2016 (Article 5 (b) of AMRO Agreement). The AMRO Mission team was headed by Dr Sumio Ishikawa, Group Head and Lead Economist. Members include Mr Paolo Hernando, Senior Economist; Dr Ruperto Majuca, Senior Specialist; Mr Enrico Tanuwidjaja, Specialist; and Dr Akhis Hutabarat, Economist. AMRO Director Dr Junhong Chang and Chief Economist Dr Hoe Ee Khor also participated in key policy meetings with the authorities. This AMRO Annual Consultation Report on the Philippines for 2016 was approved by Dr Hoe Ee Khor, AMRO Chief Economist.

3. The analysis in this Report is based on information available up to 11 November 2016.

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. On behalf of AMRO, the Mission team wishes to thank the Philippines authorities for their comments on this Report, as well as their excellent meeting arrangements and hospitality during our visit.

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Executive Summary

*In the **March 2016 country report**, AMRO expected this year's headline inflation to remain subdued and growth momentum to continue, mainly driven by election-related spending, the continued positive impact of low commodity prices, the stimulus from solid remittances on household consumption, and robust Business Process Outsourcing activity. The current account surplus was expected to narrow somewhat as growth momentum remained strong while external demand was soft. The external position was expected to stay strong with domestic liquidity remaining ample. **Since March 2016**, the Philippine economy has grown at a faster pace and inflation has remained subdued. The external position has remained strong supported by increased international reserves. The structural problems underlying the government's underspending on infrastructure have been largely addressed with tax revenue remaining buoyant. Risks to the growth outlook are tilted to the downside with risks mainly stemming from global economic and financial shocks, and a slowdown in remittances. Downside risks to the fiscal position mainly stem from weak implementation of the tax reform. Monetary policy has remained committed to anchoring inflation expectations and preserving financial stability, while maintaining ample liquidity to support growth. The central bank should continue to maintain exchange rate flexibility to cushion the economy from adverse shocks to capital flows, and macro-prudential policies to foster financial stability. Tax reform should result in revenue enhancement equivalent to at least 2.0 percentage points of GDP in order to ensure the budget deficit does not exceed the new ceiling of 3.0 percent of GDP.*

Recent Developments and Outlook

1. **The Philippine economy accelerated in the first half of 2016 reflecting low inflation, higher private consumption boosted by election spending, better private investment sentiment, and improved government budget execution.** The high growth is expected to remain in 2017, driven by sustained private consumption and a pickup in investment expenditure, including infrastructure projects.

2. **Inflation remained soft mainly due to a prolonged period of low oil prices that has led to reduced power generation costs and lower transportation costs**. Headline inflation is forecast to rise to within the target band in 2017, reflecting the diminishing effects of low energy prices.

3. **The external position remains strong, supported by adequate international reserves.** With faster investments and imports, and moderate growth in overseas remittances, the current account surplus is forecast to continue decrease in the short-term.

4. **Robust tax buoyancy and higher infrastructure spending have enhanced the government's ability to support growth.** The structural problems underlying the government's underspending on infrastructure have been largely addressed, resulting in increased budget absorption and improved quality of expenditure.

5. **The BSP remains committed to achieving the inflation target and preserving financial stability**. With firm domestic demand and well-behaved inflation expectations, the BSP has maintained its monetary policy stance since September 2014 and kept exchange rate flexibility as a buffer against shocks.

6. **The banking system remained sound with adequate capital buffers, sufficient liquidity, and low NPLs.** Bank loans and property demand are likely to strengthen going forward, in view of the prospect of investment-driven growth and robust business process outsourcing (BPO) activity.

Risks and Vulnerabilities

7. **Downside risks to the medium-term growth outlook could emanate both from external and domestic fronts.** The external risks mainly stem from global economic shocks -such as growing protectionist sentiment, weaker-than-expected global trade slowdown, a slower-than-expected China's economy, and prolonged low oil prices-, global financial shocks –such as further development following the Brexit vote, and subsequent Federal Fund rate hikes-, and geopolitical tensions. On the domestic front, downside risks emanate from stronger-than-expected impact of extreme weather conditions, delays in infrastructure projects, logistics bottlenecks (e.g., in imports processing), and closure of mines.

8. **The risks to the inflation outlook are deemed to be on the upside.** The upside risks to inflation include possible adjustments in power rates along with the temporary impact of proposed tax policy measures.

9. **Tax reform implementation poses downside risks to the fiscal position.** Government revenue may fall short of the target if revenue enhancing measures fail to offset the decline in income tax revenue stemming from the income tax rate cut.

10. **Risks to external stability mainly emanate from a sharper than expected decline in the current account surplus, reflecting still-weak exports, faster infrastructure-related imports and slower remittances.** The financial account also faces downside risks stemming from adverse developments in global financial markets, triggered by the start of Brexit process, and a further Fed rate hike.

Policy Recommendations

11. **Monetary policy should continue to focus on maintaining low and stable inflation in line with an inflation target, and on preserving financial stability**. The central bank has implemented the Interest Rate Corridor (IRC) system and mopped up excess liquidity using the term deposit facility (TDF). A faster absorption of excess liquidity should be pursued in order to strengthen the monetary policy framework and allow monetary policy to respond pre-emptively to the risks of the economy overheating or an escalation in financial stability risks. The central bank should continue to maintain exchange rate flexibility to help cushion the economy from adverse shocks to capital flows.

12. **Macro-prudential policies that foster financial stability continue to be warranted.** Since credit growth is expected to accelerate in view of the prospect of higher economic growth, the current stance of macro-prudential policies, which are mainly in the real estate sector, should be maintained.

13. **To ensure the budget deficit does not exceed the new ceiling of 3.0 percent of GDP, the tax reform should be revenue enhancing, generating additional revenue equivalent to at least 2.0 percentage points of GDP.** The government should speed up the implementation of public infrastructure projects in view of its crowding-in effects on private investment.

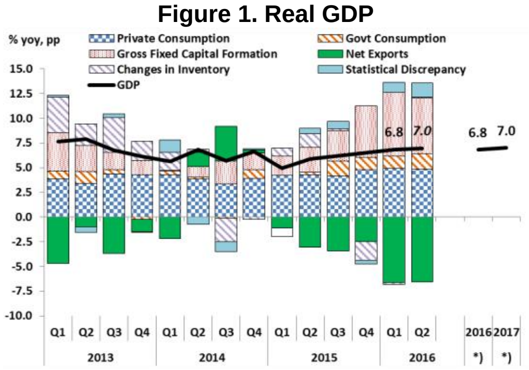
14. **Further implementation of the structural reform agenda is warranted in the areas of product competitiveness, production value chain, market competition, financial inclusion and human capital development.**

A. Recent Developments and Outlook

A.1 Growth and Inflation

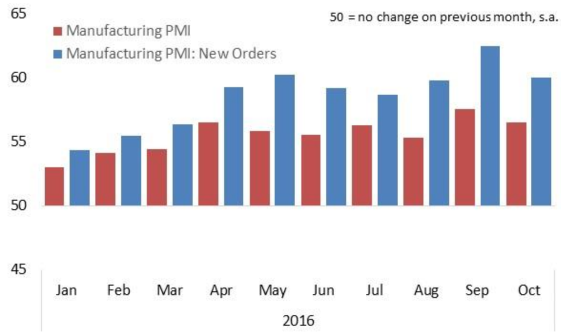
15. **The Philippine economy has regained growth momentum and inflation has remained soft**. After slowing down in 2015, real GDP has rebounded in 2016[1] despite still-weak external demand (Figure 1). The election spending effect, low inflation, better private investment sentiment and improved government budget execution drove the growth. Monetary conditions have also been supportive of growth through a stable policy interest rate and ample liquidity.

Figure 1. Real GDP



Source: Philippine Statistics Authority (PSA), AMRO staff calculation

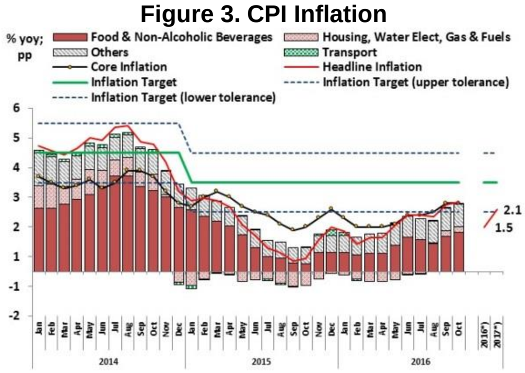
Figure 2. Manufacturing PMI



Source: Nikkei, IHS Markit

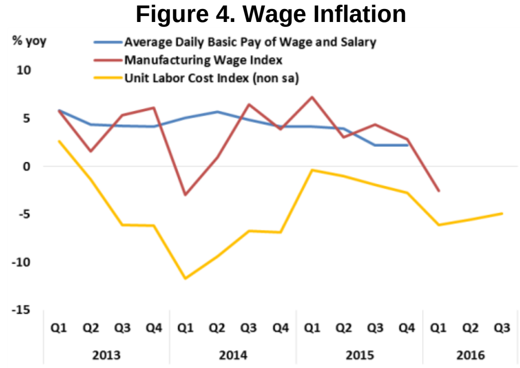
16. **The economy is expected to strengthen further in 2017 driven by private consumption and pickup in investment expenditure, particularly infrastructure projects.** The reform agenda of the new administration includes the acceleration of infrastructure spending and relaxation of restrictions on foreign investment in order to boost private investment sentiment.

Figure 3. CPI Inflation



Source: PSA, Bangko Sentral ng Pilipinas (BSP)

Figure 4. Wage Inflation



Source: PSA, Oxford Economics, Datastream

17. **Average headline inflation remained soft in 2016, mainly due to a prolonged period of low oil prices that has led to reduced power generation costs and lower transportation costs** (Figure 3). It is forecast to rise to within the target band in 2017,

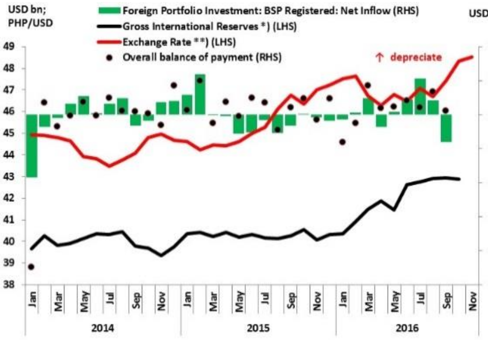
[1] The manufacturing PMI shows continued strong demand in Q3 and early Q4 2016 (Figure 2).

reflecting the diminishing base-year effects of low energy prices. Thus far, pressures on wage inflation have been subdued (Figure 4), given that the labor market is still slack as indicated by the persistently high rate of under-employment and the high number of Filipinos going abroad to find jobs.

