AMRO Annual Consultation Report

The Philippines – 2019

The ASEAN+3 Macroeconomic Research Office (AMRO)

February 2020

Acknowledgments

1. This Annual Consultation Report on the Philippines has been prepared in accordance with the functions of AMRO to monitor and assess the macroeconomic status and financial soundness of its members; identify relevant risks and vulnerabilities; report these to member authorities; and if requested, assist them in mitigating these risks through the timely formulation of policy recommendations. This is being done in accordance with Article 3(a) and (b) of the AMRO Agreement.

2. This Report is drafted on the basis of AMRO's Annual Consultation Visit to the Philippines from September 30-9 October 2019 (Article 5 (b) of AMRO Agreement). The AMRO Mission team was headed by Dr Siu Fung (Matthew) Yiu, Group Head and Lead Economist. Members included Dr Zhiwen Jiao (Country Economist for the Philippines), Mr Paolo Hernando (Back-up Economist for the Philippines), Dr Ruperto Majuca (Back-up Economist for the Philippines), and Dr Wei Sun (Financial Specialist). AMRO Director Mr Toshinori Doi 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 2019 was prepared by Dr Siu Fung (Matthew) Yiu and Dr Zhiwen Jiao with contributions from Mr Paolo Hernando, Dr Wei Sun, and Dr Ruperto Majuca; peer-reviewed by Dr Sumio Ishikawa (Group Head and Lead Specialist) and Ms Diana del Rosario (Economist); and approved by Dr Hoe Ee Khor.

3. The analysis in this Report is based on information available up to 3 February 2020.

4. By making any designation of or reference to a particular territory or geographical area, or by using the term "member" or "country" in this Report, AMRO does not intend to make any judgments as to the legal or other status of any territory or area.

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

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Executive Summary

Since AMRO's last annual consultation report, the external environment facing the Philippine economy has become more adverse with heightened global trade tensions and a deepening global slowdown, but also more supportive with easing global financial conditions and lower oil prices. Reflecting a protracted budget delay, the Philippine economy slowed down sharply in the first half of 2019 but rebounded in the subsequent quarters. Looking ahead, growth is projected to continue to recover as the government ramps up fiscal spending. However, policymakers should remain vigilant to address challenges on growth and financial market volatilities from heightened uncertainties in the external environment.

1. **The Philippine economy slowed markedly in H1 2019 but rebounded sequentially since Q3, reflecting the swing in government spending amid weakening external demand.** Despite the rebound, GDP growth declined from 6.2 percent in 2018 to 5.9 percent in 2019. Against weaker investment and exports, a modest recovery in private consumption has become the main driver of growth. Going forward, growth is expected to continue to recover, led by a further increase in government expenditure. Overall, the economy is projected to grow by 6.4 percent in 2020.
2. **Inflation declined sharply largely due to favorable supply-side developments.** Headline inflation has slid from 5.2 percent in 2018 to 2.5 percent in 2019, within the 2-4 percent target range. As global oil prices and domestic food prices are likely to stay low and demand-side pressure to remain subdued, inflation will continue to be benign. Inflation is expected to pick up to 3.0 percent in 2020.
3. **The external position strengthened on the back of a narrower current account deficit and strong portfolio inflows.** As a result, international reserves increased to a historical high. Going forward, as the government ramps up spending on infrastructure, the current account deficit is likely to widen again. At the same time, capital inflows in the second half of 2019 will likely subside and become more volatile amid heightened external uncertainties. Nonetheless, easy global financial conditions should help sustain portfolio inflows.
4. **Monetary conditions have eased markedly following the BSP's reduction of the policy rate and required reserve ratio (RRR).** However, funding costs to the real economy have remained elevated, in part owing to the time lag in the monetary policy transmission process. Credit growth has continued to moderate, but is expected to pick up in the months ahead as easier monetary conditions translate into lower borrowing costs, while faster government spending boosts investment demand. The banking sector is sound with adequate capitalization and liquidity.
5. **Fiscal revenue has continued to improve following the implementation of the TRAIN[1] law, while fiscal spending was severely constrained by the delay in budget approval, compounded by the ban on public works spending during election period.** The contraction of fiscal spending combined with stronger fiscal revenue, had resulted in a fiscal tightening in the first half of 2019. As the government ramps up disbursement, fiscal spending will continue to expand, thereby injecting a strong fiscal impulse into the economy.

1 TRAIN refers to the first package under the Comprehensive Tax Reform Program that was passed in late 2017 and implemented in 2018.

Nonetheless, the government may miss its fiscal deficit target in 2019 due to time and capacity constraints.

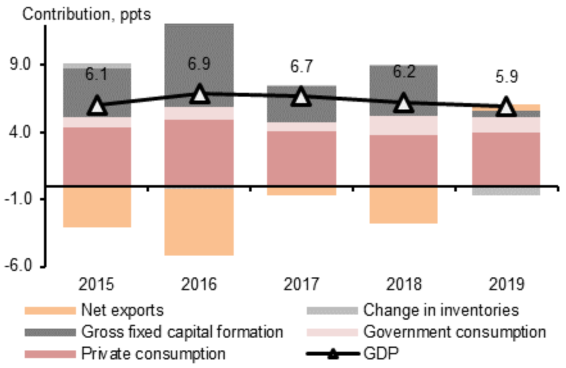
6. **Despite higher budget deficits and borrowing in the last few years, the fiscal position has remained strong.** Although the national government has been borrowing aggressively since 2015 to finance infrastructure investment, the debt to GDP ratio has been stable at a moderate level during the past two to three years. With more infrastructure projects coming on stream, government borrowing needs will remain relatively high. However, the government's commitment to fiscal discipline, the ongoing efforts to raise more revenue, and greater reliance on domestic local currency sources of financing, will help contain fiscal risks.
7. **The main short-term risks facing the economy stem from external sources.** Notwithstanding recent easing of the U.S.-China trade tensions, global policy uncertainties remain elevated while business sentiments remain depressed and continue to weigh on investment spending. These uncertainties could exacerbate the current slowdown of the world economy and increase global market volatilities. On the upside, global oil prices have moderated and global financial conditions have eased following the dovish pivot by major central banks at the beginning of the year, providing a respite for emerging markets central banks. Domestically, policy restrictions on Philippine Offshore Gaming Operators (POGOs) and a ban on the establishment of new economic zones in the National Capital Region may lead to downward pressures on the property markets. For the longer term, sustaining trend growth in productivity after the global financial crisis remains a challenge.
8. **The government's effort to make up for the fiscal underspending in the first half of this year and to avoid any budget delay in 2020 is welcome.** Fiscal spending has picked up in the second half of 2019, narrowing the spending gap significantly. The government's decision on extending the validity of the FY 2019 appropriation for some budget items into 2020 was appropriate and pragmatic. The swift passage of Budget 2020 will allow for timely disbursement and better support the economy in 2020.
9. **Given the subdued inflationary environment, monetary policy should be on an easing bias to support the economy if growth turns out to be weaker than expected.** The reduction of 75 basis points in policy rate and the staggered 400 basis points cuts in reserve requirements since May 2019 have led to a substantial easing in monetary conditions, providing support for a recovery in economic activities in the months ahead. However, if lending rates remain at elevated levels, the BSP may consider a recalibration of its policy mix.
10. **Macro-financial surveillance should be strengthened and potential risks from a downward adjustment in the property market should be closely monitored.** The authorities should continue to enhance the comprehensiveness, coverage and timeliness of financial surveillance database, particularly those of large conglomerates.
11. **Despite the challenging external environment, the current wave of reconfiguration of global supply chains also opens a window of opportunities.** The Philippine authorities should continue to push forward key reforms and ensure effective implementation of ongoing reforms to lay a good foundation for long-term sustainable development. The authorities' continued efforts to improve the doing business environment are also welcome.

A. Recent Developments and Outlook

A.1 Real Sector Developments and Outlook

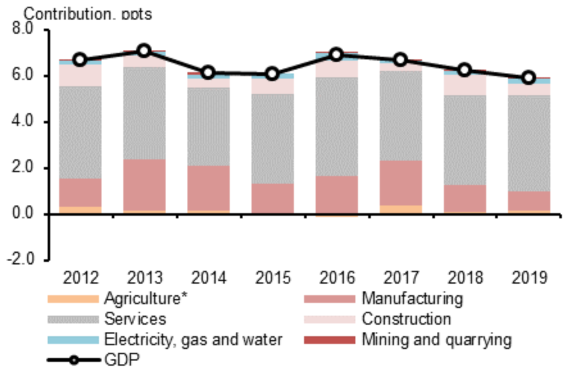
1. Reflecting a protracted budget delay, the Philippine economy slowed markedly in H1 2019 and rebounded sequentially since Q3 2019, reflecting the swing in government spending amid weakening external demand. Real GDP growth rate slid from 6.2 percent in 2018 to 5.5 percent in H1 2019 and rose to 6.4 percent in Q4 2019. On average, GDP grew by 5.9 percent in 2019 (Figure 1), lower than in 2018 and slightly below the government's 6-7 percent target. The slowdown was led by a plunge in capital investment in H1 2019, as government spending was severely constrained due to the budget impasse[2] and infrastructure spending freeze before the mid-term elections in May 2019. As government spending turned around in Q3 2019, investment spending has rebounded and public consumption has accelerated, albeit still slower than in 2018. Meanwhile, weak external demand continued to weigh on the economy. As a result, a modest recovery in private consumption, supported by declining inflation, improving consumer confidence and expansion of employment, became the main source of growth. Reflecting the shift in composition of demand, construction and manufacturing production declined, while the more consumption-oriented services sector held up well (Figure 2).

Figure 1. Real GDP Growth by Expenditure



Source: PSA; AMRO staff calculations

Figure 2. Real GDP Growth by Sector



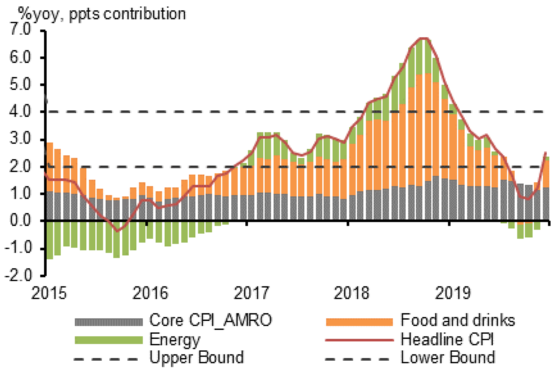
Note: Agriculture includes agriculture, hunting, forestry and fishing.
Source: PSA; AMRO staff calculations

2. **Inflation declined sharply largely due to favorable supply side developments.** Headline inflation fell from 6.7 percent in October 2018 to 0.8 percent in October 2019, dipping below the lower bound of the 2-4 percent target range, then inched up to 2.5 percent in December 2019. On average, inflation declined to 2.5 percent in 2019, 2.7 percentage points lower than in 2018. The sharp drop of inflation was largely driven by lower oil and food prices (Figure 3) on the back of excess supply in the global oil market, better domestic food management, and a base effect from the increase in excise taxes. The implementation of rice tariffication law, together with other government measures has led rice prices to drop

[2] An impasse between the two houses of Congress led to the delayed passage of the General Appropriations Act, only to be signed into law in mid-April, which has typically been passed prior to the start of the fiscal year. In the interim, the government has to operate under a reenacted 2018 budget that excluded appropriations for new or recently approved infrastructure projects, among others. The situation was exacerbated by the moratorium of the construction of public works and the disbursement of public funds in the 45-day period prior to the mid-term election in mid-May 2019.

substantially[3]. Meanwhile, an appreciation of the peso in 2019 also helped dampen price pressures. In addition, the sharp deceleration of inflation combined with the BSP's strong commitment to maintain price stability, has brought down inflation expectations (Figure 4).

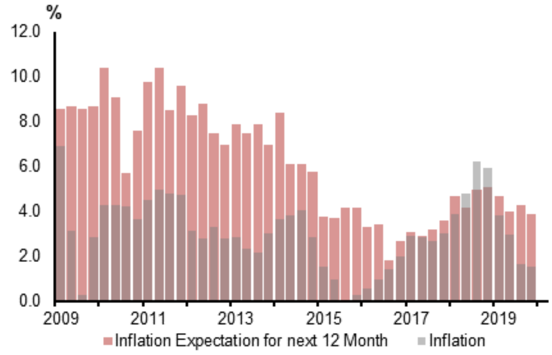
Figure 3. Inflation and Contribution



Note: Inflation data are 2012 based. Here core inflation is calculated by AMRO to exclude all food and energy related components.

Source: PSA; AMRO staff calculations

Figure 4. Inflation and Inflation Expectations

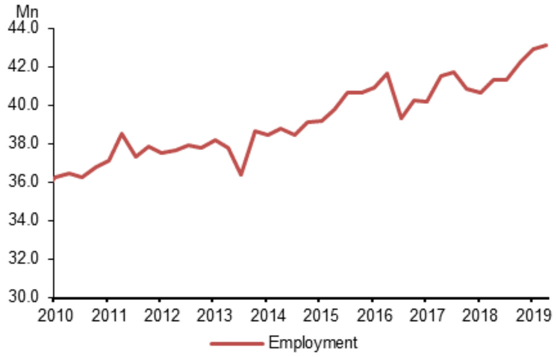


Note: Inflation data are 2012 based.

Source: PSA; BSP; AMRO staff calculations

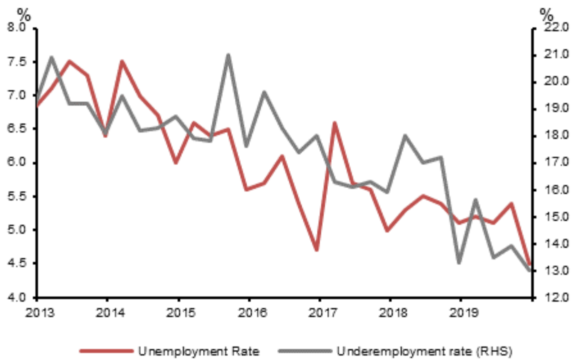
3. **Employment has continued to expand robustly while unemployment rate has remained on a declining trend.** Employment increased from 41.2 million in 2018 to 42.4 million in 2019 (Figure 5), growing by 3.1 percent, slightly higher than 2018. The acceleration of employment expansion was mainly driven by faster job creation in the services sector, especially wholesale and retail, transportation, accommodation and food services and public administration and social security. However, employment in manufacturing declined, the first time since 2009, in part due to tepid exports. Thanks to continued employment expansion, the unemployment rate has edged down from 5.3 percent in 2018 to 5.1 percent in 2019, while the underemployment rate has declined from 16.4 percent to 14 percent during the same period of time (Figure 6).

Figure 5. Employment in the Philippines



Source: PSA; AMRO staff calculations

Figure 6. Unemployment Rate and Underemployment Rate



Source: PSA; AMRO staff calculations

[3] The average farmgate price of palay has declined from its peak of 20.5 PHP/Kg in Q3 2018 to 17.2 PHP/Kg in Q3 2019.

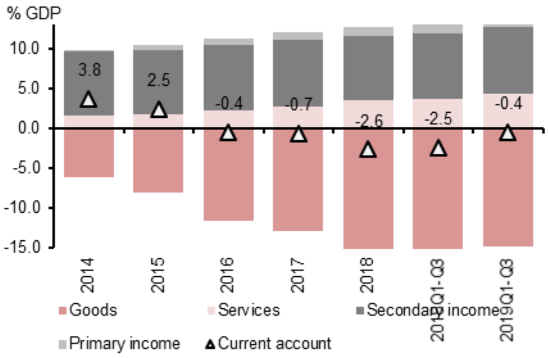
4. **Going forward, economic growth is expected to recover, supported by a strong rebound in government spending.** The ramp-up in government spending is likely to lead to a rebound in investment and stronger government consumption in H2 2019. As part of the disbursement will be cashed out in 2020 together with a larger budget for the year, the recovery of investment will continue into 2020. At the same time, a further recovery of private consumption is likely to be modest in an environment of benign inflation, moderate employment expansion, and stable overseas remittances. In contrast to the encouraging prospect of domestic demand, external demand will remain tepid amid a slowdown in the global economy and lingering trade conflicts among major economies. Overall, the Philippine economy is projected to grow by 6.4 percent in 2020, with the balance of the risks tilted to the downside.