A.2 External Sector

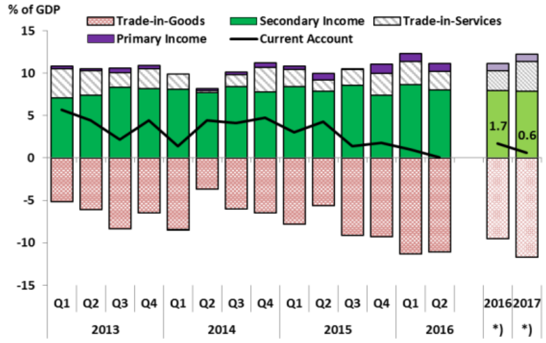
18. **The Philippine economy has maintained a strong external position, supported by high international reserves** (Figure 5). The economy faces a narrowing current account surplus amidst stronger investment, softer demand for overseas Filipino workers (OFWs) and still-weak external demand. Meanwhile, the services account is likely to remain in surplus, supported by robust BPO activity. With faster imports and slower overseas remittances, the current account surplus is forecast to narrow in the short term (Figure 6). The reduction in the current account surplus, if combined with heightened risks in global financial markets, could impose pressure on the exchange rate and international reserves going forward.

Figure 5. Exchange Rate & International Reserves



Note: *) half of actual values; **) as of 11 November 2016
Source: BSP

Figure 6. Current Account



Note: *) forecast
Source: BSP, AMRO staff estimate

A.3 Fiscal Sector

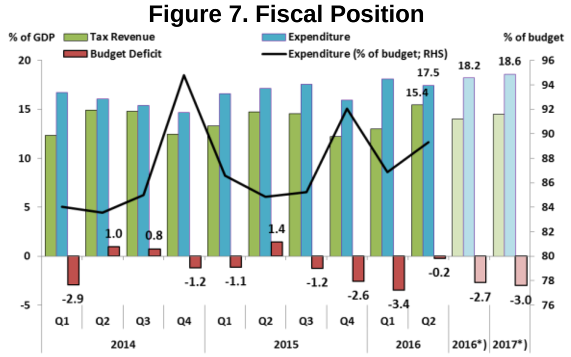
19. **Robust tax buoyancy and increased infrastructure spending have enhanced the government's ability to support growth.** Tax revenue grew faster than nominal GDP during the election quarter (Q2 2016) with the tax-to-GDP ratio reaching a record high 15.4 percent of GDP since Q2 2006. Structural problems underlying government underspending on infrastructure have been largely addressed, resulting in increased budget implementation (Figure 7) and improved quality of expenditure (Figure 8). The government's decision to raise the budget deficit ceiling from 2.0 to 3.0 percent of GDP[2] is justifiable to support its policy of expanding public infrastructure outlays to at least 5.0 percent of GDP by 2019. With higher growth, the sustainability of public debt can be maintained.

[2] The Development & Budget Coordination Committee (DBCC) has revised the medium-term fiscal program enlarging the deficit ceiling to 3.0 percent of GDP to allow more public investments in infrastructure and to support social services. The DBCC also revised the 2016 deficit ceiling to 2.7 percent of GDP from the original 2.0 percent program following the first half performance of revenue and expenditure.

20. **The proposed 2017 budget is on the right track in supporting infrastructure investment and human capital development to accelerate potential growth, reduce unemployment and promote inclusive growth**. The national budget for fiscal year 2017 amounts to PHP3.35 trillion, which is 11.6 percent higher than the 2016 budget and equivalent to 21.0 percent of the projected GDP. The budget prioritizes infrastructure, agriculture and rural development, as well as law and order.

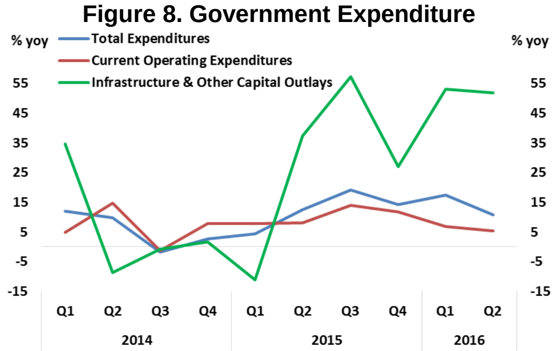
21. **The government has submitted to Congress the first package of tax reforms to help fund its agenda for inclusive growth.** The first stage is the largest component, involving the reform of the Personal Income Tax to make it more equitable, introducing new or increased excise taxes on petroleum products, as well as broadening the value-added tax (VAT) base through the removal of several exemptions (Selected Issues S.3).

Figure 7. Fiscal Position



Note: *) forecast
Source: Department of Finance (DOF), Department of Budget and Management (DBM), AMRO staff estimate

Figure 8. Government Expenditure



Source: DBM

22. **The shift towards long-term domestic bond financing of the budget has continued, contributing to efforts to deal with rising foreign interest rate and exchange rate depreciation.** The share of foreign denominated debt to total debt remained modest (37.7 percent as of September 2016) and floating rate coupon debt, as of 11 November 2016, accounts for only 1.2 percent of the total portfolio. Moreover, the total government debt that requires rollover within the next 12 months remains stable at PHP7.9 billion or 7.2 percent of total debt as of 11 November 2016.

A.4 Monetary Sector

23. **The BSP remains committed to achieving the inflation target and takes into consideration emerging risks to the inflation outlook and to inflation expectations.** The BSP has kept its monetary policy stance unchanged since September 2014 as domestic demand has been firm supported by ample liquidity condition, inflation expectation has been well behaved, the inflation forecast was below its target band for 2016 and within its target band for 2017, while global financial markets have been volatile. Inflation expectations also

remain broadly consistent with the inflation target over the policy horizon. Meanwhile, exchange rate flexibility has been maintained as a buffer against external shocks.

24. **Since 3 June 2016, the BSP has adopted an IRC system as a framework for conducting its monetary operations.** The auction-based TDF is used as a key liquidity absorption facility to withdraw a large part of the liquidity from the banking system. This absorption is expected to bring short-term interbank rates closer to the policy interest rate, i.e. the interest rate of the overnight reverse repurchase (RRP) facility. Since its implementation, the TDF auctions have absorbed excess liquidity in the financial system (Selected Issues S.1).

A.5 Financial Sector

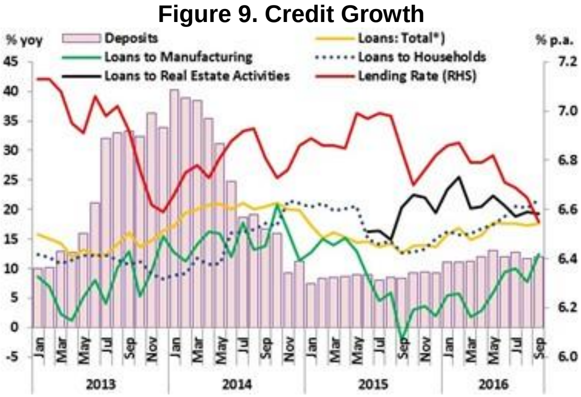
25. **The banking system has remained sound with adequate capital buffers, ample liquidity, and low NPLs** (Table 1). Credit growth edged up to 17.7 percent in end-September 2016, in line with the pickup in economic activity (Figure 9). Meanwhile, property-related indicators generally still grew at a moderate pace, but showed some acceleration compared to early this year (Figure 10). Property demand is likely to strengthen in view of the prospect of investment-driven growth and healthy BPO activity.

Table 1. Financial Soundness Indicators for Commercial and Universal Banks (ratios in percent, %)

	2014				2015				2016	
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Capital Adequacy Ratio	15.5	15.9	16.3	15.2	15.1	15.5	15.6	14.9	15.0	15.4
Non Performing Loans Ratio	2.2	2.1	2.0	1.8	2.0	1.8	1.8	1.6	1.7	1.7
Return on Equity	10.1	9.8	9.9	11.0	11.1	10.7	10.1	9.8	9.8	9.8
Loan to Deposit Ratio	62.3	63.7	65.3	66.6	65.1	66.2	66.5	69.0	66.9	68.4
Cash and due from Banks to Deposit Ratio	32.4	31.4	29.6	29.1	28.6	27.7	27.6	27.2	27.9	27.4
Liquid Assets to Deposit Ratio	61.4	59.6	57.8	57.4	57.6	57.2	58.2	55.6	56.3	55.3
Cost to Income Ratio	63.7	64.0	63.5	61.2	61.0	61.2	62.0	63.6	63.8	63.9

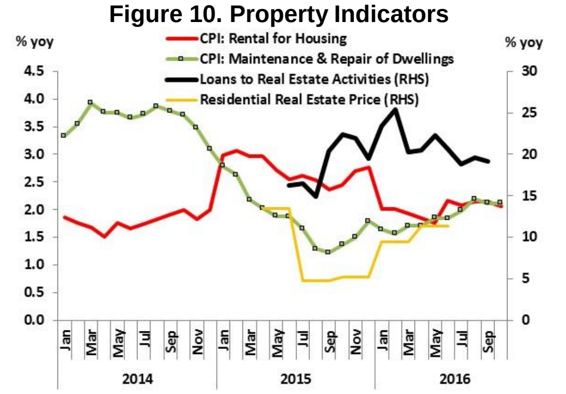
Source: BSP

Figure 9. Credit Growth



Note: *) Universal & Commercial Banks, Net of Reverse Repurchase Arrangement; **) Net of Financial and Insurance Activities; ***) High Lending Rates
Source: BSP, PSA

Figure 10. Property Indicators



Source: PSA, BSP

B. Risks and Vulnerabilities

B.1 Risks to Growth Outlook

26. **Risks to the growth outlook are tilted to the downside, mainly owing to slower-than-expected global economic growth, a further slowdown in OFWs remittances, and extreme weather conditions.** In terms of external risks, slower-than-expected global economic growth, led by a weakening of growth in China, Japan and the Eurozone, could lead to a further contraction in exports. Weak global economic growth could also weaken the demand for OFWs, which will lead to slower remittances and consumption. Downside risks to growth outlook through remittances are also present if oil price reverse recent gains to a lower level, despite the agreement among Organization of Petroleum Exporting Countries' members and several other major producers to limit supply of oil.[3] In addition, U.S. protectionist policies also pose downside risks to the growth outlook through their impact on exports of goods and BPO services as well as on demand for OFWs. On the fiscal side, fiscal spending may fall short of the budget due to poor execution, resulting in a smaller fiscal stimulus. Finally, extreme weather condition may turn out to be more severe than usual causing widespread damage to agricultural crops and infrastructure. They also pose downside risks to consumption demand through higher domestic food prices.