5. **Inflation is projected to remain within the target range in 2020.** The supply-side factors are likely to remain favorable in the foreseeable future. The slowing global economy is likely to keep oil prices at bay and the readiness of shale producers to ramp up production at notice will help contain the risk of short-term supply disruptions. This is reflected in the benign outlook of futures market for oil prices in the next few years. At the same time, with the implementation of the rice tariffication law, domestic rice prices will be more in line with global market prices, and less susceptible to effects of production disruptions due to weather disturbances. In addition, demand-side pressure will remain subdued as the economy is expected to grow around potential. Under such environment, inflation is likely to be relatively stable and low. Inflation is estimated to rise from 2.5 percent in 2019 to 3.0 percent in 2020.

A.2 External Sector and the Balance of Payments

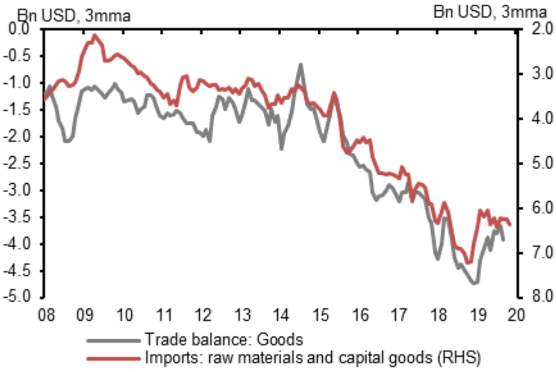
6. **The current account deficit shrank markedly because of the improvement in the balance of goods and services trade and primary income.** The current account deficit narrowed from USD 5.8 billion in Q1-Q3 2018 to less than USD 1.0 billion in Q1-Q3 2019, or from 2.5 percent of GDP to 0.4 percent of GDP (Figure 7). The improvement in the current account balance was driven by an increase in surplus of services trade and primary income and a smaller goods trade deficit as well. While the recovery of tourism can continue to support services trade, the improvement in primary income is likely to be transitory as earnings of domestic companies recover and dividend payments abroad increase. Meanwhile, the rebound in government spending on infrastructure will lead to higher imports of capital goods and raw materials, thereby widening the goods trade deficit going forward (Figure 8). Consequently, the current account deficit is likely to widen after a temporary improvement.

Figure 7. Current Account



Source: BSP; AMRO staff calculations

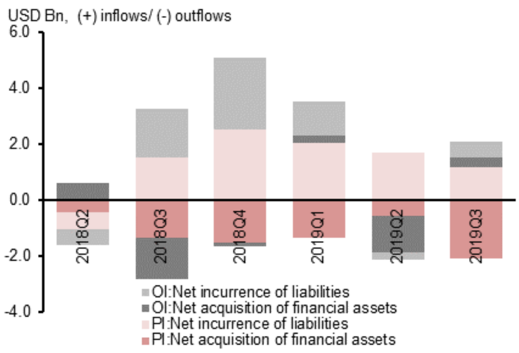
Figure 8. Trade Balance and Imports of Capital Goods and Raw Materials



Source: BSP; AMRO staff calculations

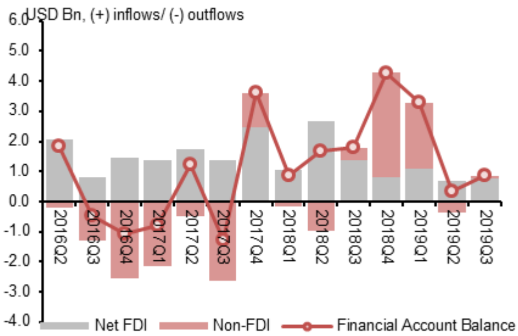
7. **The financial account registered strong inflows, largely driven by an influx of portfolio investments.** Unlike the resident-driven outflows in 2018, the strong portfolio investment in 2019 was mainly driven by an increase in non-residents' holdings of domestic assets, supported by a shift by major central banks to an easing stance and a decline in domestic inflation. On a net basis, portfolio investment recorded an inflow of USD1.0 billion in the first three quarters of 2019, while other investments registered an inflow of USD0.8 billion. On the other hand, FDI inflows declined from USD8.1 billion in Q1-Q3 2018 to USD5.1 billion in the same period in 2019. As a result, net FDI inflows moderated from USD5.1 billion in the first three quarters of 2018 to USD2.5 billion in the same period in 2019. Overall, the financial account witnessed an inflow of USD4.5 billion in the first three quarters of 2019, slightly higher than the same period in 2018. However, capital inflows are likely to become volatile into 2020 amid the heightened external uncertainties.

Figure 9. Non-FDI Capital Flows



Source: BSP; AMRO staff calculations

Figure 10. Financial Account Balance

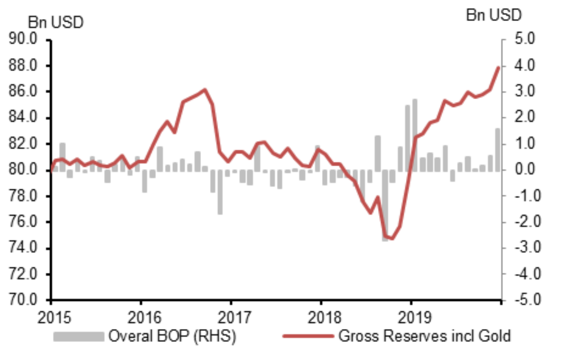


Source: BSP; AMRO staff calculations

8. **The strong capital inflows together with a much smaller current account deficit, led to a strengthening of the external position.** Overall BOP has remained in the positive territory since late 2018. This has not only led to a rebuilding of international reserves from the drawdown in 2018, but also drove them up to a historically high level. Gross international reserves have recovered from USD 79.2 billion at the end of 2018 to USD 87.8 billion as of end-2019 (Figure 11). In terms of adequacy, gross international reserves was equivalent to

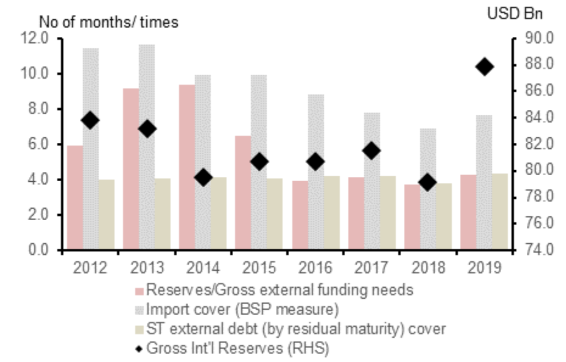
7.7 months of goods and services imports and payments of primary income, and 5.5 times larger than repayment need of short-term debt based on original maturity and 4.3 times based on residual maturity by the end -2019 (Figure 12).

Figure 11. Overall BOP and International Reserves



Source: BSP; AMRO staff calculations

Figure 12. Coverage of External Financing Needs

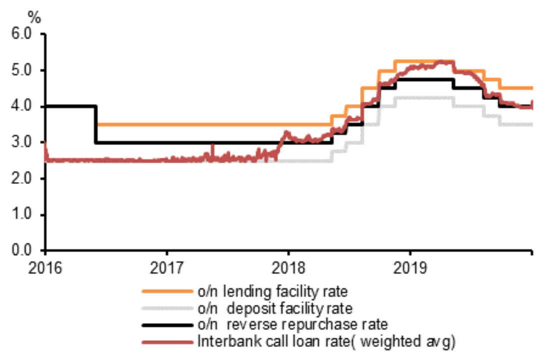


Source: BSP; AMRO staff calculations

A.3 Monetary and Financial Developments

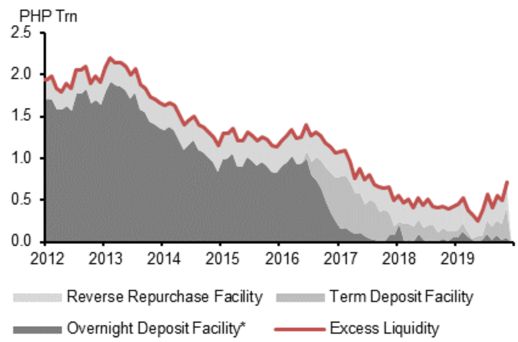
9. Monetary conditions continued to tighten in early 2019 following the monetary policy tightening in 2018, but has started to ease in recent months. The interbank call loan rate rose to the upper band of the interest rate corridor (IRC) and stayed around there in early 2019 (Figure 13). The tightness of monetary conditions was also reflected in the reduction of excess liquidity in the banking system to historically low levels (Figure 14). The unusual tightening in interbank liquidity was due to the front-loading of government bond issuance combined with lower government disbursement due to the delayed budget in early 2019. As a result, the proceeds from bond issuance was deposited into the accounts of the government at the BSP. In view of the growth slowdown, dissipating inflationary pressures and tight liquidity conditions, the BSP has cut interest rate three times by a cumulative 75 basis points and lowered the Required Reserve Ratio (RRR) by 400 basis points since May. These policy adjustments[4] have caused the interbank call loan rate to move back to the center of the IRC and eased the liquidity tightness in the banking system.

Figure 13. Policy Rates and Interbank Rate



Source: BSP; AMRO staff calculations

Figure 14. Banks' Excess Liquidity[5]



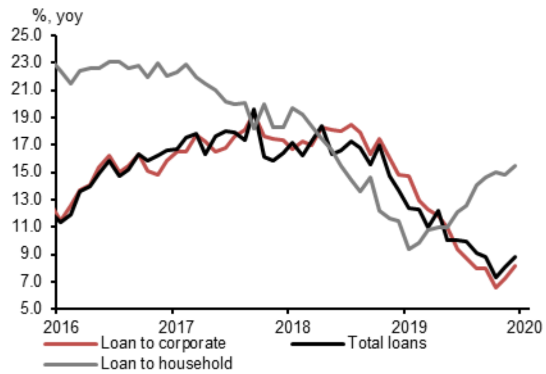
Source: BSP; AMRO staff calculations

[4] Aside from these policy adjustments, there was PHP197 billion Treasury bond matured in late November which the National Government did not replace, also contributing to the liquidity in the banking system.

[5] Note: Starting June 3, 2016, the Reverse Repurchase Agreement and Special Deposit Account were replaced by the Reverse Repurchase Facility and Overnight Deposit Facility, respectively, and a Term Deposit Facility was introduced in line with the implementation of the IRC system.

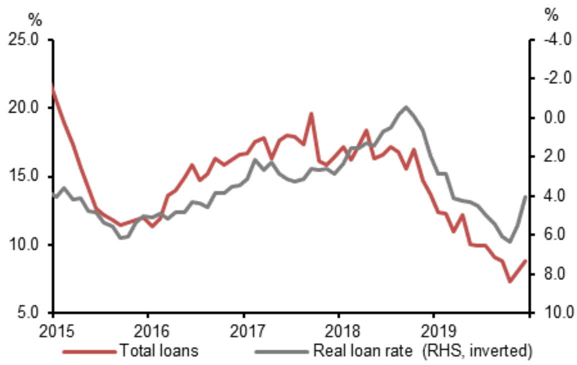
10. **Credit growth continued to moderate but started to pick up in late 2019.** Total loan growth declined to 7.4 percent in October then edged up to 8.1 percent and 8.8 percent in November and December 2019 respectively. The weakness in credit growth was mainly driven by sluggish corporate borrowing (Figure 15), while household borrowing has picked up after the cliff effects of front-loaded auto sales before the tax changes. The deceleration of corporate loans was most pronounced in manufacturing, wholesale and retails, and transportation and storage, owing to higher interest rates and tepid domestic demand. In contrast, lending to construction and real estate has remained strong, likely supported by the ongoing boom in the real estate sector. Looking ahead, credit growth is expected to continue to pick up as easier monetary conditions gradually translate into lower borrowing costs, and faster government spending boosts investment demand (Figure 16).

Figure 15. Bank Loan Growth



Source: BSP; AMRO staff calculations

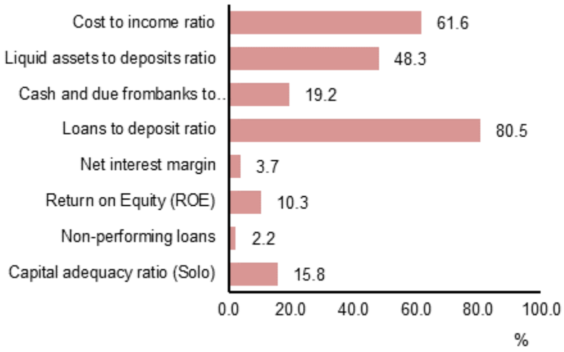
Figure 16. Loan Growth and Interest Rate



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

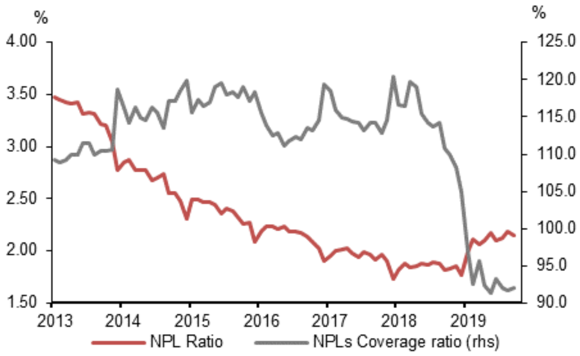
11. **The banking system remains generally sound (Figure 17).** Despite continued rapid credit expansions over the past few years, the capitalization of the Philippine banking system remains broadly stable, reflecting continued supervisory efforts and shareholders' strong financial support. The banking sector capital adequacy ratio on a solo basis has consistently stood above 15 percent since 2011. Overall liquidity in the banking system remains adequate. The Liquidity Coverage Ratio and Net Stable Funding Ratio of universal and commercial banks stayed at 173.1 percent and 130.2 percent on a solo basis respectively, as of end-June 2019, while loan-to-deposit ratio hovered around 80 percent. However, loan asset quality indicators deteriorated somewhat, with non-performing loans ratio rising from 1.8 percent at the end of 2018 to 2.2 percent as of end-September 2019 (Figure 18). At the same time, non-performing loans coverage ratio declined from around 110 percent to close 90 percent. The increase in NPL was due mainly to a stricter loan classification requirements and the bankruptcy of Hanjin Heavy Industries and Construction, the Philippine subsidiary of a major South Korean shipbuilder. Although the Philippine banks' exposure to Hanjin is relatively small, some banks may have to increase their loan loss provisions.