27. **A successful implementation of the revenue enhancing tax reform could have a temporary dampening effect on growth as households and firms are left with lower disposable incomes.** The net revenue-enhancing tax reform implies that firms and households, in aggregate, are expected to pay more taxes, implying lower disposable incomes. However, in the longer term, the tax reform and higher infrastructure investment would improve the growth outlook by stimulating more inclusive household consumption and productivity.

28. **The government's ban of labor-only contracting practice poses downside risks to labor demand and growth**. In an attempt to improve the level and sustainability of labor income, the government has banned labor-only contracting practice that has exploited employees' low bargaining power. This new regulation will have a positive impact on wages and benefits but will increase labor cost to firms that may reduce the demand for labor in the short run (Selected Issues S.2).

[3] Further decline in oil prices may stimulate household consumption but the effect will be reduced by the increase in excise tax on petroleum product.

B.2 Risks to the Inflation Outlook

29. **The risks to the inflation outlook are deemed to be on the upside.** The upside risks include possible adjustments in power rates along with the temporary impact of proposed tax policy measures.

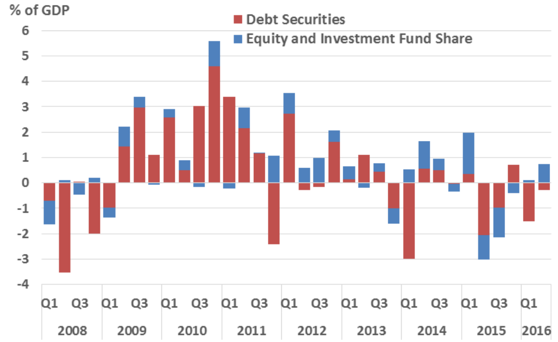
B.3 Risks to the Fiscal Position

30. **The tax reform implementation poses downside risks to the fiscal position**. Government revenue may fall short of the target if the revenue-enhancing measures fail to offset the decline in income tax revenue stemming from the income tax rate cut (Selected Issues S.3). Meanwhile, government expenditures can grow at a faster pace, driven mainly by infrastructure spending. As a result, the budget deficit may exceed the ceiling of 3.0 percent of GDP in 2017.

B.4 Risks to External Stability

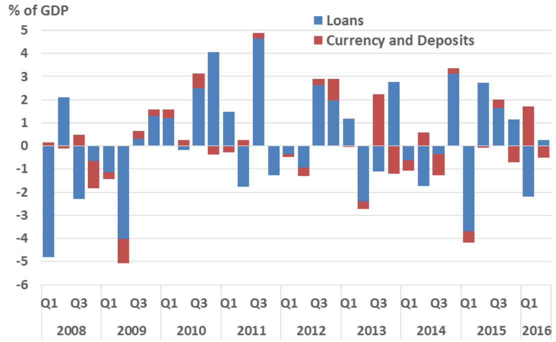
31. **Risks to external stability emanate mainly from the rapid decline in the current account surplus**. The current account balance may turn into deficit sooner than expected if exports remain weak while imports expand faster than expected as the government speeds up its infrastructure projects. The downside risks to the current account balance may be amplified if the growth in OFW remittances continue to slow down. While international reserves are currently high, the reduction in the current account balance, if sustained, could lead to a loss of reserves unless it is supported by strong capital inflows. This, together with the widened fiscal deficit, could erode market confidence in the strength of the external position.

Figure 11. Net Incurrence of Foreign Liabilities: Portfolio Investment



Source: BSP

Figure 12. Net Incurrence of Foreign Liabilities: Other Investment



Source: BSP

32. **The Philippines' financial account also faces downside risks stemming from volatilities in the global financial markets**. For instance, the start of the Brexit process[4] may impact capital inflows through heightened volatility in global financial markets. An unexpected Fed rate hike may also lead to strong capital outflows. In the past, foreign portfolio inflows

[4] The U.K. government is likely to trigger article 50 and begin the process of the country's formal departure from the E.U. early next year.

reverse quickly when global financial market conditions worsened—for example, during the global financial crisis in 2008-2009 and the taper tantrum in 2013-2014 (Figures 11, 12). On the upside, the financial account may witness more capital inflows when the tax reform is well implemented and the relaxation of restrictions on foreign investment starts, resulting in foreign investors' positive sentiment.

B.5 Risks to Financial Stability

33. **Upside risks to asset price inflation stem from high domestic liquidity but this risk is manageable in the short-term**. Persistently high liquidity in the financial system could keep the interest rates low**,** which may bring upward pressures on asset prices. Although the real estate sector still hold the largest share of loans, loan growth to real estate activities has trended down since February 2016 and the growth of residential real estate price remains moderate (Figure 10). Overall, we view this risk as moderate and manageable at present.

C. Policy Recommendations

C.1 Monetary Policy

34. **Monetary policy should continue to focus on maintaining low and stable inflation in line with the inflation target, and on preserving financial stability**. However, given the significant role of supply shocks on consumer inflation, the burden of controlling inflation should be shared with other agencies that are more directly responsible for easing supply constraints.[5] In general, monetary policy should not respond to such supply shocks except to provide temporary liquidity to those affected. However, if there is a risk of second round effects on inflation then it would be appropriate to tighten policy to dampen demand.

35. **The IRC system should be implemented using the TDF to absorb excess liquidity more rapidly, in order to improve monetary policy transmission**. Since its implementation in June 2016, the TDF auctions have absorbed excess liquidity in the financial system, mainly excess liquidity placed in the overnight deposit facility (ODF). A faster absorption of excess liquidity using the TDF would strengthen the monetary policy framework and allow monetary policy to respond pre-emptively to the risks of the economy overheating or an escalation in financial stability risks (Selected Issues S.1). To improve the transmission of monetary policy, it will also be important to take measures to develop the money market and bond markets in order to generate a longer yield curve. Moreover, it is necessary to continuously enhance

[5] Consumer inflation is predominantly driven by food supply shocks and effect of global commodity price inflation, where food items have the largest weight in the CPI basket. Consequently, there are lack of trade-offs between GDP growth and CPI inflation as well as between consumption growth and CPI inflation.

liquidity forecasting and ensure the IRC's effectiveness in managing fluctuations in liquidity condition triggered by capital flows volatility (Selected Issues S.1).

36. **The central bank should continue to maintain exchange rate flexibility to help cushion the economy from external volatility shocks.** As the current account surplus is likely to decrease further and the financial account faces downside risks stemming from developments in global financial markets, the central bank should maintain a flexible exchange rate policy and sufficient international reserve in order to keep the country's external position well-buffered.

C.2 Macro-prudential Policy

37. **Macro-prudential policies that foster financial stability continue to be warranted.** As credit growth is expected to accelerate in view of the prospect of higher economic growth, current macro-prudential policies should be maintained.[6] A further enhancement in the collaboration between financial regulators under the Financial Stability Coordination Council (FSCC) and other related parties is encouraged to ensure that proactive measures are taken to manage and address the build-up of system-wide risks.[7] This may include initiatives to expand surveillance to cover shadow banking activities in the real estate sector and to monitor property demand pressures that are driven by non-bank financing.

C.3 Fiscal Policy

38. **To ensure the budget deficit does not exceed the new ceiling of 3.0 percent of GDP, the tax reform should result in revenue enhancement of at least 2.0 percentage points of GDP**. For instance, the authorities should ensure that package 1 of the Philippine tax reform, which is Personal Income Tax Reform and Compensating Measures (Selected Issues S.3), does not end up with net revenue loss, which could affect the government's infrastructure and social program.

39. **To speed up the crowding-in effect of private sector investment, efforts should be made to expedite the implementation of public infrastructure projects.** Government expenditure should continue to focus on supporting hard and soft infrastructure investment along with human capital investment in order to expedite the transition towards an investment-driven economy and to promote inclusive growth, alleviate poverty, and narrow inequality.

[6] Appendix III lists a wide range of BSP's macro-prudential measures to prevent financial imbalances. Measures include the real estate stress test (REST) limits which were implemented as a preemptive measure to ensure that banks have sufficient capital buffer to withstand shocks affecting the real estate sector. This macro-prudential measure is in addition to the existing regulatory Real Estate Loan (REL) limit of 20 percent of a bank's total loan portfolio.

[7] The FSCC, composed of the BSP, DOF, Insurance Commission (IC), Philippine Deposit Insurance Corporation (PDIC) and Securities and Exchange Commission (SEC), signed a Memorandum of Agreement (MOA) with the Housing and Land Use Regulatory Board (HLURB) on 30 September 2016 to foster financial stability in the country. The said MOA will facilitate information sharing among the agencies as a proactive initiative of the FSCC to better understand the interconnectedness and to mitigate the buildup of systemic risks in the financial system.

While speeding up the infrastructure spending, the government should also take appropriate measures to manage the project execution risk of infrastructure investment.

C.4 Structural Reform Policy

40. **Implementation of the structural reform agenda should be accelerated in the areas of product competitiveness, production value chain, market competition, financial inclusion and human capital development.** Such reforms will enable the economy to grow more sustainably and inclusively, and to remain on the right track to join other upper middle income economies. Structural reform policies should be reinforced in the aforementioned areas to overcome structural problems such as underinvestment and lack of market competitiveness,[8] underemployment, low financial inclusion[9], and limited production value chain.

[8] The government should tighten market competition at a much more progressive pace in order to encourage a more inclusive and larger private investment as well as to maintain low and stable prices. To support this effort, the Philippine Competition Commission (PCC) should be strongly empowered to implement the competition law and reduce the business concentration ratio. The plan to liberalize foreign investment should be pursued to speed up FDI.

[9] Philippine authorities has implemented substantial reforms to promote financial inclusion but further concerted initiatives are encouraged to further tap the potential for a more inclusive financing structure for economic development. As a deliberate approach to generate greater public awareness and support for financial inclusion, the National Strategy for Financial Inclusion (NSFI) was launched on 1 July 2015. The NSFI is developed through a broad-based consultative process with private and public sector stakeholders involved in financial sector development to optimize collective efforts toward financial inclusion in the Philippines. The BSP and relevant industry stakeholders launched the National Retail Payment System (NRPS) Framework on 9 December 2015 aimed to improve the payment system infrastructure for strengthening the country's economic competitiveness. The framework aimed to create a safe, efficient, and reliable electronic retail payment system that is interconnected and interoperable. Such a retail payment system presents the potential for increased efficiencies, greater opportunities for consumers and businesses and increased access to financial services. BSP also expanded the scope of allowable activities in micro-banking offices (MBOs) as part of initiatives to promote financial inclusion by extending the physical reach of financial services. As another part of its liberalization initiatives, the BSP now allows the conversion of microfinance-oriented banks/branches into regular banks/branches and introduction of agent banking.

Appendix I. Selected Economic Indicators for the Philippines

	2012	2013	2014	2015	2016	2017
					Projection	
Real sector and prices	(In percent change, unless otherwise indicated)					
Real GDP	6.7	7.1	6.2	5.9	6.8	7.0
Final consumption	7.7	5.5	5.2	6.5	6.9	6.9
Household consumption	6.6	5.6	5.5	6.3	6.6	6.6
Government consumption	15.5	5.0	3.3	7.8	8.8	9.1
Gross fixed capital formation	10.8	11.8	6.2	15.2	21.9	21.2
Exports of goods and services	8.6	-1.0	11.7	9.0	12.1	13.8
Imports of goods and services	5.6	4.4	9.3	14.0	18.0	19.5
GDP deflator	2.0	2.0	3.2	-0.6	2.4	2.1
Consumer price inflation (period average)	3.2	3.0	4.1	1.4	1.5	2.1
External sector	(In billions of U.S. dollar, unless otherwise indicated)					
Current account balance	7.0	11.4	10.8	7.7	5.1	1.9
Current account balance (In percent of GDP)	2.8	4.2	3.8	2.6	1.7	0.6
Trade balance	-18.9	-17.7	-17.3	-23.3	-29.2	-38.9
Exports, f.o.b.	46.4	44.5	49.8	43.2	44.8	48.2
Imports, f.o.b.	65.3	62.2	67.2	66.5	74.0	87.1
Services balance	6.2	7.0	4.6	5.6	7.1	11.8
Receipts	20.4	23.3	25.5	29.3	32.3	38.4
Payments	14.3	16.3	20.9	23.7	25.2	26.6
Secondary income	19.5	21.1	22.8	23.5	24.6	26.2
Receipts	20.1	21.7	23.4	24.3	25.4	27.0
Payments	0.6	0.6	0.7	0.8	0.8	0.8
Capital and financial account balance	6.7	-2.4	-9.7	-3.3	2.5	3.0
Direct investment, net	-1.0	0.1	-1.0	0.1	0.5	0.7
Portfolio investment, net	3.2	1.0	-2.7	-5.4	0.5	0.7
Financial derivatives, net	0.0	0.1	0.0	0.0	0.0	0.0
Other investment, net	4.5	-3.4	-5.9	2.0	1.6	1.7
Error and omission	-4.6	-4.2	-4.1	-2.0	-3.0	-3.0
Overall balance	9.2	5.1	-2.9	2.6	4.7	1.9
Overall balance (In percent of GDP)	3.7	1.9	-1.0	0.9	1.5	0.6
Gross reserves	83.8	83.2	79.5	80.7	85.4	87.3
Gross reserves (In months of imports of goods & services)	11.5	11.6	9.9	9.9	10.3	9.2
Total external debt (In percent of GDP)	32.0	28.9	27.3	26.5	27.1	27.0
Fiscal sector (National government)	(In percent of GDP)					
Revenue and grants	14.5	14.9	15.1	15.8	15.5	15.6
Expenditure	16.8	16.3	15.7	16.8	18.2	18.6
Overall balance	-2.3	-1.4	-0.6	-0.9	-2.7	-3.0
Primary balance	0.7	1.4	2.0	1.4	-0.6	-1.4
Government debt	51.5	49.2	45.4	44.7	42.6	41.6
Monetary and financial sector	(In percent change, unless otherwise indicated)					
Domestic credit	7.3	10.6	17.8	11.5	13.2	14.0
Of which: Private sector	14.8	16.5	19.9	12.1	16.5	16.6
Broad money	7.4	28.8	12.4	9.3	12.2	12.6
Exchange rate (peso per USD, average)	42.2	42.4	44.4	45.5	47.2	47.7

Source: Philippine authorities and AMRO staff estimates

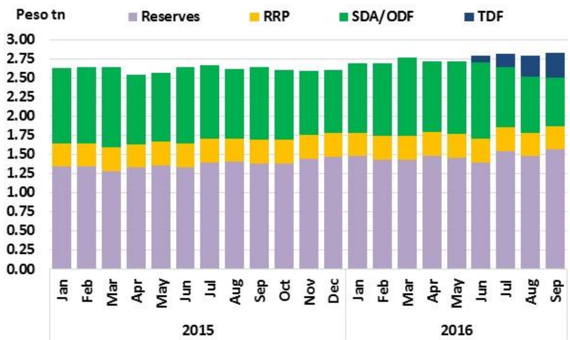
Appendix II. Selected Issues

S.1 Challenges in managing liquidity under the Interest Rate Corridor System

Background

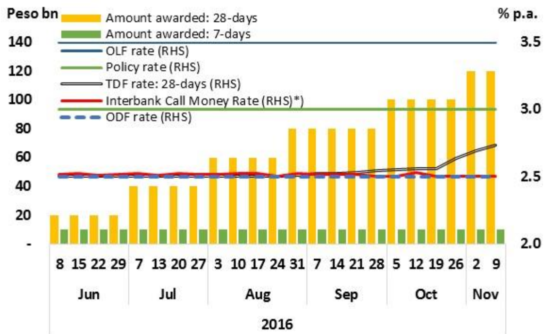
1. **Since 3 June 2016, the BSP has adopted an IRC system as a framework for conducting its monetary operations.** The auction-based TDF is used as a key liquidity absorption facility to withdraw excess liquidity from the banking system. The liquidity absorption is expected to bring short-term interbank rates closer to the policy interest rate, i.e. the interest rate of the RRP facility, from their current level near to the ODF rate.[10] Subsequently, the use of a narrower corridor is expected to influence the short-term interbank rates to move closely around the policy interest rate, which will become the anchor for the transmission of the monetary policy stance to the rest of the economy. Since its implementation in June 2016, the BSP's TDF auctions have absorbed excess liquidity in the banking system, including shifting excess liquidity from the ODF to TDF (Figure S1, S2).

Figure S1. Outstanding of Monetary Operation and Reserves



Source: BSP

Figure S2. TDF Auction: Amount Awarded & Interest Rates



Note: *) weekly average
Source: BSP

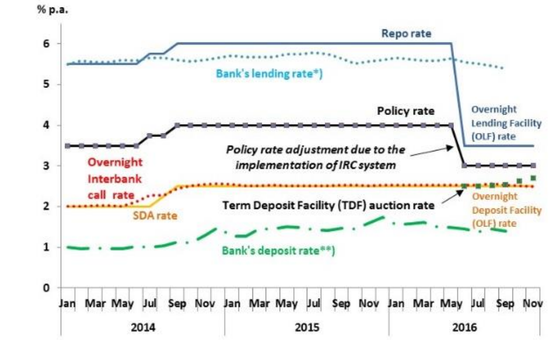
Impact on Market Interest Rates

2. **Although some excess liquidity has been absorbed, interbank money market interest rates has remained at a level close to the ODF interest rate, as liquidity is still ample, with the spread between the ODF rate and bank deposit rates remaining positive (Figure S2, S3).** Since the first auction on 8 June 2016, TDF rates have been stable at 2.5 percent until 24 August, and then increased gradually by 23.7 bps from then until 9 November 2016. The still-low interbank interest rates indicate that the interbank market is still in a condition of excess supply while banks with excess liquidity still have an option to place funds in the ODF[11] at a higher interest rate than the bank's own deposit rate. The ample liquidity in

[10] The Special Deposit Account (SDA) term facility was replaced by a standing ODF and the auction-based TDF. Non-resident funds are prohibited in the TDF and ODF.
[11] The ODF is unlimited in volume to help absorb any residual system liquidity and constraint market rates from falling below the corridor.

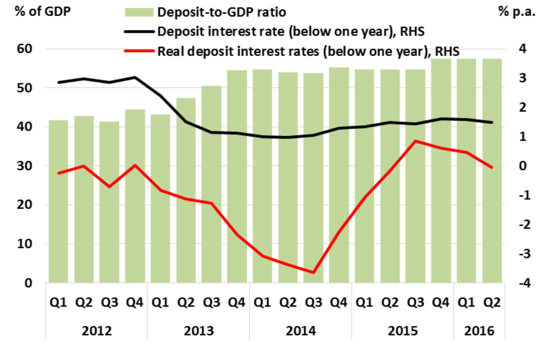
the banking system can also be observed from the continued increase in the deposit-to-GDP ratio despite low deposit rates and negative real deposit rates (Figure S4).[12]

Figure S3. Interest Rates



Source: BSP

Figure S4. Deposits



Source: BSP, PSA

3. **Going forward, further liquidity absorption may put upward pressure on the TDF rate, interbank money market interest rates, and deposit interest rates**.[13] The amount awarded in the 28-day TDF auction has steadily increased since the first auction on 8 June 2016 (Figure S2). If the quantity targets continue to be raised, the weighted average of TDF yields will move towards the policy interest rate, putting upward pressure on the interbank rates. Although the policy rate is kept unchanged, this increase in the interbank rate can be passed through to deposit and lending rates as those rates are more highly correlated with interbank rates than with the policy rate.[14]

Implications for liquidity management

4. **Further enhancement in liquidity forecasting and managing excess liquidity to support open market operations is warranted**. Liquidity management should take into account the state of the economy, macroeconomic conditions, and risks stemming from excess liquidity.