Figure 17. Selected Bank Performance Indicators as of end-September 2019



Source: BSP

Figure 18. NPL Ratio and NPL Coverage Ratio

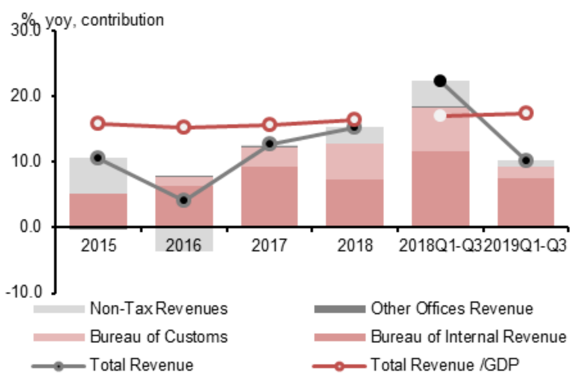


Source: BSP

A.4 Fiscal Sector and Fiscal Soundness

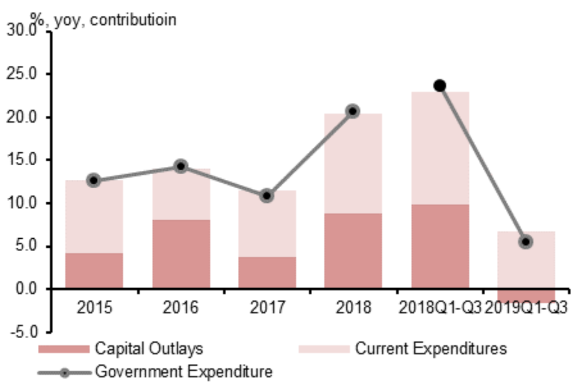
12. **Fiscal strength continues to improve following the implementation of the TRAIN law[6].** Total government revenue increased by 10.2 percent in the first three quarters of 2019, albeit slower than the same period of 2018, but faster than nominal GDP growth. As a result, its share to GDP rose from 16.9 percent in the same period of 2018 to 17.5 percent (Figure 19), the highest level in the past 20 years. The strong increase in government revenue was mainly supported by robust tax revenues, especially from excise tax and income tax from financial transactions, while non-tax revenues growth declined sharply due to some one-off factors. The strong revenue growth is likely to be sustained on the back of tax reforms and improved tax compliance. The implementation of the laws on tax amnesty, rice tariffication, and higher excise taxes on tobacco, will continue to support revenue buoyancy, albeit on a smaller magnitude (see Box 1.).

Figure 19. Fiscal Revenue



Source: Bureau of Treasury (BTr); AMRO staff calculations

Figure 20. Fiscal Expenditure



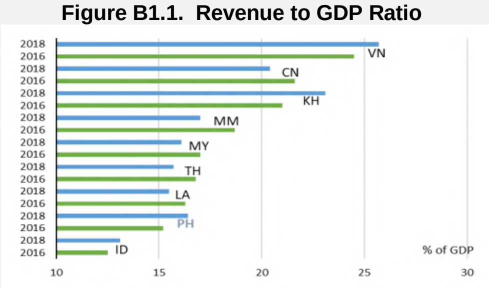
Source: DBM; AMRO staff calculations

[6] The first package under the Comprehensive Tax Reform Program was passed in late 2017 and implemented in 2018, so 2019 is the second year of implementation.

Box 1. Tax Reform in the Philippines[7]

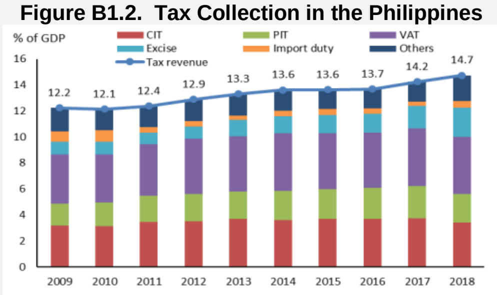
Raising revenue has been one of the major fiscal challenges in the Philippines. While recent reforms implemented by the current administration have markedly raised the revenue-to-GDP ratio, revenue collection still requires considerable improvement to enable the government to fund its development goals in a sustainable manner (Figure 1). In the Philippines, tax is the major source of revenue, accounting for almost 90 percent of national government receipts. Tax revenue can be disaggregated into six major types, with value-added tax (VAT) and corporate income tax (CIT) as the two largest components, accounting for around 32 percent and 27 percent of total tax revenue, respectively. These are followed by personal income tax (PIT, making up 17 percent of total tax revenue, excise tax (10 percent), and import duties (3 percent), while the remainder consists mostly of taxes on interest income, documentary stamp tax, and various types of financial taxes (Figure 2).

Figure B1.1. Revenue to GDP Ratio



Source: National authorities

Figure B1.2. Tax Collection in the Philippines



Source: Department of Finance (DOF)

Increasing tax collection as a stable source of revenue to fund priority programs has been a prime concern of the government. With taxes accounting for the bulk of total revenue, the authorities have embarked on a Comprehensive Tax Reform Program (CTRP) to intensify tax collection efforts in order to finance its infrastructure program and various social spending priorities. The first package of CTRP called the TRAIN[8] Law was passed on 19 December 2017. The legislation reformed PIT, expanded the VAT base, hiked excise taxes and introduced other new taxes such as the sugar-sweetened beverage tax, among other measures. During the first full-year of implementation of TRAIN in 2018, the results were generally satisfactory, as reforms related to TRAIN were able to increase tax revenue by 0.4 percent of GDP. This result fell slightly short of the target of 0.6 percent, as the original proposal to expand the VAT base and raise excise taxes on automobiles had been watered down, although it was partially compensated by the less-than-expected fall in PIT (Table 1). TRAIN will continue to provide incremental revenues to the government via provisions that mandate a staggered increase across several years for particular tax items[9]. This year, a tax amnesty package was passed in February focusing on estate tax and delinquent taxpayers with outstanding cases. It is expected to result in a one-time contribution to revenue equivalent to 0.1 percent of GDP in 2019. In addition to TRAIN, the country also passed a law in June imposing higher rates on tobacco excise tax, and this is estimated to provide additional revenue of 0.1 percent of GDP beginning in 2020.

Table B1.1. Incremental Tax Revenue Increases Related to TRAIN in 2018 (% of GDP)

Type	2018 Target	2018 Actual
PIT	-0.8	-0.6
VAT	0.3	0.1
Excise	0.7	0.5
Others	0.4	0.4
Total	**0.6**	**0.4**

Source: DOF; AMRO staff estimates

Table B1.2. Remaining Tax Reform Packages

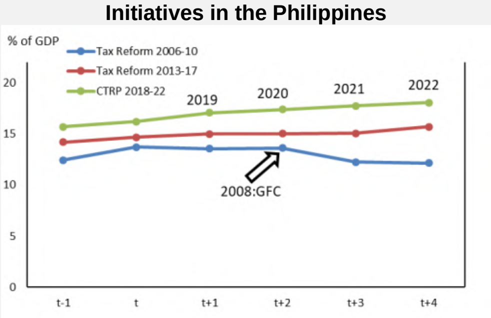
Tax Reform	Salient Features	Impact (% of GDP)
CITIRA	Lower corporate income tax rate and streamlining of investment incentives reform	Neutral
Sin Taxes	Increase in alcohol and e-cigarettes tax	+ 0.2 to 0.3
Real Property Valuation	Update property values closer to market prices and modernize valuation system	+ 0.1
Passive Income Tax Reform	Unification/ simplification of passive income and financial intermediation	+ 0.1

Source: DOF

[7] Prepared by Mr Paolo Hernando.
[8] TRAIN stands for Tax Reform for Acceleration and Inclusion.
[9] For example, excise tax for petroleum is mandated to increase by PHP7, PHP9 and PHP10 per liter in 2018, 2019 and 2020; while excise tax for diesel is mandated to increase by PHP2.5, PHP2.0 and PHP1.5 per liter in 2018, 2019 and 2020.

Passage of the remaining tax reform measures are crucial in attaining the overarching goals of the government. Major remaining components of the CTRP include the Corporate Income Tax and Incentives Rationalization (CITIRA), Sin Tax Reform, Reform Property Taxes and Reform of Passive Income and Financial Taxes (Table 2). These remaining reforms will augment funds needed by the government for infrastructure and social spending, and at the same time improve the equity and efficiency of the tax system. The authorities' target is to raise tax revenue to the equivalent of 16.4 percent of GDP by the end of the current government's term in 2022 (Figure 3). This is an ambitious goal compared to past tax reform programs, but is achievable with the momentum built up from the implementation of successive reforms and the strong push for the passage of additional tax reforms.

Figure B1.3. Evolution of Various Tax Reform Initiatives in the Philippines



Note: t denotes the first year of implementation of the tax reform. The values denoted for 2019 to 2022 are tax revenue targets. All other values are actual tax outturns.
Source: DOF; AMRO staff estimates

Figure B1.4. Evolution of Various Tax Reform Initiatives in the Philippines

Note: Incremental tax revenue change is computed by comparing the ta to GDP ratio between t+4 and t-1
Source: DOF; AMRO staff estimates

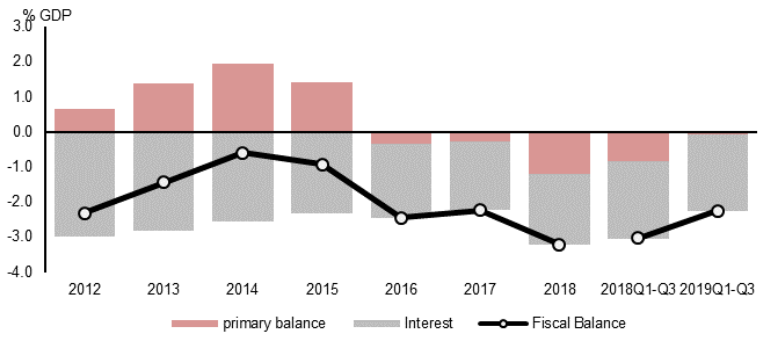
It will be important to build on the success and learn from the past reforms, as previous gains from tax revenue measures were subsequently eroded. In 2006, VAT rates were increased from 10 percent to 12 percent. The VAT base was also broadened by abolishing exemptions for petroleum products, enabling VAT collection to increase. However, subsequent tax policy measures reversed these gains in the following years. In particular, for PIT, general exemptions and allowances were raised and minimum wage earners were exempted in mid-2008; the corporate income tax (CIT) rate was reduced from 35 to 30 percent and VAT on electricity transmission was replaced by a franchise tax in 2009. Tax collections during those years were also heavily affected by cyclical fluctuations, as the 2008 Global Financial Crisis had a significant dampening effect on the Philippine economy and tax collection efforts. In another tax reform implemented in 2013, excise taxes on alcohol and tobacco were raised and generated additional revenue of around 0.3 percent of GDP in the initial year. However, tax collection as a percentage of GDP remained relatively flat thereafter as no further tax reforms were implemented.

The key to preserving gains in tax revenue is by making sustained efforts in enhancing tax administration. It is targeted that, by the end of the current government's term, tax revenue will have increased by more than 2 percentage points of GDP, higher than that realised under previous reforms (Figure 4). This goal will only be achieved if broad-based tax reforms are complemented by continuous efforts to modernize the tax system and improve tax administration to enable tax revenues to grow steadily. Improving the process to ease the burden of filing taxes is very important in encouraging compliance. This would involve constant efforts to streamline steps and simplify procedures to make tax payment transparent, easy to accomplish and less time consuming. The use of information technology and enhanced cooperation across different government agencies also need to be given focused attention. Initiatives to utilize electronic receipts, real-time data and enhanced interconnection and data sharing across government will help maximize the revenue potential by improving compliance and reducing tax leakages. To support the technical and system improvements, parallel efforts are needed to strengthen the institutional framework and capacity building of revenue collection agencies to ensure that personnel are in step with the latest developments and technologies.

13. **Fiscal spending was severely constrained by the delay in budget approval due to an unusually long political gridlock and the ban on public works during the election period.** Despite the government's efforts to alleviate the impact of the delay, fiscal spending fell well behind budget schedule, growing by 5.5 percent in the first three quarters of 2019, much lower than the same period of last year (Figure 20). The slowdown in fiscal spending

combined with stronger fiscal revenue, resulted in a fiscal tightening. Overall fiscal deficit narrowed from 3.0 percent of GDP in the first three quarters of 2018 to 2.2 percent in the same period of 2019 (Figure 21). Excluding interest payments, the primary balance shifted from a deficit of 0.8 percent of GDP to near zero over the same period. Going forward, the government will continue to ramp up disbursement, which will inject a strong fiscal impulse into the economy, particularly through infrastructure spending. Even so, the fiscal deficit may not reach the 3.2 percent of GDP target in 2019, given the time and capacity constraints.

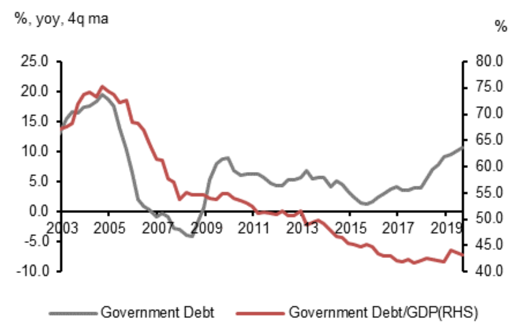
Figure 21. Fiscal Balance



Source: BTr; DBM; AMRO staff calculations

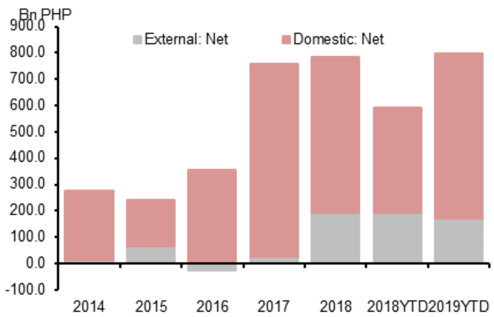
14. **Despite higher budget deficits and borrowing in the last few years, the fiscal position has remained strong.** Although the national government debt has been on a rising trend since 2015, government debt as percent of GDP has remained at relatively low levels over the past 2-3 years (Figure 22). It declined slightly from 41.8 percent of GDP as of end 2018 to 41.5 percent by the end of 2019. The debt decrease mainly came from slower borrowing in foreign debt, while domestic borrowing remains relatively stable. Going forward, with more infrastructure projects coming online, government borrowing needs will remain relatively high. However, the government is committed to prudent fiscal discipline and containing the fiscal deficit to 3.2 percent of GDP in the medium term. Hence, the ongoing efforts to raise more revenue is critical to the efforts to contain the deficit while increasing infrastructure spending. Moreover, greater reliance on domestic local currency sources (see Annex 1.) of financing (Figure 23) will help to reduce the exposure to exchange rate volatility and to alleviate the risks inherent to the banking sector while providing funds for the government's infrastructure program.