5. **First, the issuance of additional government securities in the domestic market may tighten peso liquidity.** Since the government will continue to rely more on domestic financing to cover its deficit, the private sector's acquisition of government securities in the primary market will lead to a shift of money from the banking system into the central government account at the BSP. Before the government started spending the funds, this asset

[12] The correlations between deposit growth and deposit rate and between deposit growth and real deposit rate in 2010-2016 are -0.63 and -0.59 respectively.

[13] The implementation of the IRC was intended to provide greater flexibility for the BSP in actively managing liquidity given its inability to issue its own debt securities, except during times of extraordinary movement in prices. By introducing the Term Deposit Facility (TDF) which is auction-based, the IRC system intends to absorb bulk of the liquidity through the 7-day and 28-day TDF. Meanwhile, the overnight RRP facility, which is the main policy tool, will be the BSP's fine-tuning instrument that will help ensure that short-term market rates will converge closer to the BSP policy rate. It is expected that in the long term, the IRC system will reduce the country's reliance on reserve requirements (RR) for sterilization purposes, allowing the BSP to reduce RRs in line with regional norms.

[14] The implementation of the IRC was intended to provide greater flexibility for the BSP in actively managing liquidity given its inability to issue its own debt securities, except during times of extraordinary movement in prices. The BSP's stock of collateral could not be expanded to absorb a large part of the structural liquidity. For this reason, liquidity has been absorbed more through a combination of reserve requirement ratio (RRR) policy and SDA than though the RRP. As a result, the SDA rate became an important driver of market interest rates in the pre-IRC period.

portfolio shift may temporarily tighten peso liquidity and raise the interbank rates. The effect of this portfolio shift on peso liquidity will be larger if the government issues its new securities in a front-loading manner.

6. **Second, the liquidity in the banking system may be eased when the government starts to increase its spending.** Increased government spending especially on infrastructure, together with its crowding-in effect on private investment, in turn, will expand the holdings of deposits by firms and households. However, the increase in deposits may not be followed by a commensurate expansion of bank loans, thus increasing excess peso liquidity in the banking system.

7. **Third, increased external financing of the fiscal deficit and FDI could also ease peso liquidity**. Despite the government's reliance on domestic financing, an increase in the budget deficit target could also increase external financing, which in turn will add more peso liquidity. In addition, the government's intention to ease restrictions on foreign investment will lead to more capital inflows and could boost peso liquidity. The excess peso liquidity resulting from the above-mentioned conditions would need to be absorbed if the excess liquidity poses significant risks to financial stability and price stability.

8. **Fourth, peso liquidity could tighten in the event of a prolonged balance of payment deficit.** The recent moderation in the net inflows of portfolio capital and income amidst the prolonged period of weak exports and expanded imports of capital goods, if sustained, may lead to a deficit in the balance of payment, a reduction in the gross international reserves and contraction in peso liquidity. In this event, the central bank may need to inject liquidity into the system. For this reason, it is necessary to ensure the IRC's effectiveness in managing domestic liquidity in the banking system.

9. **Monetary operation has gradually shifted the excess liquidity placed in the BSP's monetary operation instrument from the ODF to the TDF, which has longer maturity.** A faster absorption of excess liquidity using the TDF would strengthen the monetary policy framework and allow monetary policy to respond pre-emptively to the risks of the economy overheating or an escalation in financial stability risks. Subsequently, once the existing excess liquidity is fully absorbed, the BSP has room to reduce the required reserve ratio on banks gradually and absorb the reserve through the TDF auction. However, this excess liquidity shifting should be managed cautiously as this may signal a change in the monetary policy stance, unless supported by appropriate policy communication.

10. **To further improve its monetary operation, the BSP should issue its own debt certificates/ securities as its main instrument of open market operations.** This instrument is expected to enhance the absorption capacity of excess liquidity and guide the movement of

the interbank bank rates around the policy rate thus further enhancing the monetary policy transmission. The BSP is currently pursuing various amendments to the BSP Charter to enhance its capacity and ability to promote price and financial stability.[15] These amendments include an increase in capitalization from 50.0 billion pesos to 200.0 billion pesos, and the reinstatement of authority to issue debt certificates/ securities for the purpose of conducting open market operation. The new central bank law is expected to come into effect next year since it is already included in the priority list of legislations to be amended by the Congress of the Philippines.

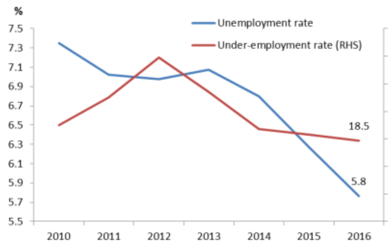
[15] According to the New Central Bank Act of the Philippines 1993 (Republic Act No. 7635 Sec. 92), the BSP has no authority to issue debt certificates/ securities, unless that issuance is made only in cases of extraordinary movement in price levels. This results in its reliance on the reserve requirement and SDA to absorb excess liquidity of the peso as a consequence of having a high level of international reserves.

S.2 Downside risks to employment and growth stemming from the ban on labor-only contracting

Background: Wage Income and Labor Supply Conditions

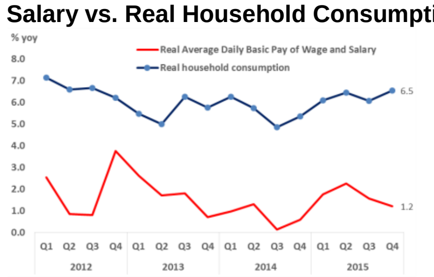
11. **Philippines' economic growth has been characterized by a lack of quality employment and the low contribution of wage income on consumption.** Economic growth has remained strong despite having faced problems of prolonged underinvestment, persistent underemployment[16] and protracted external headwinds.[17] The unemployment rate has continued to decline but underemployment has remained persistently high (Figure S5), reflecting a lack of quality employment and labor absorption in the formal sector, as well as indicating low upward pressures on wages. Real wage growth has persistently been below real household consumption growth (Figure S6) and the unemployment rate has a weak and negative correlation with real GDP growth, as indicated in Figure S7, reflecting the low contribution of wage income on household consumption and growth. Moreover, the historical average elasticity of labor supply with respect to change in real wage is quite high at 1.6[18] with most of the elasticities from Q1 2009 to Q4 2015 are more than one (Figure S8), reflecting abundant supply of labor that leads to workers' low bargaining power.

Figure S5: Unemployment & Under-employment*)



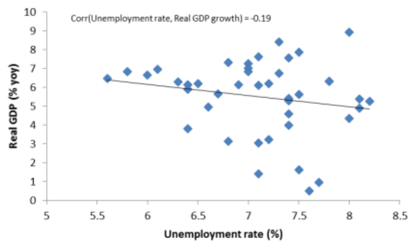
Note: *) average of quarterly data
Source: PSA

Figure S6: Real Average Daily Basic Pay of Wage and Salary vs. Real Household Consumption



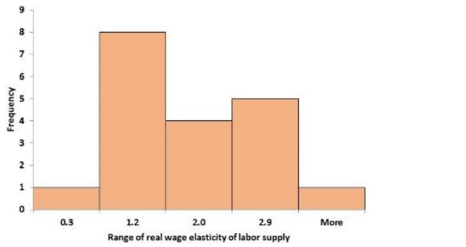
Source: PSA, AMRO staff calculations

Figure S7: Unemployment rate vs. Real GDP growth



Source: PSA, AMRO staff calculations

Figure S8: Real Wage Elasticity of Labor Supply



Source: AMRO staff calculations

[16] According to the Philippine Statistics Authority, "unemployed" consists of persons in the labor force who are reported as (1) without work; and (2) currently available for work; and (3) seeking work or not seeking work because of the belief that no work is available, or awaiting results of a previous job application, or because of temporary illness or disability, bad weather or waiting for rehire or job recall. "Underemployed" refers to the employed persons who express the desire to have additional hours of work in their present job or an additional job, or have a new job with longer working hours.

[17] The sustained strong economic growth was mainly due to household consumption resilience with the support of robust income from OFW remittances, strong growth of business process outsourcing and low inflation.

[18] The average real wage elasticity of labor supply is calculated as the average **positive** elasticity from Q1 2009 to Q4 2015 using quarterly data of index of average real daily basic pay of wage and salary workers, as a proxy of real wage (w), and index of labor force (LF) as a proxy of labor supply. The quarterly elasticities are calculated as $\varepsilon_t = \left(\frac{LF_t - LF_{t-4}}{LF_{t-4}}\right) / \left(\frac{w_t - w_{t-4}}{w_{t-4}}\right)$

Regulation on Labor-Only Contracting

12. **As an effort to improve the level and sustainability of labor income, the government has banned labor-only contracting practice that have exploited employees' low bargaining power.** On 25 July 2016, the government issued a labor advisory that prohibits labor-only contracting, a practice popularly known as "endo" or "end-of-contract", in which workers are only hired by their employers for five months to avoid the requirement to regularize their job status and provide them with employment benefit. This policy directive is intended to ensure strict implementation and enforcement of workers' right to security of job tenure.

The Regulation Impact and Risk

13. **This new regulation will have a positive impact on the wage income of employees while putting upward pressures on firms' labor cost which poses a downside risk to labour demand and economic growth.** Firms may respond to this policy by reducing their labor demand if they are unable to pass on the higher cost. The lack of flexibility can be due to high degree of market imperfection, or little capacity to pass on the higher labor cost or offset the increase by enhancing efficiency and productivity. Such a policy may result in the lower real GDP growth if the decline in labor demand outweighs the increase in remuneration.

14. **The growth of value added of the economy has been driven by profit income, which may be associated with low elasticity of profit margins with respect to the increase in labor costs.** The contribution of real profit to real GDP growth can be estimated from the firm's real value added, which is expressed as the sum of real primary inputs, consisting of real labor cost (wL), real consumption of fixed capital or real depreciation of capital (δK), real taxes less subsidies, ($tx - s$), and real profit (Π_t), as shown in (1).[19] The growth of a firm's real value added can be decomposed into the contribution of each of the primary inputs (2). We can apply (2) to the real value added of the aggregate economic agents and estimate the contribution of real profit to real GDP growth.[20] Figure S9 shows that the estimated contribution of real profit to real GDP growth is more than double that of real labor cost contribution. This estimation is based on the share of business surplus to total input, which amounted to 23.9 percent in the Input Output (IO) Table 2006. This proxy of average profit margin for all sectors is lower than the average gross profit margin of 10 conglomerates

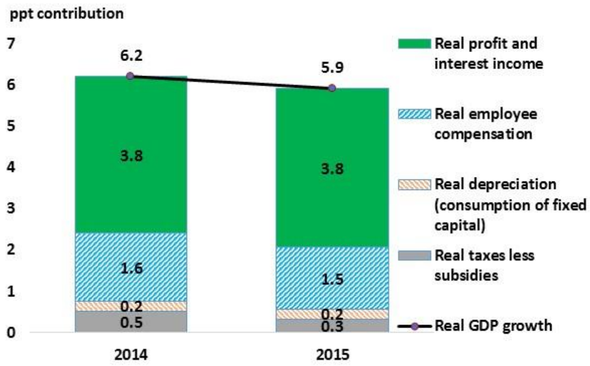
[19] $y_t = w_t L_t + \delta K_{t-1} + (tx_t - s_t) + \Pi_t$ (1)

$$\underbrace{\left(\frac{\Delta y_t}{y_{t-1}}\right)}_{\substack{\text{growth of}\\ \text{real GDP}\\ \text{or real GDI}}} = \underbrace{\left(\frac{\Delta(w_t L_t)}{w_{t-1}L_{t-1}}\right)}_{\substack{\text{growth of}\\ \text{real labor}\\ \text{cost}}}\underbrace{\left(\frac{w_{t-1}L_{t-1}}{y_{t-1}}\right)}_{\substack{\text{labor}\\ \text{share}}} + \underbrace{\left(\frac{\Delta(\delta K_{t-1})}{\delta K_{t-2}}\right)}_{\substack{\text{growth of real}\\ \text{fixed capital}\\ \text{consumption}}}\underbrace{\left(\frac{\delta K_{t-2}}{y_{t-1}}\right)}_{\substack{\text{depreciation}\\ \text{share}}} + \underbrace{\left(\frac{\Delta(tx_t - s_t)}{tx_{t-1} - s_{t-1}}\right)}_{\substack{\text{growth of}\\ \text{real taxes}\\ \text{less subsidies}}}\underbrace{\left(\frac{tx_{t-1} - s_{t-1}}{y_{t-1}}\right)}_{\substack{\text{share of}\\ \text{net taxes}}} + \underbrace{\left(\frac{\Delta \Pi_t}{\Pi_{t-1}}\right)}_{\substack{\text{growth of}\\ \text{real profit}}}\underbrace{\left(\frac{\Pi_{t-1}}{y_{t-1}}\right)}_{\substack{\text{profit}\\ \text{share}}} \quad (2)$$

[20] Assuming that real gross domestic income is equal to real gross domestic product.

in 2011-2015, which stood at 38.6 percent (Table S1). The estimate of profit contribution and profit margin data indicates that the country's growth is driven by profit income, which may be associated with the low elasticity of profit margin with respect to an increase in production cost, including labor costs. As a result, some firms could pass on the cost increase into output prices, fully or partially, without sacrificing their output demand, while others may need to decrease labor demand in order to keep their profits and output prices unaffected.

Figure S9. Estimated Contribution of Profit to GDP Growth*)



Note: *) The growth of real employee compensation is calculated from the growth of average daily basic pay of wage/ salary and inflation. The real consumption of fixed capital is assumed to grow at 2.0 percent and the growth of real indirect taxes less real subsidies is approximated from the growth of nominal national government tax revenue and inflation. The share of employee compensation, consumption of fixed capital, taxes less subsidies and business surpluses refer to their corresponding ratios to total primary input in the Input Output Table 2006. The growth and contribution of the economy's real profit and interest income to the real GDP in 2014 and 2015 is then calculated given the real GDP growth of 6.2 percent and 5.9 percent in 2014 and 2015 respectively.
Source: Datastream, PSA, DOF, AMRO staff calculations

Table S1. Conglomerates' Gross Profit Margin vs. Profit Share in the 2006 Input Output Table

Conglomerate	Main sectors of interest	Gross Profit Margin (%)					
		2011	2012	2013	2014	2015	Average
San Miguel	Food and beverages, power generation, infrastructure	24.1	14.9	14.5	13.5	19.8	**17.3**
SM Investment	Banking, shopping malls, property	24.6	35.7	37.9	37.3	37.6	**34.6**
JG Summit	Shopping malls, property, air travel	27.6	27.8	31.7	33.8	34.2	**31.0**
Ayala	Banking, shopping malls, property, telecoms, infrastructure	27.0	27.3	27.6	27.5	28.5	**27.6**
Philippine Long Distance Telephone (PLDT)	Telecoms, media, power distribution	43.2	74.3	32.0	30.6	27.7	**41.6**
GT Capital	Banking, property, power generation, car dealerships	47.2	47.2	33.5	20.8	22.0	**34.1**
Alliance Global	Property, fast food	28.2	44.4	46.8	44.8	41.8	**41.2**
Aboitiz Equity Venture	Power generation, banking, property	46.9	95.1	95.2	95.0	95.5	**85.5**
Lopez	Power generation, media, property	31.6	33.2	32.0	36.9	38.3	**34.4**
Average		**33.4**	**44.4**	**39.0**	**37.8**	**38.4**	**38.6**
Share of profit in the total revenue; IO Table 2006 (all sector), %		**23.9**					
Share of labor cost in the total revenue; IO Table 2006 (all sector), %		**16.2**					

Source: Datastream, FT Confidential Research, PSA

Policy Implications

15. **To minimize the risk of an increase in wages reducing labor demand and economic growth, policies related to wage improvement in the private sector should be complemented with an increased goods market competition.** Reducing the degree of market imperfection and increasing the market competition could decrease profit margin and output prices. This may lead to higher demand that in turn may offset or outweigh the decline in the profit margin. Firms operating in the highly competitive goods market may be able to absorb the higher wage costs through lower profit margin if demand increases as a result of lower prices. In addition, higher demand for the output, triggered by lower prices, could in turn lead to higher demand for labor and improve workers' bargaining power.

S.3 Tax reform for acceleration and inclusion - Package 1

16. **The Philippines is embarking on a comprehensive tax reform initiative that is packaged into several phases.** It is envisioned to help focus discussion on specific issues in each phase, with a view to ensure the timely enactment. The tax reform program for acceleration and inclusion envisions to create a tax system that is simpler, fairer, and more efficient, characterized by low rates and a broad base, while also raising the resources needed to invest in infrastructure and in people. The main goal is to correct the tax system's inequitable treatment. The government will lessen the overall tax burden of the poor and the middle class. This will be complemented by major tax administration reforms in both the Bureau of Internal Revenue and Bureau of Customs. In addition to tax policy and administration reforms, budget reforms are being pursued to promote spending transparency and efficiency.

17. **The overarching goal of the tax reform is to raise sufficient tax revenue to fund additional infrastructure and social spending, and also to improve the equity and efficiency of the tax system.** Ensuring that the reform is net revenue positive will provide the foundation for medium-term and long-term sustainability of the fiscal accounts, enhance macroeconomic stability, and support the credit rating of the country, and more importantly to steer the country towards an irreversible path of inclusive growth characterized by improved public services; safe, healthy, and peaceful communities, more money in the people's pocket, and a more comfortable life for all. Authorities submitted to Congress the proposed Package 1 reform on 26 September 2016. Package 1 has the following key features: On the personal income tax (PIT), adjust the income brackets to correct for "income creeping," reduce the maximum rate to 25% over time, except for the highest income earners to maintain progressivity, and shift to a modified gross system to simplify the PIT system. Revenue losses from the PIT reform will be offset by i) expanding the VAT base by limiting exemptions to raw food and other necessities (e.g., education and health), ii) increasing excise tax rates on all petroleum products to address negative externalities brought about by congestion and pollution, iii) increasing the excise tax on automobiles to make the tax system more progressive while addressing negative externalities. These increases in various excise taxes will be indexed to inflation to preserve the excise burden. To mitigate the impact of higher oil prices on low income and vulnerable households, highly targeted transfers programs will be used to ensure that the poorest 50 percent of the population is fully protected from the increase in oil taxes, while the next 30 percent, which covers the commuting class, will be protected through indirect subsidies to public utility vehicles.

Personal Income Tax (PIT) Reform

18. **A major overhaul of the Personal Income Tax structure is being proposed with significant implications for individual workers and the economy as a whole.** The proposed reform on Personal Income Tax has the following features: A higher income threshold for the exemption of paying tax, adjust tax brackets to correct for income creeping, reduce PIT max rate to 25% over time, except for the highest income bracket to maintain progressivity, and deletions of certain personal exemptions to simplify tax compliance and administration.[21] As can be seen from Table S2, there is a significant increase in the income threshold for being exempted from income tax, which will result in a smaller tax base. Brackets will be adjusted every five years based on inflation.

19. **The accumulated result of these changes in the structure of the PIT is estimated by the Philippine Department of Finance to result in a loss of 127.4 billion pesos (0.7 percent of GDP) of tax revenues in the first year of implementation.** According to the tax authorities' data, around 4.6 million people in the workforce earn below 250,000 pesos per year and will not need to pay PIT if the proposed threshold is approved, up from 1.7 million people under the current tax system (Table S3).[22] In addition to the higher income tax threshold, tax rates have also been cut except for the highest income bracket to maintain progressivity.