Figure 22. Government Debt Level and Growth



Source: BTr; AMRO staff calculations

Figure 23. Government Financing

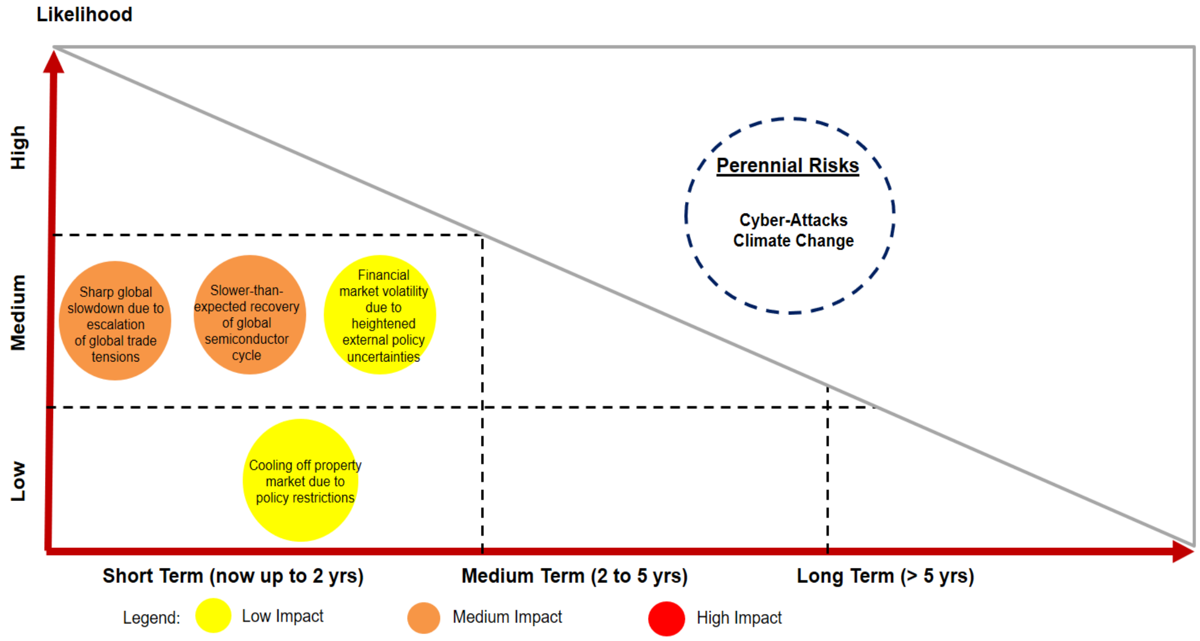


Source: BTr; AMRO staff calculations

B. Risks, Vulnerabilities and Challenges

15. **In the short term, the main risks facing the Philippine economy stem from the external environment**. The uncertainties arising from lingering trade conflicts, policy ambivalence of major central banks, and an imminent Brexit, have eased recently but remain heightened, thereby weighing on an already slowing global economy and setting the stage for broad market volatilities. Domestically, policy restrictions on online gaming industry and on the establishment of new economic zones in the National Capital Region (NCR) may lead to a cooling off of the property markets, putting some pressure on credit growth and banks' asset quality. For the longer term, sustaining high productivity growth remains to be a key challenge for the Philippine government to achieve its vision of becoming a prosperous society free of poverty by 2040.

Risk Map



Source: AMRO

B.1 Near-term Risks to Macro Outlook

16. **Economic growth is set to face more pressure from the deepening global economic slowdown amid heightened trade tensions.** Although the U.S. and China have been raising tariffs on imports from each other, the direct impact on the Philippine economy is estimated to be mild, due to its limited integration into the global value chains compared to regional peers. AMRO staff has estimated that the tariff increases thus far[10] could on average reduce 0.16 percentage points from Philippine GDP growth in 2019 and 2020. However, the higher uncertainty following recent trade conflict escalation has weakened business

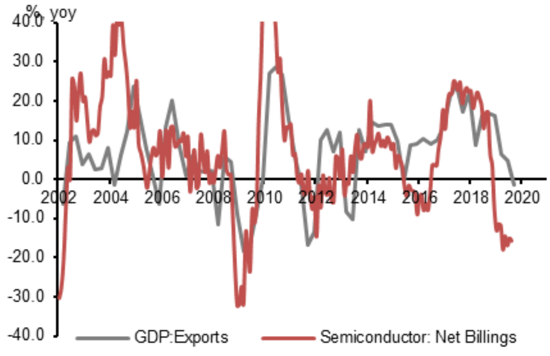
[10] AMRO staff estimate the impact of tariff based on the four rounds of U.S. tariff increases on Chinese goods, comprising three rounds of escalating tariffs set to peak at 25 percent and imposed on USD250 billion of exports, and a fourth round, launched in September 2019, involving a further escalation of the earlier rounds of tariff increase to 35 percent and an additional 10 percent tariff increase on an additional USD115 billion of exports to be effective on October 1

sentiments and delayed investments, increasing the risk of an even sharper global economic slowdown. The cascading effects from a synchronized global slowdown could further exacerbate the export downturn in the Philippines (Figure 24). AMRO estimates that, in an adverse scenario, global slowdown could shave off 0.5 percentage point from GDP growth in the Philippines. In addition, the prospect of exports is clouded by the downswing of the semi-conductor cycle[11], which has shown some early signs of bottoming recently (Figure 25). Given the dominance of electronics products in the Philippines' total exports, a slower-than-expected recovery of the semi-conductor cycle can keep exports depressed and dampen growth.

Figure 24. Philippine Export Growth and Global Export Orders

Source: Markit; PSA; AMRO staff calculations

Figure 25. Philippine Export Growth and Semiconductor Cycle

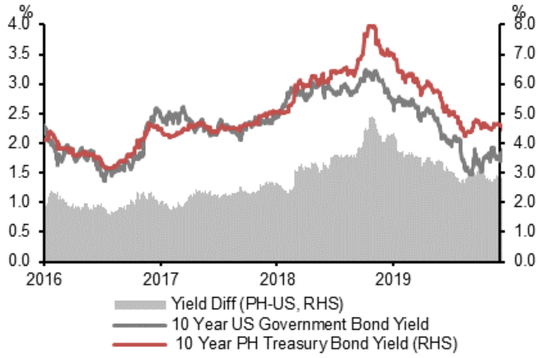


Source: CEIC; AMRO staff calculations

17. **Financial markets and capital flows are likely to witness bouts of volatilities.** The revival in capital inflows to the Philippines and other Emerging Market Economies (EMEs) in general, has occurred in an environment of easing monetary conditions in the U.S. and Eurozone, with weakening global growth. This indicates that the recent performance of financial markets and capital flows is liquidity-driven (Figure 26), which is susceptible to a tightening in global financial conditions. Given the heightened uncertainty of current global environment, global financial conditions can be temporarily tightened by a flare-up of risk events and policy surprises through spikes in risk aversion. The Philippine financial markets could experience similar selloffs as in May and August 2019, should trade conflicts re-escalate, Brexit process becomes disorderly, or the Fed fails to deliver on the rate cuts discounted by markets. As inflation has fallen sharply and bond yields have declined close to their lowest levels in the past three years, further capital gains on the Philippines' government bonds have diminished. The anticipated wider current account deficit in the coming months may add downward pressure on the exchange rate, thus reducing expected returns to foreign investors (Figure 27). However, the easy global financial conditions and the country's resilient economic fundamentals should help sustain inflows.

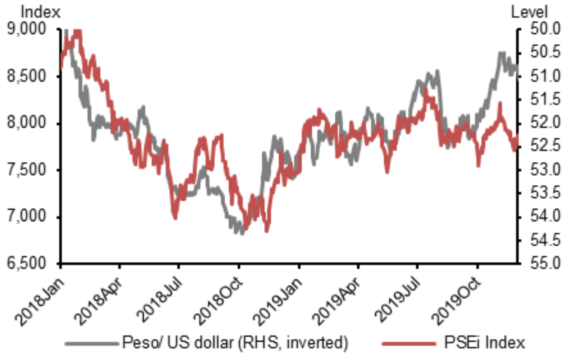
[11] The semiconductor industry may see a recovery of DRAM and NAND demand next year due to inventory drawdown and improving demand from 5G, autos, cloud and IoT.

Figure 26. Philippine and U.S. Government Bond Yields



Source: Bloomberg; AMRO staff calculations

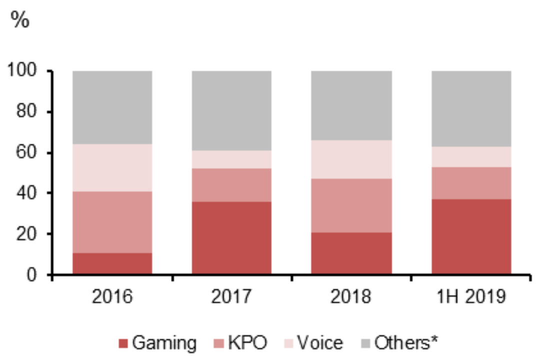
Figure 27. Philippine Equity Market Performance and Peso Exchange Rate against U.S. Dollar



Source: Haver; AMRO staff calculations

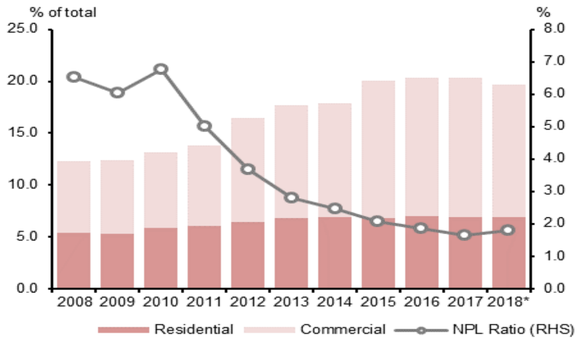
18. **The property market may cool off and could cause distress in banks' loan portfolio.** Foreign investors as well as expatriate employees in the growing business process outsourcing (BPO) and online gaming industries have been an important driver behind the booming real estate market in the Philippines over the past few years, particularly in the Metro Manila area. Some surveys show that the BPO and online gaming industries account for 60-70 percent of office space take-up (Figure 28). The moratorium on new POGO[12] licenses and current policy uncertainties toward this industry, together with the ban on new economic zones in the NCR, will weaken office demand. As a large portion of new office supply in the next 5 years will be in Metro Manila area, the restrictions could lead to lower office and housing occupancy rates and rentals. Meanwhile, China's intensified campaign against cross-border gambling could dampen foreign investment in real estate. This could put downward pressure on office and condominium prices, and cause a downward adjustment in the property markets. Given the large share of the real estate loans in total bank loans (Figure 29), these developments could weigh on credit growth and weaken banks' loan portfolio.

Figure 28. Office Take- up by Sectors



Note: The "Others" segment includes traditional firms, government offices and flexible workspace operators
Source: Colliers International; AMRO staff calculations

Figure 29. Real Estate Loans



Note: The 2018 data was compiled up to Q2 2018
Source: BSP; AMRO staff calculations

[12] POGO refers to Philippine Online Gaming Operator.

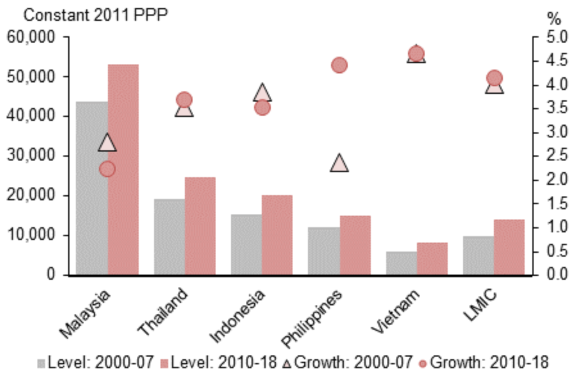
Authorities' View

19. The authorities concur with AMRO's assessment of the risk factors facing the Philippine economy, particularly the uncertainties from the external environment. While the authorities agree that policy restrictions may affect the property market, they believe the impact will be moderate and manageable. This is because there remains a high demand for real estate that could offset the potential loss in the event of POGO exit. Nevertheless, its impact is not contained within the property market, considering its backward and forward linkages to the rest of the economy. Also, policy restrictions on POGOs and setting up economic zones will not only affect the National Capital Region. Data shows that working permits have been granted to POGO companies to operate in major cities outside Metro Manila. It is also worthy of noting that as of June 2019, the Real Estate Stress Test (REST) indicated that the stressed capital adequacy ratio (CAR) and common equity tier 1 (CET1) ratio of the universal and commercial banks (U/KB) industry registered above the 10 percent and 6 percent minimum requirements, respectively, both on solo and consolidated bases indicating manageable credit risk and availability of sufficient capital buffer for the bank's real estate exposures. Besides, the BSP will continue to closely monitor potential risks not only from downward adjustments, but also from other sources within the property market.

B2 Longer-term Challenges

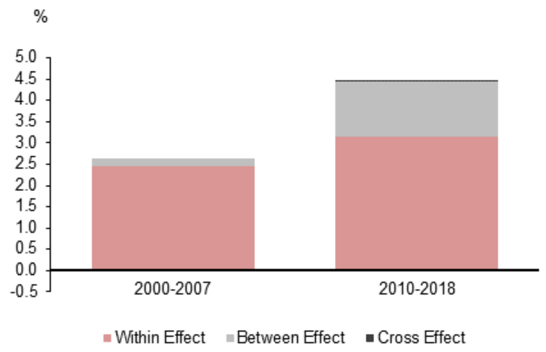
20. **Labor productivity growth in the Philippines has increased substantially after the global financial crisis.** Labor productivity growth has risen to above regional peers in the past three years (Figure 30), supported by strong government infrastructure spending and business-friendly reforms. The improvement offers the opportunity to gradually close the wide productivity gap with regional peers. Among sectors, both manufacturing and services sectors experienced a strong increase in labor productivity (Figure 31). Deeper analysis shows the improvement in labor productivity is driven more by between-sector productivity gains, which on average contributed to around 60 percent of the total increase. Nonetheless, the Philippine economy still relies on within-sector productivity gains, although less than before. The stronger productivity gains from resource reallocation reflects the movement of labor from the low productivity agriculture sector to more productive sectors such as manufacturing and BPO services.

Figure 30. Labor Productivity and its Growth Rate among Regional Peers



Note: Labor productivity here refers to value-added GDP per worker; LMIC refers to lower middle income countries.
Source: WDI; AMRO staff calculations

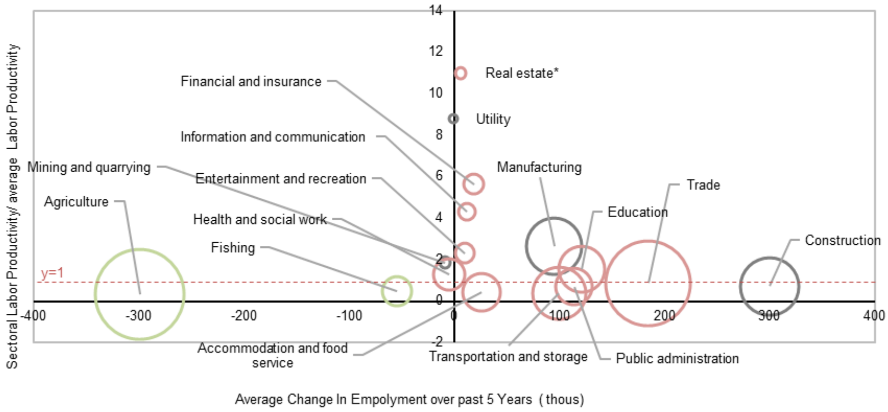
Figure 31. Composition of Labor Productivity Growth in the Philippines



Note: Between-effect is holding the labor share constant; Within-effect is due to labor share change; and Cross-effect is due to both the labor share change and productivity change.
Source: PSA; AMRO staff calculations

21. **Nonetheless, sustaining high productivity growth remains a challenge.** The productivity gains from the shift in sectoral employment derived mainly from the movement into higher productivity services and manufacturing sectors, however, most of the movement from agriculture has been into the low productivity services and construction sectors (Figure 32). The limited reallocation of labor into manufacturing and relatively high productivity services indicate that the expansion of employment in these sectors may be constrained by supply factors, such as a shortage of skilled labor. At the same time, labor productivity in construction sector has declined, indicating inefficiency from the influx of labor from agriculture over the past few years. In the longer term, the sectoral reallocation of employment out of agriculture will continue to underpin the improvement in labor productivity, but sustaining high productivity growth will depend on policies to upskill the labor force and facilitate the entry into the high productivity sectors.

Figure 32. Employment Changes in Each Sector relative to its Productivity



Note: Real estate sector productivity is 23 times the average, it is intentionally lowered to be shown in the chart; the primary sectors are in green, the secondary sectors are in grey and the services are in red.

Source: PSA; AMRO staff calculations

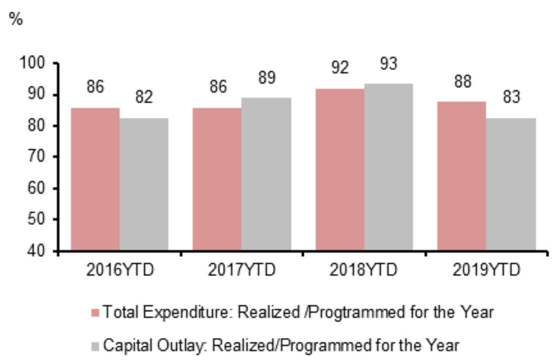
C. Policy Discussion and Recommendations

22. **Given the growing risks from a faltering global economy, macro-economic policies should focus more on supporting growth while guarding financial stability.** The ensuing benign global financial conditions and low domestic inflation have created more room for policy adjustments. As for potential financial risks, more targeted macroprudential measures can be used. In addition to addressing those short-term concerns, the authorities should take the opportunity created by strong political support and the current wave of reconfiguration of global supply chains, to continue pushing forward key structural reforms, to improve the business environment, attract more foreign investment, and lay a solid foundation for long-term sustainable development.

C.1 Fiscal Policy

23. **The government's effort to make up for the fiscal underspending in the first half of this year and to avoid any budget delay in 2020 is welcome.** The government has released a "catch-up plan" in May. It has led to a pick-up in fiscal spending in the second half of 2019. In the first eleven months of 2019, total capital outlays reached 83 percent of the full-year program, albeit still below the average of 88percent in the same period of the past three years (Figure 33). While the gap to spending target has narrowed significantly, and disbursement could have been made to relevant agencies as of end-2019, it remained challenging for projects to fully use the fund by the end of 2019. It would rely on the concerted efforts of relevant line agencies. The government's decision on extending the validity of the FY 2019 appropriation for some budget items into 2020 was appropriate and pragmatic. And the swift passage of the Budget 2020 by the Congress and signed into law by the President will support timely disbursement and allow contractors and projects to tap the fund more sufficiently in 2020.

Figure 33. Progress of Fiscal Spending



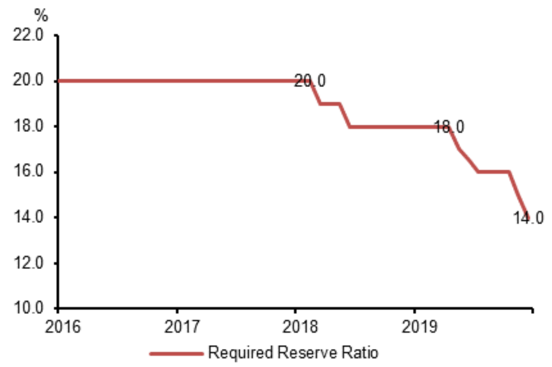
Note: YTD refers data as of November of each year.
Source: DBM; AMRO staff calculations

C.2 Monetary Policy

24. **Given the subdued inflationary environment, monetary policy should be on an easing bias to support the economy if growth turns out to be weaker than expected.**

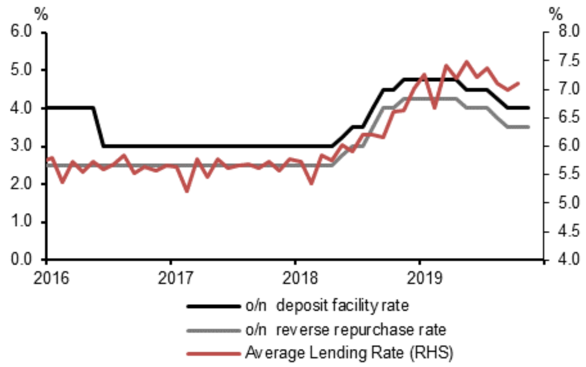
The reduction of 75 basis points in policy rate and the staggered 400 basis points cuts in reserve requirements (Figure 34) since May have led to a substantial easing in monetary conditions, providing support for the recovery in economic activity in the period ahead. However, the average lending rate to the real economy has only edged down slightly and remains elevated around 7.1 percent as of October (Figure 35), 110 basis points higher than at the start of this hiking cycle in May 2018. This in part reflects the time lag in the policy rate transmission process. The liquidity conditions should ease further with the government's acceleration of fiscal disbursement in the coming months, which is likely to lead to a decline in the lending rate. However, if the lending rate remains at elevated levels and credit growth remains weak while the economic recovery is lagging, the BSP may consider a recalibration of its policy mix.

Figure 34. Reserve Requirement Ratio



Source: BSP; AMRO staff calculations

Figure 35. Loan Rate and Money Market Rate



Source: BSP; AMRO staff calculations

C.3 Prudential Policy

25. **Macro-financial surveillance should be strengthened and potential risks in property market should be closely monitored.** To facilitate the effectiveness of financial surveillance, the authorities should continue to enhance data coverage and timeliness, particularly those of large conglomerates. In view of the banking system's large exposure to the real estate sector, the risk from a downward adjustment in the property markets warrants closer monitoring. The BSP, through the Financial Stability Coordination Council, can continue to work closely with other relevant agencies to monitor the development of the real estate sector and developers' financial health, and rigorously assess the potential impact on banks' asset quality. In particular, the BSP should continue conducting stress tests on the real estate sector to better understand the scope and magnitude of the potential impacts. Based on the results of the stress tests, targeted measures and tools can be employed as appropriate in a pre-emptive manner.

C.4 Structural Policy

26. **The government should continue to sustain strong reform momentum and ensure effective and timely implementation of the reforms.** The government's continued

efforts to push forward key reforms[13] to improve the business environment are commendable. A business-friendly environment will facilitate private sector investments, which is not only important for job creation but also critical for enhancing productivity. To that end, effective implementation of the Ease of Doing Business Law is important. Besides, amendments to the Public Service Act, Foreign Investment Act, and Retail Trade Act, should be pushed forward. The passage of these legislations will further improve the business environment and attract more foreign investors. To meet the needs of the investors, sufficient supply of skilled labor is necessary. It may require the refinement of the K-12 basic education program through the skills enhancement of instructors, upgrading certification standards of vocational work, and integration of in-demand skills in the curricula. In general, all reforms should be designed and implemented to ensure that the country becomes a more attractive destination for FDI (see Annex 2.). Greater participation of foreign investors will help enhance market competition and accelerate the technology adoption and diffusion to the local companies.

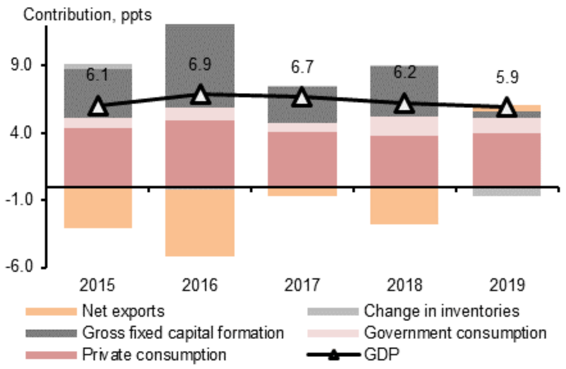
13 Besides those mentioned in the text, other ongoing initiatives which are expected to improve the business environment and enhance productivity and efficiency are the implementation of the Philippine Export Development Plan and strengthening of the National Quality Infrastructure (NQI). The Philippine Export Development Plan 2018-2022 was approved by the President on June 26. 2019. Meanwhile, the Department of Trade and Industry (DTI) is committed to strengthen the country's National Quality Infrastructure Policy to improve quality standards and enhance the competitiveness of the Philippine goods and services. According to the Competitiveness Bureau of the DZTI, the NQI is second in priority under the DTI's present Legislative Agenda. The DTI is currently drafting a new version of the NQI Bill for submission to Congress.

Appendices

Appendix 1. Selected Figures for Major Economic Indicators

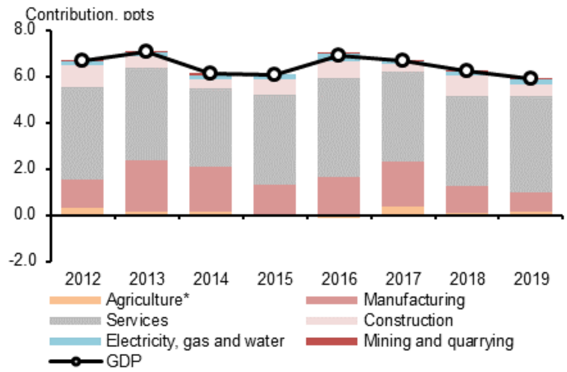
Figure 1.1. Real Sector

Economic growth slowed down in 2019 due to a budget delay and weaker external demand.



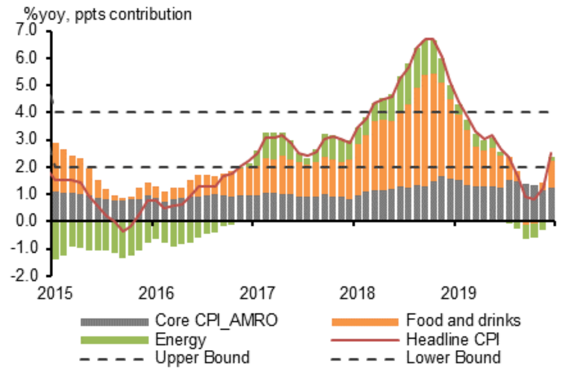
Source: PSA; AMRO staff calculations

While the growth rate of more investment and export-oriented sectors declined, the growth of services sector held up well.



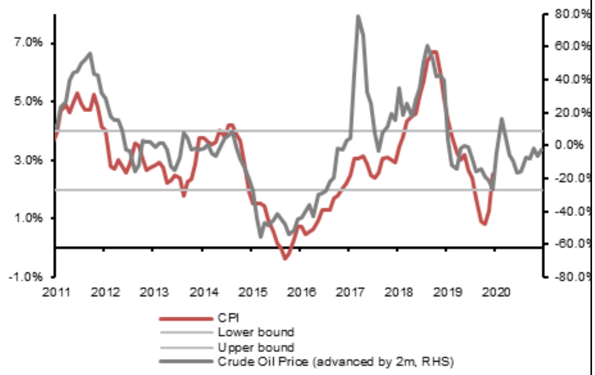
Source: PSA; AMRO staff calculations

Inflation has decelerated sharply, dipping below the target range for several months driven by lower oil prices and better food management.



Source: PSA; AMRO staff calculations

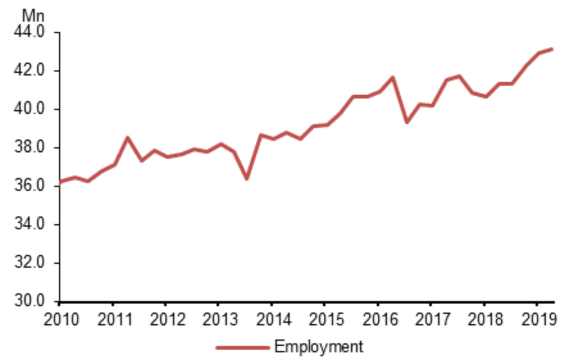
As prospects of supply-side factors seem favorable, inflation is likely to remain in the target range in 2020.



Note: Crude oil prices for 2020 are based on oil future prices curve.

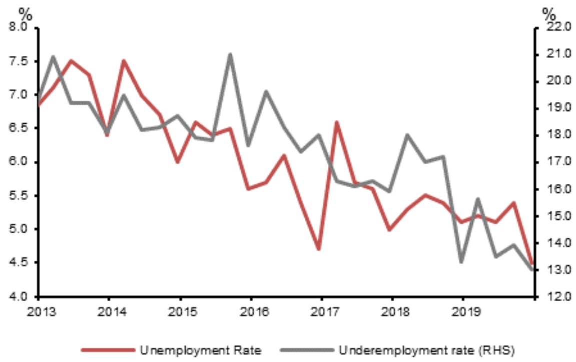
Source: PSA; Haver; AMRO staff calculations

Employment continued expanding robustly, particularly in services



Source: PSA

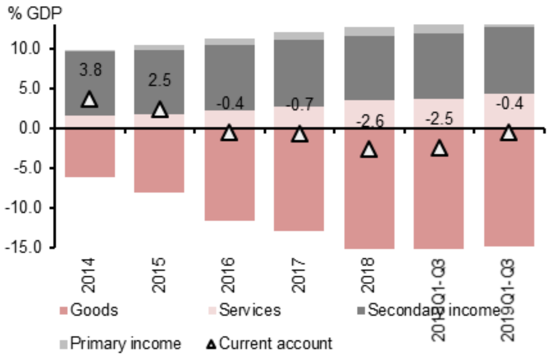
Unemployment rate remained on a declining trend



Source: PSA

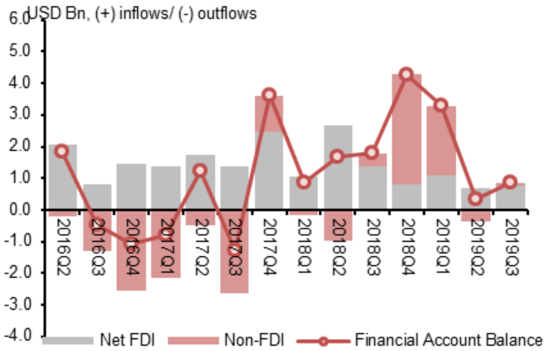
Figure 1.2. External Sector

The current account deficit narrowed noticeably



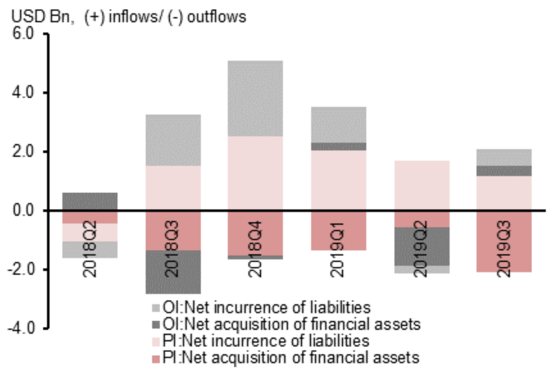
Source: BSP; AMRO staff calculations

The financial account witnessed strong inflows driven by an influx of portfolio inflows



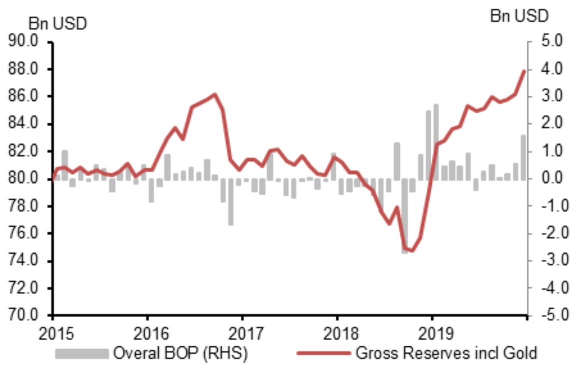
Source: BSP; AMRO staff calculations

The strong portfolio investment was mainly driven by non-residents' increase of domestic financial assets



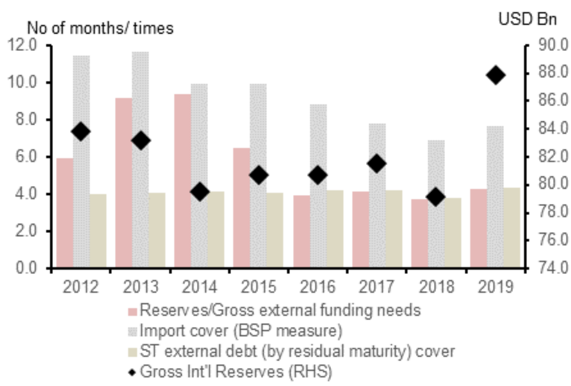
Source: BSP; AMRO staff calculations

The BOP continued to improve and pushed international reserves up to a historically high level



Source: BSP

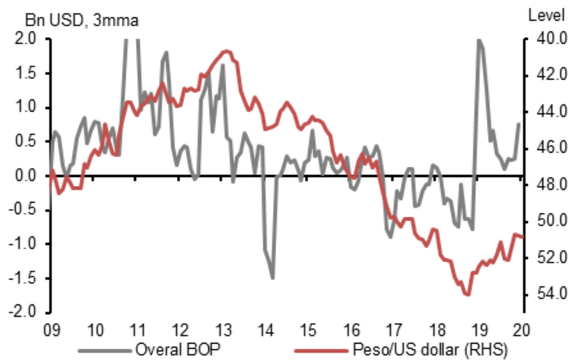
International reserves adequacy has been strengthened



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

Source: BSP; AMRO staff calculations

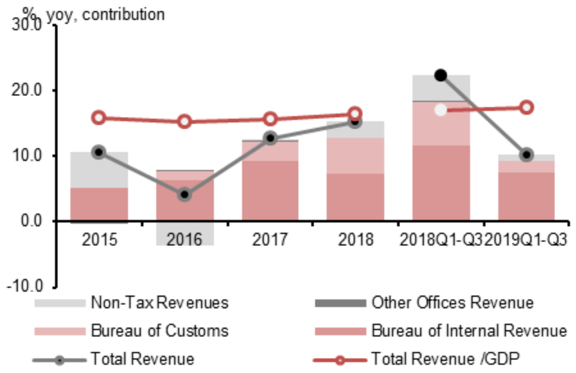
The continued improvement in the BOP also supported a stronger peso



Source: BSP

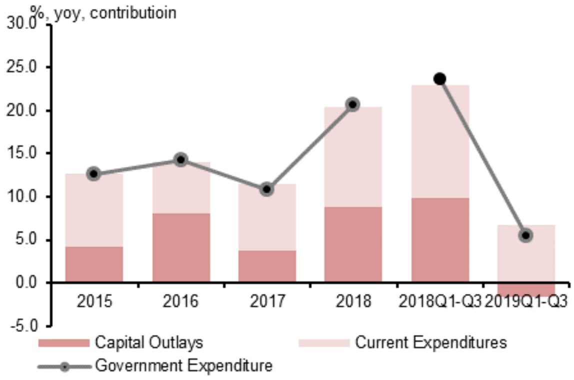
Figure 3. Fiscal Sector

Fiscal revenue collection continued to improve on the back of tax reforms.