Table S2. Current and Proposed Tax Schedules

CURRENT TAX SCHEDULE

ANNUAL INCOME BRACKET				TAX DUE				
Not over	10,000			5%				
Over	10,000	but not over	30,000	500	plus	10%	of the excess over	10,000
Over	30,000	but not over	70,000	2,500	plus	15%	of the excess over	30,000
Over	70,000	but not over	140,000	8,500	plus	20%	of the excess over	70,000
Over	140,000	but not over	250,000	22,500	plus	25%	of the excess over	140,000
Over	250,000	but not over	500,000	50,000	plus	30%	of the excess over	250,000
Over	500,000			125,000	plus	32%	of the excess over	500,000

PROPOSED TAX SCHEDULE (YEAR 1)

Income Bracket	Tax Rate
0 - 250,000	0%
Over 250,000 - 400,000	20% of the excess over 250,000
Over 400,000 - 800,000	30,000 + 25% of the excess over 400,000
Over 800,000 - 2,000,000	130,000 + 30% of the excess over 800,000
Over 2,000,000 - 5,000,000	490,000 + 32% of the excess over 2,000,000
Over 5,000,000	1,450,000 + 35% of the excess over 5,000,000

PROPOSED TAX SCHEDULE (YEAR 2)

Income Bracket	Tax Rate
0 - 250,000	0%
Over 250,000 - 400,000	15% of the excess over 250,000
Over 400,000 - 800,000	22,500 + 20% of the excess over 400,000
Over 800,000 - 2,000,000	102,500 + 25% of the excess over 800,000
Over 2,000,000 - 5,000,000	402,500 + 30% of the excess over 2,000,000
Over 5,000,000	1,302,500 + 35% of the excess over 5,000,000

Note: Although the current tax schedule states tax due for low income earners, this has been superseded by Republic Act (RA) 9504 passed in July 2008, which stipulates that minimum wage earners will be exempt from paying income tax. Minimum wages are adjusted annually, with non-agriculture minimum wage at the National Capital Region currently set at 491 pesos per day, or 128,151 pesos per annum for a five-day work week.
Source: DOF.

[21] The following exemptions are proposed to be deleted: 50,000 pesos personal exemption, 25,000 pesos additional exemption for each dependent, tax-exempt bonuses and other income.
[22] Minimum wages are adjusted annually, with non-agriculture minimum wage at the National Capital Region currently set at 491 pesos per day, or 128,151 pesos per annum for a five-day work week.

Table S3. Number of taxpayers by income bracket (present and proposed)

PRESENT			PROPOSED (1ST YR)		
Income Bracket	Number of Taxpayers		Income Bracket	Number of Taxpayers	
Min. Wage Earners	1,752,009		0-250,000	4,658,173	No tax
0-10,000	1,280,919		250,001-400,000	447,181	Lower rate
10,001-30,000	250,391		400,001-800,000	357,875	
30,001-70,000	474,072		800,001-2,000,000	114,856	
70,001-140,000	688,120		2,000,001-5m	28,099	
140,001-250,000	533,907		over 5 million	5,593	Higher rate
250,001-500,000	370,544				
over 500,000	262,815				

Source: DOF

20. **Greater equity is the main driving force for reforming the PIT**. The proposed reform is designed to address the phenomenon of bracket creep, wherein people are forced into higher tax brackets due to inflation. The CPI index has doubled from the time the brackets were enacted into law in 1998, pushing middle-income earners into higher tax brackets. The current tax bracket also distorts the wage setting in the labor market for low-income earners, since workers earning at the minimum wage have little incentive to work towards higher wages, as slightly higher wages will result to a low-income wage earner being taxed.

Figure S10. Effective Tax Rates (Lower Income)

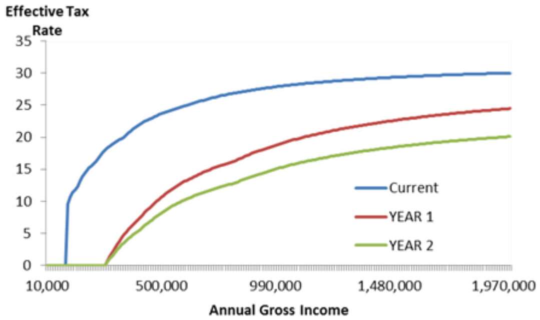
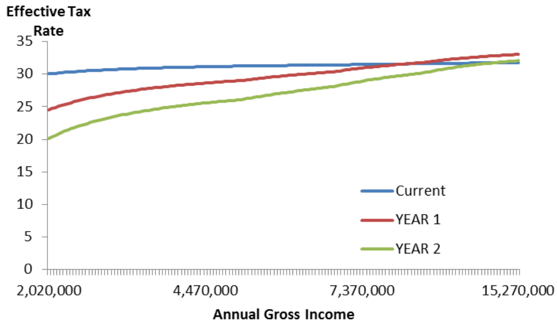


Figure S11. Effective Tax Rates (Higher Income)



Note: Assumes single household with no dependents. Includes personal deduction of 50,000 pesos, SSS, Philhealth and Pag-IBIG deductions. Includes 13th month pay.
Source: AMRO staff estimates

21. **Enhanced progressivity of the tax structure and a lower tax burden (except for those in the highest income bracket) are the main features of the PIT reform.** As shown in Figure S10, the distortion of the tax-free minimum wage which results in a spike in effective tax rates for wages slightly above the minimum wage in the current system is removed by setting a higher income tax threshold. The proposed tax brackets result in a smooth rise of effective tax rates for incomes of 250,000 pesos and above, showing improved equity due to the more progressive nature of the tax structure. The progressivity of the tax structure is extended to higher income brackets (Figure S11). The tax burden, as shown by the effective tax rates[23] across the spectrum of taxpayers, are also markedly lower, except for the highest

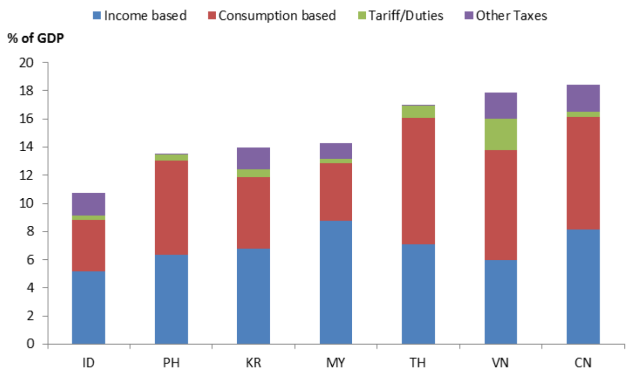
[23] Calculated by dividing income tax by taxable income.

income earners. As already noted, the combination of these changes are estimated by the authorities to result in a revenue loss of around **127.4 billion pesos**, which needs to be compensated from other revenue sources to provide enough funds for additional infrastructure and social expenditure promised by the current administration.

Revenue Compensating Measures

22. **Low tax revenue imposes constraints on government spending on much needed infrastructure and social spending given the ceiling on the budget deficit.** There is a need for enhanced infrastructure spending to support economic growth and targeted social spending to reduce poverty. For the current administration to realize its development vision of increasing infrastructure and social spending over the medium term, it will not only need to offset the loss in revenue from the PIT reform, but also raise additional revenue given the Philippines' relatively low tax effort (Figure S12). Package 1 includes several revenue-generating measures, particularly the broadening of the VAT tax base, excise tax increase on petroleum products and automobile, which will enable a net revenue positive outcome.

Figure S12. Tax Revenue (2015)



Source: CEIC

23. **Several VAT exemptions are proposed to be eliminated in order to expand the tax base.** The passage of the Expanded Value Added Tax (E-VAT) in 2005 enabled the government to increase the overall tax effort and reduce the fiscal deficit. However, since then, several exemptions have been legislated that have eroded the VAT tax base. Using a small sample of 10 countries, an ADB study noted that the Philippines, although having one of the highest VAT rates in the sample, had the lowest VAT collection-to-GDP ratio.[24] With the goal of improving the efficiency of VAT and simplifying VAT administration, the government has proposed the removal of several of these exemptions, particularly for senior citizens, persons with disability, social housing, local/ community cooperatives and electricity transmission companies. **The government estimates that the broadening of the VAT tax base will result in additional revenue of 111.2 billion pesos.**

[24] A Comparative Analysis of Tax Administration in Asia and the Pacific (Manila: ADB, 2016), p.7

24. **To capture some fiscal gains from the currently low global oil prices and impose a cost on the negative externality of pollution, the government proposes to hike excise taxes on petroleum products.** Gasoline and related products' taxes are proposed to increase from 4.35 pesos to 10 pesos per liter. Meanwhile, an excise tax of 6 pesos per liter will be imposed on diesel, kerosene and other related products—from having no excise tax currently. Also under the proposal excise tax shall be indexed by 10 percent annually since excise taxes on petroleum are not indexed to inflation, and thus there has been an erosion on the collection of oil excise taxes relative to total tax revenues. The timing of the hike in oil excise tax may also be appropriate, as the impact on prices may be mitigated by the still low oil prices in the global market. **The authorities' estimate that the additional excise taxes on petroleum products will result in additional revenues of around 145.4 billion pesos.**

25. **For the excise on automobile, there shall be a shift to an ad valorem system that increases and simplifies the computation of excise tax on automobile**. Brackets for the manufacturing price or import price can be indexed to inflation once every two years if the USD exchange rate is more than 10 percent. If more than 20 percent movement in exchange rate, then the full movement of the exchange rate will be the basis for the indexation (Table S4). Buses, trucks, cargo vans, jeepney, single cab chassis and special purpose vehicles are exempted. **Estimated revenue from the automobile excise is around 45 billion pesos.**

Table S4. Brackets for the manufacturing/import price

Net manufacturing/ importation price in pesos	Current (in pesos)	Proposed
Up to 600,000	2%	**5%**
Over 600,000 to 1.1 million	12,000 + 20% in excess of 600,000	**20%**
Over 1.1 million to 2.1 million	112,000 + 40% in excess of 1.1 millions	**40%**
Over 2.1 million	512,000 + 60% in excess of 2.1 million	**60%**

Source: DOF

26. **The combination of measures under package 1 is designed to result in a net revenue gain for the fiscal account.** The combination of revenue enhancing measures under the first package is estimated by the authorities to fully offset the fall in PIT collection, resulting in a net revenue gain of **174.2 billion pesos (1.0 percent of GDP)**.