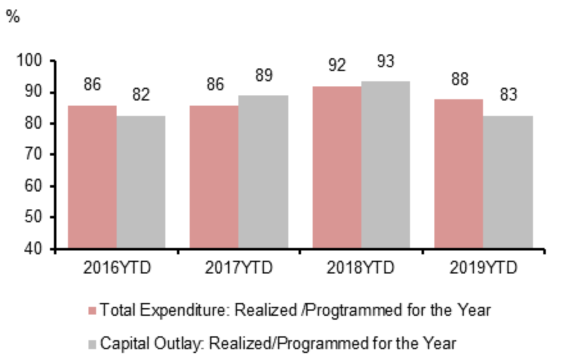
Source: Bureau of Treasury

Fiscal spending slumped due to the 2019 budget delay and a spending ban before the election in May



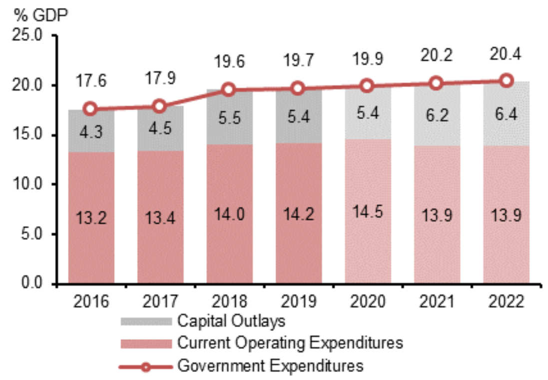
Source: Bureau of Treasury

The government needs significant effort to catch up with the spending target



Note: YTD refers to data as of November.
Source: Bureau of Treasury

For 2020, the government is preparing a larger spending program

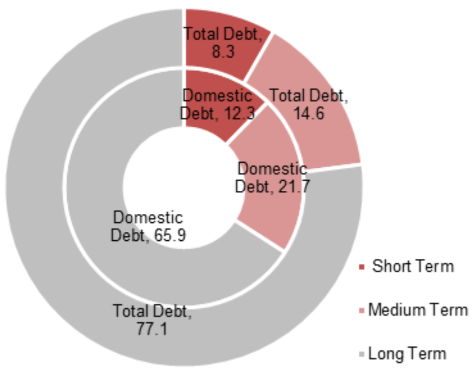


Note: data for 2019-2022 are from the budget.
Source: DBM

Despite strong borrowing, government debt remains relatively low.

Source: DBM

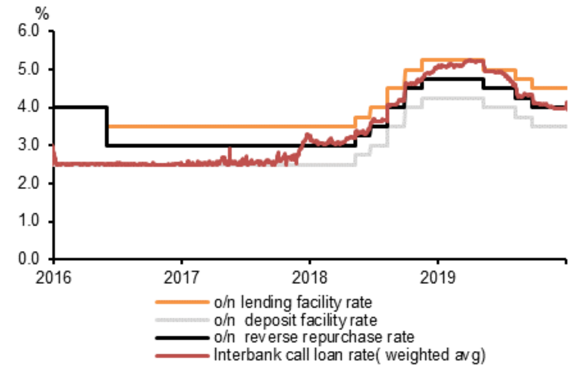
Greater reliance on domestic and long-term sources of funds should help contain debt risk.



Source: DBM

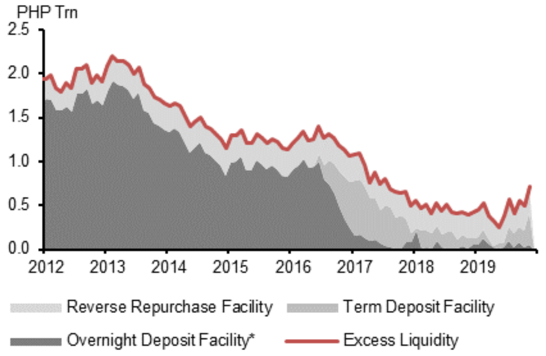
Figure 1.4. Monetary and Financial Conditions

Monetary conditions continued to tighten in early 2019 and eased significantly over the past few months



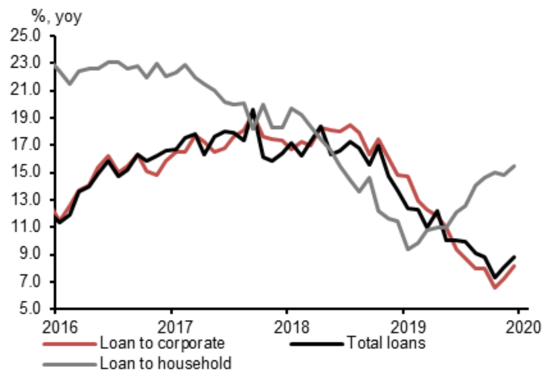
Source: BSP

The tightness of monetary conditions was also reflected in the decline of excess liquidity of banking system



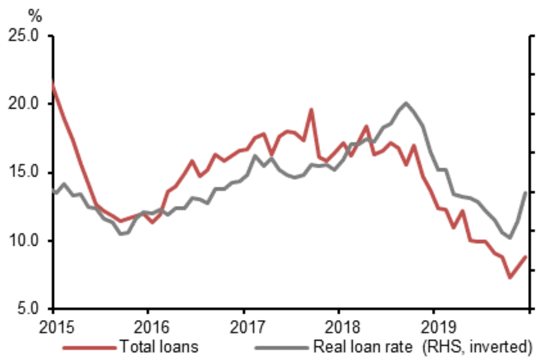
Source: BSP

Credit growth continued to moderate but started to pick up in late 2019



Source: BSP.

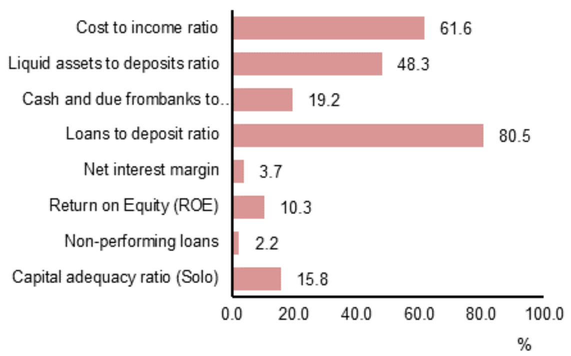
As easing monetary conditions gradually translate into lower borrowing costs and the government accelerates public capital expenditure, credit demand will stabilize and recover



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

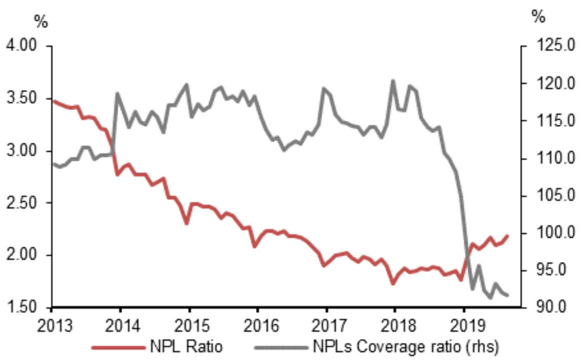
Source: BSP

The banking sector remains generally sound as of end-September 2019



Source: BSP

Some asset quality indicators show signs of weakness



Source: Haver

Appendix 2. Selected Economic Indicators for the Philippines

	2015	2016	2017	2018	Projection* 2019	Projection* 2020
Real sector and prices	(in percent change, unless specified)					
Real GDP	6.1	6.9	6.7	6.2	5.9	6.4
Private consumption	6.3	7.1	5.9	5.6	5.8	6.0
Government consumption	7.6	9.0	6.2	13.0	10.5	9.4
Gross fixed capital formation	16.9	26.1	9.4	12.9	1.5	12.0
Exports of goods and services	8.5	11.6	19.7	13.4	3.2	5.3
Imports of goods and services	14.6	20.2	18.1	16.0	2.1	8.7
Prices						
Consumer price inflation (end of period 2012=100)	0.7	2.2	2.9	5.1	2.5	3.2
Consumer price inflation (period average 2012=100)	0.7	1.3	2.9	5.2	2.5	3.0
Core inflation (period average 2012=100)	1.0	1.6	2.4	4.2	3.2	3.1
GDP deflator	-0.6	1.7	2.3	3.8	0.9	1.6
External sector	(in billions of U.S. dollars, unless specified)					
Current account balance	7.3	-1.2	-2.1	-8.7	-3.8	-9.3
(in percent of GDP)	2.5	-0.4	-0.7	-2.6	-1.0	-2.4
Goods trade balance	-23.3	-35.5	-40.2	-51.0	-50.4	-59.3
Services trade balance	5.5	7.0	8.7	11.6	13.7	15.6
Primary income, net	1.9	2.6	3.2	3.8	5.3	6.2
Secondary income, net	23.3	24.7	26.2	26.8	27.6	28.1
Financial account balance	2.3	0.2	-2.8	-8.6	-9.4	-7.8
Direct investment, net	-0.1	-5.9	-7.0	-5.9	-3.6	-5.4
Portfolio investment, net	5.5	1.5	2.5	1.4	-3.1	-1.9
Financial derivatives, net	0.0	0.0	-0.1	-0.1	0.1	-0.3
Other investment, net	-3.1	4.6	1.7	-4.1	-2.6	-0.8
Error and omission	-2.4	0.3	-1.6	-2.3	2.7	0.0
Overall balance	2.6	-1.0	-0.9	-2.3	7.8	-1.4
Gross international reserves (end-period)	80.7	80.7	81.6	79.2	87.8	86.5
Total external debt (percent of GDP)	26.5	24.5	23.3	23.9	23.6	22.4
Short-term external debt (percent of total)	19.5	19.4	19.5	20.3	21.0	21.5
Fiscal sector (National Government)	(in percent of GDP)					
Government revenue	15.8	15.2	15.6	16.4	16.7	16.9
Government expenditure	16.7	17.6	17.9	19.6	19.6	20.1
Fiscal balance	-0.9	-2.4	-2.2	-3.2	-2.9	-3.2
Primary balance	1.4	-0.3	-0.3	-1.2	-0.8	-1.0
Government debt	44.7	42.1	42.1	41.8	41.5	41.3
Monetary sector	(in percent change, end-period unless specified)					
Domestic credit	11.5	17.0	13.9	14.9	8.3	-
Of which: Private sector	12.1	16.6	16.4	15.1	6.9	-
Broad money	9.3	13.4	11.3	9.0	8.4	-
Memorandum items:						
Exchange rate (peso per USD, average)	45.5	47.5	50.4	52.7	51.9	51.8
Exchange rate (peso per USD, eop)	47.2	49.8	49.9	52.7	51.0	52.0
Gross domestic product at current price (In trillions of pesos)	13.3	14.5	15.8	17.4	18.6	20.1
Gross domestic product at current price (In billions of U.S. dollar)	292.8	304.9	313.6	330.9	358.4	387.7
GDP per capita (in U.S. dollar)	2,882.7	2,953.2	2,989.1	3,104.3	3,310.0	3,526.3

Note: data in light grey are realized data and data in dark grey are AMRO' staff estimates. Data for monetary sector are as of end-November 2019.
Source: Philippine authorities; AMRO staff estimates

Appendix 3. Balance of Payments

	2014	2015	2016	2017	2018
	(in millions of U.S. Dollars, unless specified)				
Current Account (I)	10,756	7,266	-1,199	-2,143	-8,729
Goods	-17,330	-23,309	-35,549	-40,215	-50,972
Exports	49,824	43,197	42,734	51,814	51,985
Imports	67,154	66,506	78,283	92,029	102,958
Services	4,576	5,455	7,043	8,693	11,623
Exports	25,498	29,065	31,204	34,832	38,412
Imports	20,922	23,610	24,160	26,139	26,789
Primary Income	727	1,857	2,579	3,226	3,779
Receipts	8,779	9,503	9,556	10,583	12,066
Payments	8,052	7,646	6,977	7,357	8,287
Secondary Income	22,782	23,263	24,728	26,153	26,842
Receipts	23,446	24,086	25,411	26,897	27,607
Payments	663	823	684	745	765
Capital Account (II)	108	84	62	69	65
Receipts	121	99	77	103	103
Payments	13	15	15	34	38
Financial Account (III)(+ indicates inflows)	-9,631	-2,301	-175	2,798	8,615
Net Acquisition of Financial Assets	-15,004	-6,139	-5,658	-6,717	-7,384
Net Incurrence of Liabilities	5,373	3,838	5,483	9,515	15,999
Direct Investment	-1,014	100	5,883	6,952	5,884
Net Acquisition of Financial Assets	-6,754	-5,540	-2,397	-3,305	-3,948
Net Incurrence of Liabilities	5,740	5,639	8,280	10,256	9,832
Portfolio Investment	-2,708	-5,471	-1,480	-2,454	-1,374
PI:Net Acquisition of Financial Assets	-2,705	-3,343	-1,216	-1,658	-4,740
PI:Net Incurrence of Liabilities	-3	-2,128	-264	-796	3,366
Financial Derivatives	-4	-6	32	51	53
Net Acquisition of Financial Assets	293	531	701	503	679
Net Incurrence of Liabilities	-297	-537	-669	-453	-626
Other Investment	-5,905	3,076	-4,610	-1,750	4,051
OI:Net Acquisition of Financial Assets	-5,838	2,213	-2,746	-2,257	626
OI:Net Incurrence of Liabilities	-66	864	-1,864	508	3,426
Net unclassified items (V)	-4,091	-2,433	274	-1,588	-2,256
Overall BOP (I+II+III+V)	-2,858	2,616	-1,038	-863	-2,306
Change in Reserve Assets	-2,858	2,616	-1,038	-862	-2,305
Memorandum items:					
Current Account (% GDP)	3.8	2.5	-0.4	-0.7	-2.6
Gross International Reserves	79,541	80,667	80,692	81,570	79,193
In months of imports of goods and services	10.8	10.7	9.5	8.3	7.3
Changes in gross reserves	-3,646	1,126	25	878	-2,377
Nominal GDP (USD billion)	285	293	305	314	331

Source: Philippine authorities; AMRO staff calculations

Appendix 4. National Government Operations

	2014	2015	2016	2017	2018
	(In percent of GDP, unless specified)				
Government Revenue	15.1	15.8	15.2	15.6	16.4
Tax Revenue	13.6	13.6	13.7	14.2	14.7
Bureau of Internal Revenue (BIR)	10.6	10.8	10.8	11.2	11.2
Net Income & Profits	6.2	6.4	6.4	6.5	5.9
Excise Tax	1.1	1.2	1.1	1.3	1.7
Sales Taxes & Licenses	2.7	2.6	2.7	2.8	2.6
Others	0.6	0.6	0.6	0.6	0.9
Bureau of Customs (BOC)	2.9	2.8	2.7	2.9	3.4
Other Offices	0.1	0.1	0.1	0.1	0.1
Non Tax & Grant	1.5	2.2	1.5	1.4	1.6
Government Expenditure	15.7	16.7	17.6	17.9	19.6
Current Operating Expenditures	12.8	13.4	13.2	13.4	14.0
Personal Services	4.8	5.0	5.0	5.1	5.7
Maintenance and Other Operating	2.4	3.0	2.9	2.9	3.0
Subsidy	0.6	0.6	0.7	0.8	0.8
Allotment to LGUs	2.2	2.3	2.4	2.5	2.4
Interest Payments	2.5	2.3	2.1	2.0	2.0
Tax Expenditure	0.2	0.1	0.1	0.1	0.1
Capital Outlays	2.8	3.3	4.3	4.5	5.5
Infrastructure & Other Capital Outlays	2.2	2.6	3.4	3.6	4.6
Equity	0.0	0.0	0.1	0.0	0.0
Capital Transfers to LGUs	0.6	0.7	0.8	0.9	0.9
Net Lending	0.1	0.1	0.1	0.0	0.0
Government Balance	- 0.6	- 0.9	- 2.4	- 2.2	- 3.2
primary balance	2.0	1.4	- 0.3	- 0.3	- 1.2
Government Financing	2.2	1.8	2.3	4.8	4.5
External: Net	0.1	0.5	- 0.2	0.2	1.1
External: Gross	1.1	1.4	1.0	1.1	1.7
Project Loan	0.1	0.2	0.1	0.2	0.2
Program Loans	0.0	0.0	0.0	0.0	0.0
Global Bonds	0.5	0.7	0.7	0.6	0.6
Amortization	1.0	0.9	1.2	0.9	0.6
Domestic: Net	2.1	1.3	2.5	4.6	3.4
Domestic: Gross	3.1	3.2	2.5	4.6	3.7
Treasury Bills: Net	- 0.3	- 0.1	0.2	0.2	1.0
Retail Treasury Bonds			0.7	2.8	0.7
Fixed Rate Treasury Bonds	2.3	1.3	1.6	1.7	1.7
Amortization	2.4	2.7	2.2	1.5	1.8
Memorandum items:					
Government Debt	45.4	44.7	42.1	42.1	41.8
Domestic	30.2	29.2	27.2	28.1	27.4
Foreign	15.2	15.5	14.9	14.0	14.4
Short-term(% of Total)	4.9	4.4	4.7	4.7	6.8
Medium-term (% of Total)	6.8	6.7	5.8	12.0	12.6
Long-term (% of Total)	88.2	88.9	89.5	83.3	80.7
Nominal GDP (Trillion, PHP)	12.6	13.3	14.5	15.8	17.4

Source: Philippine authorities; AMRO staff calculations

Appendix 5. Data Adequacy for Surveillance Purposes: a Preliminary Assessment

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

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

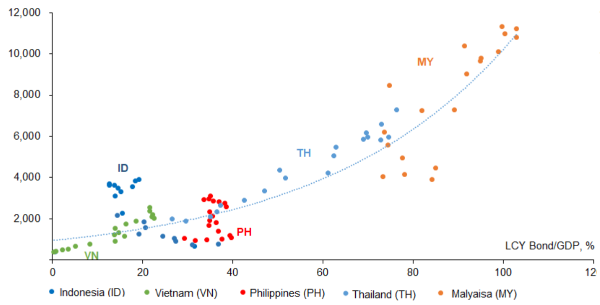
Source: AMRO staff compilations. This preliminary assessment will form the "Supplementary Data Adequacy Assessment" in the EPRD Matrix

Annexes: Selected Issues

Annex 1. Deepening the LCY Bond Market to Support Growth[14]

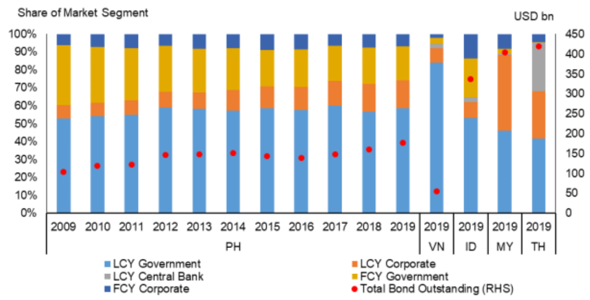
1. **A well-functioning bond market is important for the continued development of the Philippine economy.** At this juncture, the ambitious "Build, Build, Build" infrastructure program in the country calls for a deep and well-functioning bond market to attract investments from home and abroad. The central bank, empowered to issue its own securities by The New Central Bank Act, will rely on this infrastructure to conduct its open market operations. Economic theory indicates that financial deepening is conducive to economic growth (King and Levine, 1993a, 1993b). For that, empirical evidence suggests that the Philippines still has substantial potential to tap on its bond market to support growth (Figure A1.1).

Figure A1.1 Bond Market Depth vs. GDP per capita, 1999-2018



Note: Each node represents an economy-year observation.
Source: AsianBondsOnline and CEIC.

Figure A1.2 Bond Market Composition



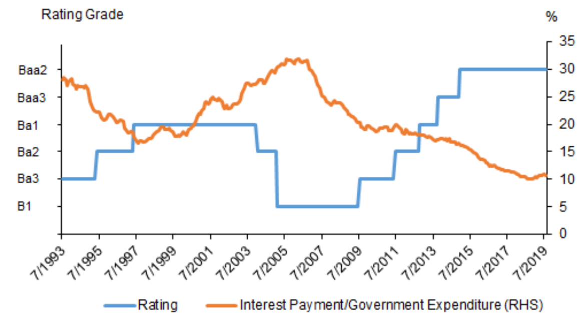
Note: Data for Vietnam, Indonesia, Malaysia and Thailand are as of the latest available dates in 2019.
Source: AsianBondsOnline.

2. **The development of the local currency (LCY) bond market in the past decade can advance further in the current environment.** To address the "double mismatch" (e.g. duration and currency mismatch) problem rooted in foreign borrowing, the Philippines joined its regional peers in developing its LCY bond market, particularly after the fiscal crisis in the early 2000s, when its sovereign rating also became highly speculative. Since then, the government has relied increasingly on the LCY market to meet its funding needs (Figure A1.2). Naturally, the deepening domestic market has helped reduce the debt-servicing burden (Figure A1.3) denominated in foreign currency. Looking ahead, the presence of yield-seeking global investors in the low interest rate environment, the strong growth prospects of the country, and the improving quality of its sovereign debt—as affirmed by major credit rating agencies—are all favorable conditions for the further development of the bond market.

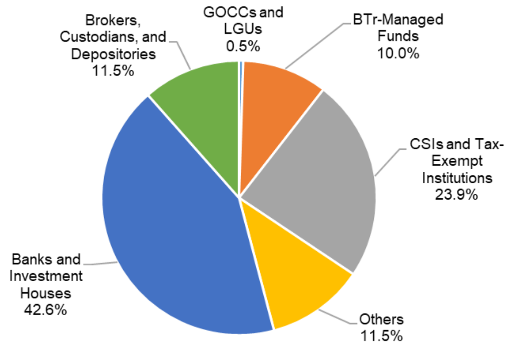
Figure A1.3 Sovereign Rating and Government Interest Payment

Figure A1.4 Investor Profile of LCY Government Bonds

[14] This selected issue is prepared by Wei Sun, Financial Specialist.



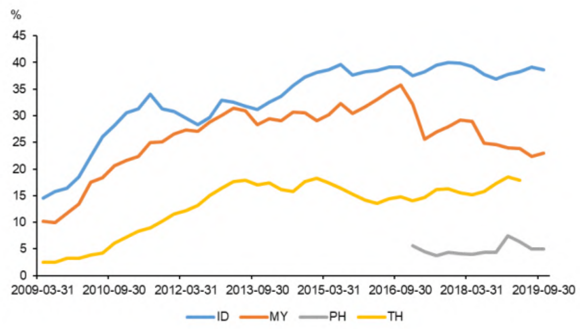
Source: Moody's and CEIC.



Note: BTr=Bureau of Treasury; CSIs=contractual savings institutions; GOCCs=government-owned or controlled corporations; LGUs=local government units. Data are as of September 2019.
Source: Bureau of Treasury.

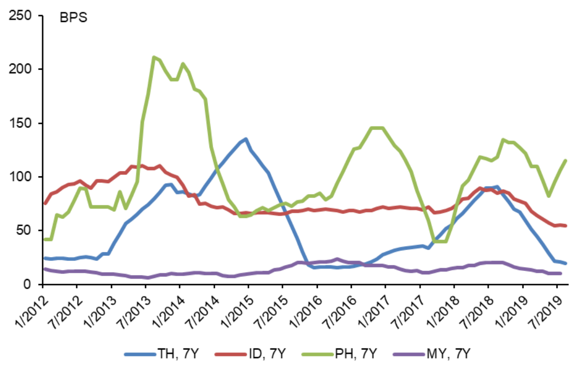
3. **That said, some critical infrastructure of the LCY bond market needs to be strengthened.** Among others, the investor base in the Philippine market consists mainly of domestic players (Figure A1.4), which largely adopt a buy-and-hold strategy. Such investors may have shielded the country from massive capital flight during turbulent times compared to the situation in regional peers with significant foreign investor participation (Figure A1.5). However, their low trading activities have not helped improve the market's liquidity conditions over time as shown by the wide bid-ask spread (Figure A1.6). Attracting foreign investors also requires an active and economical onshore FX market providing various hedging options in order to meet their needs. With the FX swaps in the country mainly serving the money market function of exchanging liquidity between financial institutions, foreign investors have to rely on the limited options offered by the forward market, which does not seem to grow over the past decade (Figure A1.7).

Figure A1.5 Foreign Holding of Government Securities



Source: AsianBondsOnline.

Figure A1.6 Bid-ask Spread



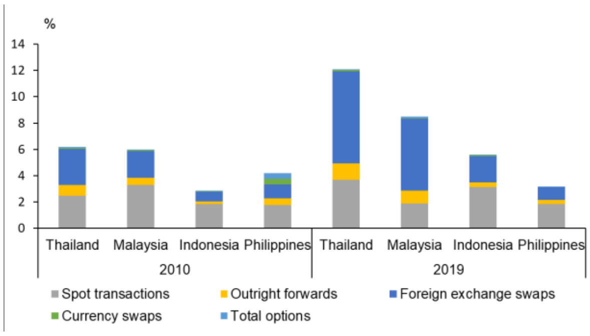
Note: The bid-ask spread is defined as the difference between bid and ask prices in basis point per 100 face value.
Source: Bloomberg.

4. **The deficiencies in bond pricing needs to be tackled.** Anecdotal evidence suggests that administrative and legal burdens increase the cost to bond issuers by at least 30bps[15]

[15] In Indonesia, for comparison, the listing cost for corporate bonds is around 2bps depending on the issuing amount, and that for government securities is even lower.

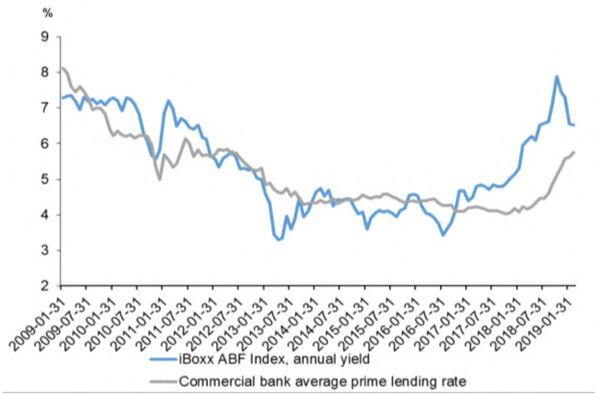
before starting their process meaningfully. Removing such frictions would therefore be an important step in attracting entities with financing needs to tap this alternative market to the banking system. Government bond yields often serve as the benchmark for pricing corporate bonds and loans; however, this role of the government bond yields is relatively weak in the Philippines. The prime lending rate, which commercial banks charge their most creditworthy customers, largely tracked the annual yield of the iBoxx ABF Philippines Index, whose constituents are sovereign and quasi-sovereign issuers. As the liquidity conditions started to tighten from 2016 as the U.S. Federal Reserve normalized its monetary policy and the Philippines embarked on a moderate fiscal expansion, their trajectories have diverged in the last few years. This divergence reflects the limited depth of the bond market and the challenges it faces to react to changing market conditions and remain a yardstick for other instruments at all times (Figure A1.8).

Figure A1.7 FX Daily Turnover to Bond Market Capitalization



Note: Please note caveat that the FX markets in some jurisdictions mainly serve domestic investors' outbound investment needs rather than foreign participants investing domestically.
Source: BIS Triennial Central Bank Survey.

Figure A1.8 Cost of Bond Financing and Bank Lending



Source: BSP, AsianBondsOnline

5. **Recent regulatory and market reforms are likely to help address some of the issues.** The current 20 percent withholding tax on the interest income of non-residents is the highest in the region, but the ongoing tax reform might reduce it, presenting a welcome change to foreign investors. The central bank has enhanced rules for banks' bond issuance and allowed qualified ones to proceed without getting prior approval[16]. The BSP has also enhanced guidelines to align its regulations with international accounting standards and in response to the adoption of a valuation methodology for peso denominated government securities by a benchmark administrator authorized by the SEC.[17] In addition, it reduced the reserve requirement rate for bonds issued by banks/quasi-bank (QBs) to three percent[18] and streamlined and simplified procedures and documentary requirements for FX transactions, providing greater flexibility for investors in managing their investments and cash flows. The passage of the Ease of Doing Business Act may help reduce the administrative cost involved in the issuing process. Authorities are also making the effort to develop a repo market, which aims

[16] BSP Circular No. 1010, 09 August 2018 (amending Circular No. 975, 10 October 2017).
[17] BSP Circular No. 1021, 15 November 2018.
[18] BSP Circular No. 1054, 11 October 2019.

to facilitate security borrowing among financial institutions. All of these, if implemented well, will encourage bond supply and boost liquidity in the market.