Changes in the Tax Structure

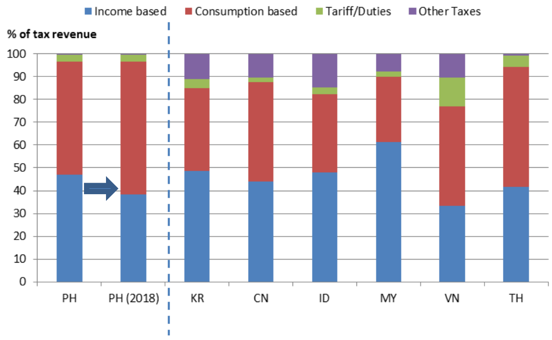
27. **There will be a significant shift of the tax structure away from income taxes to consumption taxes.** From an almost equal share of total tax revenue in 2015 (47.0 percent and 49.5 percent for income and consumption-based tax respectively), the proposed combination of a broader VAT base and higher excise tax could increase the contribution of consumption-based taxes to around 60.0 percent of tax revenue, while income-based taxes will account for around 35.0 percent of tax revenue in 2018 if the reform is passed (Table S5). This will affect individual choices on work, consumption and savings.

Table S5. Current and Projected Tax Structure

Tax Distribution by Tax Type (% of GDP)			
	2015	2018	2019
Income based	6.4	5.5	5.4
PIT	2.3	1.5	1.3
Consumption based	6.7	8.4	8.4
VAT	4.2	4.9	4.9
Excise	1.5	2.6	2.6
Tariff/Duties	0.4	0.4	0.4

Source: AMRO Staff Calculations

Figure S13. Tax Structure in the Region



Source: CEIC, and AMRO Staff Calculations

28. **The proposed reform provides the prospect of improving efficiency in the economy and supporting long-term economic growth.** The lower income tax and higher consumption tax may encourage Filipinos to work more and consume less, thereby increasing savings and the size of the economy in the long-term. The shift towards more consumption-based taxes may also lessen distortion and enhance efficiency in the economy, especially for the VAT, which is applied broadly and has a uniform rate. This action towards removing exemptions actually brings VAT reform closer to its original objective when the law was passed in 2005, before numerous legislative actions introduced exemptions, which not only narrowed the tax base, but also introduced loopholes and additional administrative difficulties in its implementation, thereby reducing efficiency. With such efficiency gains, the broader VAT base imposes less of a headwind to economic growth.

Further, in a country with a characteristically low savings rate, not much might be lost in using consumption as the tax base rather than income. Increased consumption-based taxes may also mitigate the problem of tax evasion and tax avoidance, since even if an individual is able to escape taxation in income, they will still be liable to pay tax through VAT. There is also less incentive for evasion of consumption-based taxes once the system is properly set-up, since fractional VAT payments per transaction are relatively small compared to lump-sum income tax payments.

29. **The change in the tax structure reduces the ability of tax revenue to grow with income and could possibly become less resilient to business cycles.** Less reliance on labor as a tax base may result in lost opportunity for the government to capture higher revenue from the expected demographic dividend in the future, as the Philippines still has a relatively young population. Stability of revenue might also be affected, particularly during peaks and troughs of the business cycle. During such extremes, a mix of taxes usually provides greater revenue stability. However, tax mixes necessarily depend on the economic structure and government policy decisions, with Malaysia, Korea and Indonesia having relatively higher share of income-based taxes, quite similar to what the Philippines has at the moment. With

the proposed reform, the Philippine's tax mix will be closer to that of Thailand and Vietnam (Figure S13).

30. **The impact of the shift towards consumption-based taxes requires further study, as it is not necessarily regressive in all cases, particularly when accompanied by an income tax cut.** The common criticism against greater consumption taxes is that it is regressive, since lower-income households consume a larger fraction of their income than higher-income households. However, for the proposed reform wherein an income tax cut is accompanied by increased consumption taxes, a detailed analysis on the burden of the tax by income group would need to be done to assess the impact.

Challenges and Risks

31. **Lobbying groups may derail the process if the costs and benefits of the tax reform are not clearly communicated to the public.** The challenge for the government is to successfully get the message across that a net revenue gain tax policy reform is needed from Congress to enable government to raise public spending on infrastructure and social services. By selling the reform as a package of measures, this will hopefully mitigate the risk of Congress passing only revenue-eroding measures without off-setting revenue-raising measures. The challenge is that despite a large number of people that are going to benefit from the income tax cut, they may not be properly organized to support the passage of the proposal. On the other hand, lobby groups that will be affected by the compensating measures may have more success in influencing the proceedings. Thus the risk of stalled or delayed process needs to be taken into account.

Table S6. Tax Packages and Revenue Impact

In billion pesos	Loss	Gain	Net
Package 1: PIT and consumption	**-127.4**	**301.6**	**174.2**
Lower personal income tax rate	-127.4		
VAT base expansion		111.2	
Automobile excise		45.0	
Excise tax on oil		145.4	

In percent to 2019 GDP	Loss	Gain	Net
Package 1: PIT and consumption	**-0.7**	**1.8**	**1.0**
Lower personal income tax rate	-0.7		
VAT base expansion		0.6	
Automobile excise		0.3	
Excise tax on oil		0.8	

Source: DOF

32. **The worst outcome would be the passage of the income tax cut without the accompanying revenue-raising measures.**[25] This would cause a significant fall in tax revenue, causing a deterioration of the medium-term fiscal position of the government, and would be a major setback to the current administration's efforts to raise funds for increased infrastructure and social spending.

Conclusion

33. **The proposed initiative is the first step towards comprehensive tax reform that mobilizes adequate resources for nation building.** The proposed net revenue positive tax reform for the first part of the new administration's comprehensive tax reform plan is commendable as it will provide additional resources for public expenditure on infrastructure and social spending. The proposed reform should also be credited for its effort to improve the equity of the tax structure and to improve the efficiency of the tax system. The discussion is still ongoing but the reform is targeted to be passed by December 2016. The success of this first package is crucial, as it will be the test case for the current administration's resolve to raise the additional 2.0 percent of GDP tax revenue from tax measures (see Table S6 for the complete packages) that is needed to increase government infrastructure spending in a sustainable and prudent manner.

[25] Implementation of tax reforms should fully consider the distribution of income, sharing of tax burden, incidence of tax avoidance and evasion, tax compliance, enforcement costs, and transition costs. Also, since efficiency gains from the new tax reforms take time to fully accrue, it is important that these tax reforms should be accompanied by an enhancement in tax administration system.

Appendix III. BSP Macro-prudential Measures

- **Real Estate Stress Test Limits and Expanded Real Estate Monitoring** *(Circular No. 839 dated 27 June 2014 and Memorandum No. M-2012-046 dated 21 September 2012)*. To identify potential vulnerabilities arising from banks' exposure in real estate and serve as a preemptive measure to strengthen the banking system's ability to withstand a systemic shock emanating from the property sector.
- **Higher Risk Weights and Limits on Non-Deliverable Forward (NDF) Transactions** *(Circular No. 740 dated 16 November 2011 on risk weights and Circular No. 790 dated 6 March 2013 on limits)***.** The regulations imposed higher risk weights for purposes of risk based capital calculation, and limits (20 percent and 100 percent of unimpaired capital for domestic banks, and foreign bank branches, respectively) on NDF transactions. This measure was instituted to curb speculative attacks on the Philippine Peso.
- **Institutionalization of Uniform Stress Testing Program for Banks** *(Memorandum No. M-2014-032 dated 11 August 2014)* to reinforce prudential policy that banks must have sufficient capital to absorb risks**.**
- **Enhanced/New reportorial requirement on motor vehicle loans** *(Circular No. 883 dated 10 July 2015)***, non-performing loans** *(Circular No. 814 dated 27 September 2013 and Memorandum No. M-2014-025 dated 23 June 2014)***, salary loans** *(Circular 837 dated 18 June 2014 and Circular No. 886 dated 8 September 2015)*, and **cross-border financial position** *(Circular No. 850 dated 08 September 2014)***.** This is to strengthen the conduct of financial surveillance as well as identify potential vulnerabilities that may affect the banking system.
- **Prohibition against Non-Residents from Investing in the Special Deposit Account (SDA) Facility** *(Memorandum No. M-2012-034 dated 13 July 2012)* in order to manage excess domestic liquidity in the financial system**.** The BSP limited the participation and placements to the SDA facility by banks/trust departments (TDs)/entities whose funds are obtained directly or indirectly from non-residents.
- **Regulatory Framework for Domestic Systemically Important Banks** (**D-SIBs,** *Circular No. 856 dated 29 October 2014)***.** Reduces the probability of failure of D-SIBs by increasing their going-concern loss absorbency and extent or impact of failure of D-SIBs on the domestic economy.

Appendix IV. 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 for the expenditure and production approaches; released no later than two months after the end of the reference quarter for the first, second, and third quarter estimates (that is, no later than May 31, August 31 and November 29, respectively), and no later than one month after the end of the reference quarter for the fourth quarter estimates (that is, no later than January 31).	-	-	-
Balance of Payments (BOP) and External Position	Available	Quarterly for BOP components, monthly for BOP position only; released every 19th day of the month or the nearest working day to the 19th if this falls on a weekend or is a non-working holiday (for monthly BOP position); released 11 weeks after the reference period (for quarterly BOP components). Quarterly for External Debt; released 11 weeks after the reference period.	-	-	-
State Budget and Government/ External Debt	Available	Annually for National Government budget; the proposed budget is published when submitted to the Congress of the Philippines. Breakdown of quarterly and semester budget are available. Monthly for National Government domestic and foreign debt outstanding; released one month after the reference month.	-	-	-
Money Supply and Credit Growth	Available	Monthly; released two weeks after the reference month.	-	-	-
Financial Sector Soundness Indicators	Available	Quarterly; Indicators are generally released within the next quarter after the reference 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: PSA, BSP, DBM, Bureau of the Treasury (BTr). This preliminary assessment will form the "Supplementary Data Adequacy Assessment" in the EPRD Matrix.