6. **Further advancement of the LCY bond market calls for authorities' continued and concerted efforts.** To send this market to the next developmental stage, broadening the investor base and boosting liquidity are crucially important. For example, authorities should continue their reforms in reducing administrative obstacles that prevent foreign investors from participation in the onshore bond market, and upgrading the infrastructure of the repo market following international best practice. More importantly, authorities should adhere to a coherent masterplan to develop the bond market, be tasked with clearly defined and actionable responsibilities, and be required to implement them forcefully. Naturally, the market deepening process will not be without risk. For financial institutions that are active in rebalancing their portfolios and taking excessive risk, as some anecdotes suggest, supervisors should urge them to strengthen their risk management capabilities in order to guard against market, credit and liquidity risks.

References

(i) King, Robert G., Ross Levine. 1993. “Finance and growth: Schumpeter might be right,” *The Quarterly Journal of Economics*, 108(3), 717-737.

(ii) King, Robert G., Ross Levine. 1993. “Finance, Entrepreneurship and Growth,” *Journal of Monetary Economics*, 32(3), 513-542.

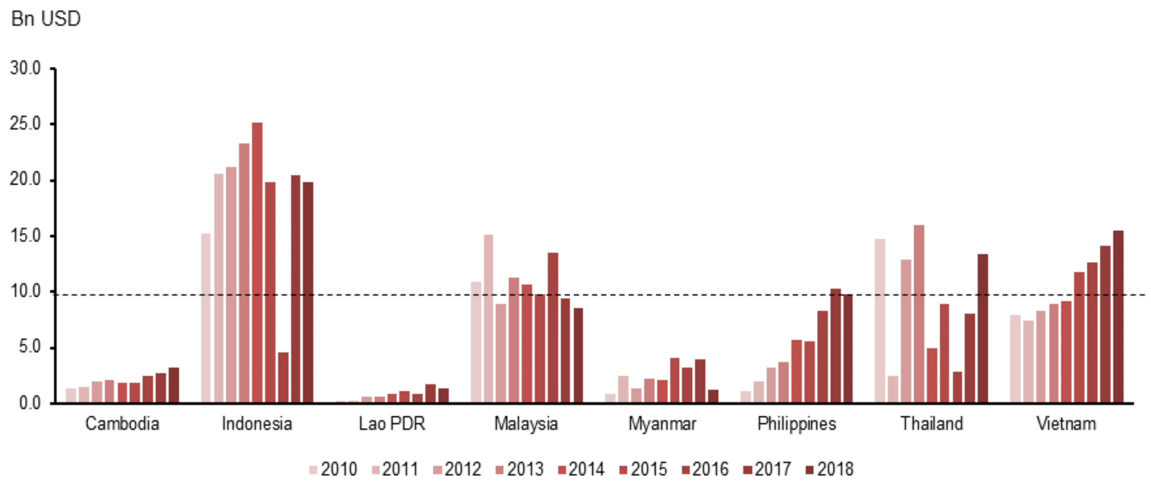
Annex 2. Strong Reforms to Unlock the Potential for FDI to the Philippines[19]

1. The U.S.-China trade conflict has renewed interest in the issue of trade diversion and the ensuing inflows of foreign direct investment (FDI) into ASEAN economies. While the focus has been on the traditional major FDI recipients, such as Singapore, Malaysia and the recent rising star Vietnam, more attention is also being paid to the Philippines, which has been the regional laggard in attracting FDI. However, the FDI to the Philippines after the 2008-09 global financial crisis (GFC) has improved, and with the right policies and continued reforms, the prospects should continue to improve.

A Nascent Catch-up in FDI

2. **The Philippines has witnessed a rapidly rising trend of FDI inflows after the GFC.** FDI has increased steadily from around USD1 billion in 2010 to around USD10 billion in 2017 and 2018, making the Philippines the country with the most rapidly growing FDI in the Asian region after the GFC and one of the few countries in the region, along with Singapore and CLMV countries, that has experienced a rising trend in FDI, when the FDI inflows of other countries has either remained flat or declined (FigureA2.1).

Figure A2.1 FDI Inflows into ASEAN Countries after GFC

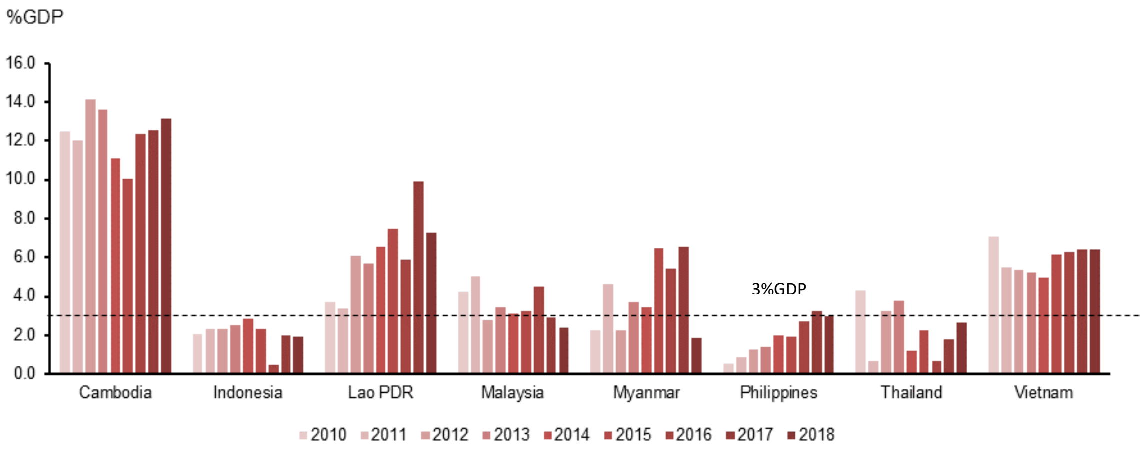


Source: IMF; AMRO staff calculations

3. **The level of FDI inflows is already on par with some regional peers if not higher in the past two years.** In terms of absolute level, FDI to the Philippines was generally on par with Malaysia and Thailand, and higher than most of CLMV countries, but still lower than Indonesia, Vietnam and Singapore. Relative to the size of the economy, FDI to the Philippines has risen from around less than 1 percent of GDP in 2010 to around 3 percent of GDP in 2018, surpassing Malaysia, Thailand and Indonesia, but lower than the CLMV countries (Figure A2.2). The data seem to indicate that the Philippines is no longer a laggard in attracting FDI compared with traditional peers.

[19] Prepared by Dr Zhiwen Jiao.

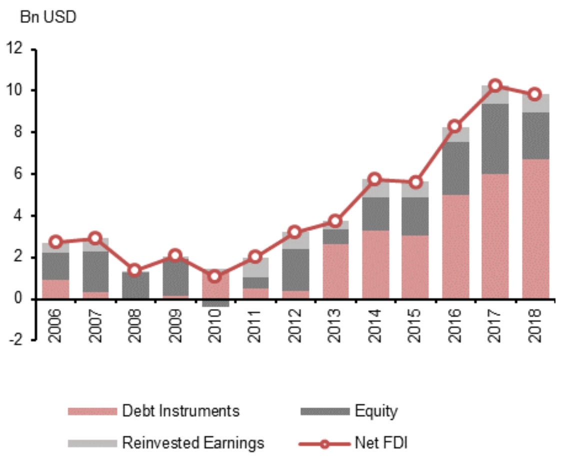
Figure A2.2 FDI Inflows in ASEAN as Percentage of GDP



Source: IMF; AMRO staff calculations

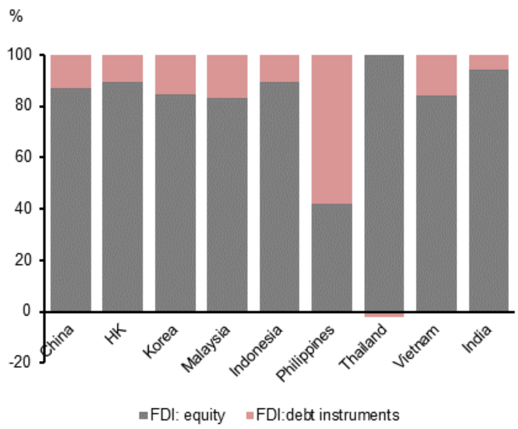
4. **However, the FDI inflows were mainly supported by intercompany lending[20] of existing companies.** Behind the rising trend of FDI, around 58 percent was funded by net investment in debt instruments, 24 percent by equity capital[21], and the rest by reinvestment of earnings for the period of 2010-2018(Figure A2.3). The pattern has generally been stable since 2013, but the dynamics of different components were much varied. Investment in debt instruments continued its rising trend after a jump from USD0.4 billion in 2012 to USD2.7 billion in 2013 and rose to USD6.7 billion in 2018, earnings reinvestment remained relatively stable in the range of USD0.7 billion-USD0.9 billion, whereas investment in equity capital was volatile and had exhibited only a moderately upward trend since 2014. Despite the moderate increase, investment in equity capital remained persistently below one percent of GDP. Interestingly, the dominance of debt instruments in FDI inflows was unique to the Philippines (Figure A2.4), suggesting the influence of idiosyncratic factors.

Figure A2.3 FDI in the Philippines by Type of Funds



Source: BSP; AMRO staff calculations

Figure A2.4 Asian Countries' FDI by Type of Funds 2010-2018



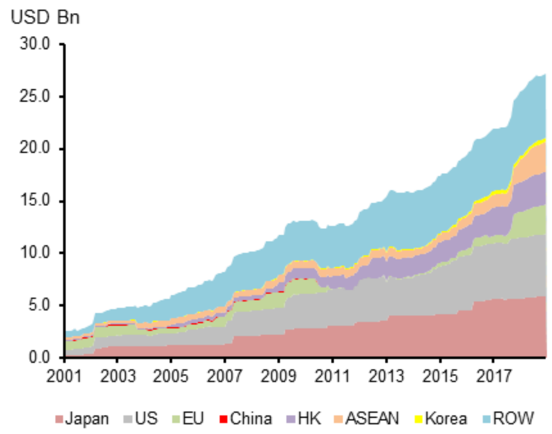
Source: IMF; AMRO staff calculations

[20] Intercompany lending is used to describe direct investment debt flows between affiliated enterprises. It includes debt instrument transactions and positions other than those between selected affiliated financial corporations. Intercompany lending is not limited to loans.

[21] Equity FDI does not include reinvestment of earnings.

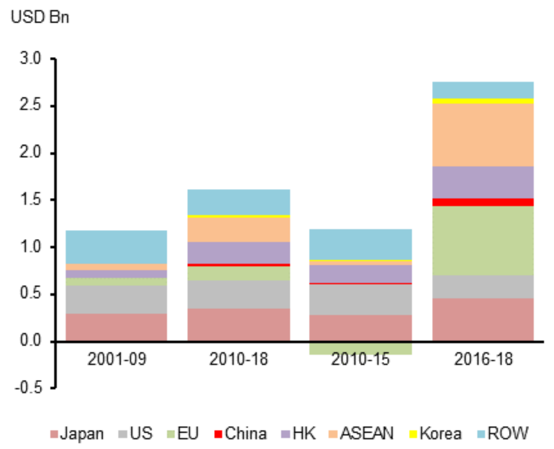
5. **In spite of its less impressive inflows, FDI in equity capital data show more active participation of new players in the past few years.** Traditionally, Japan and the U.S. have been the two major FDI source countries, together accounting for 44 percent of net equity capital inflows on average (Figure A2.5). The situation has changed substantially in the past three years. While Japanese and U.S. companies continue to be active, they were dwarfed by non-traditional/non-major investors. The most noticeable change was the sharp increase in net equity capital investment from Singapore, EU and Hong Kong (Figure A2.6). At the same time, China and Korea have also started playing a bigger role, albeit still at very low levels. Together, Singapore and Hong Kong provided an average of 37 percent of net equity capital investment from 2016-2018 to the Philippines, up from an average of 18 percent from 2010-2015, while the share of net equity capital FDI from Japan and the U.S. declined to 26 percent. Investment from the EU has increased sharply in recent years, mainly on account of a large investment from the Netherlands in 2017 in the energy sector. By comparison, investments from Singapore and Hong Kong have risen steadily, indicating the growing role of regional investors in the Philippine market.

Figure A2.5 Cumulative FDI Inflows in the Philippines by Country since 1999



Nore: 1) ROW refers to rest of the world.
2) Equity FDI does not include reinvestment of earnings.
Source: BSP; AMRO staff calculations

Figure A2.6 Average FDI Inflows in the Philippines by Country in Different Periods



Nore: Equity FDI does not include reinvestment of earnings.

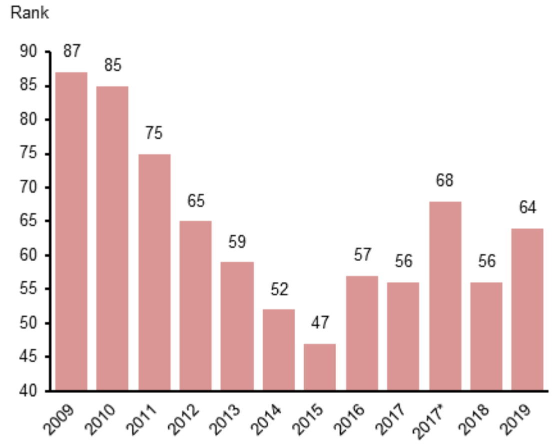
Source: BSP; AMRO staff calculations

Common and Idiosyncratic Drivers of FDI

6. **The impressive performance of FDI inflows can be attributed to the improvements in the institutional, policy and economic environment.** Since 2010, the Philippine government has been making efforts to reform governance and fight corruption, ensure sound public finances, modernize infrastructure and enhance policy management. These efforts have led to notable improvements in administrative efficiency, government accountability and doing business environment, which is reflected in the great improvement in the World Economic Forum's Global Competitiveness Index and the World Bank's Doing Business survey. The Philippines' ranking rose from 85 in 2010 to 47 in 2015 out of 144 countries in the Global Competitiveness Index (Figure A2.7), and from 148 in 2011 to 95 in 2015 out of 189 countries in the Doing Business survey (Figure A2.8) with some fluctuation in

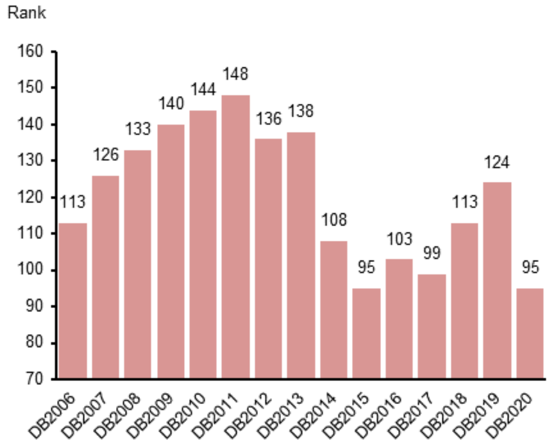
following years. These developments have substantially changed the perception of investors toward the Philippine economy and society and enhanced their confidence.

Figure A2.7 The Philippines' Global Competitiveness Ranking



Source: World Economic Forum, AMRO staff calculations

Figure A2.8 The Philippines' Ease of Doing Business Ranking



Source: World Bank Doing Business Report, AMRO staff calculations

7. **The country's attractiveness to foreign investors was further enhanced by better macroeconomic stability and brighter growth prospects.** The Philippine economy has been growing above 6.0 percent since 2010 (except for 2011), becoming one of the few high-growth economies in the region. Meanwhile, inflation has been kept within the target range most of the time. In addition, during the same period, the Philippine government's debt level was substantially reduced and international reserves were nearly doubled. The marked improvement in the fiscal position and financial buffers and macroeconomic stability earned the Philippine government investment grade from major global rating agencies in 2013 and the rating has been upgraded since. In April 2019, Standard &Poor's raised the Philippines sovereign credit rating to BBB+, just one notch below A. The endorsement by the rating agencies further reinforced investors' confidence, as more investors see business opportunities from a brighter growth prospect.

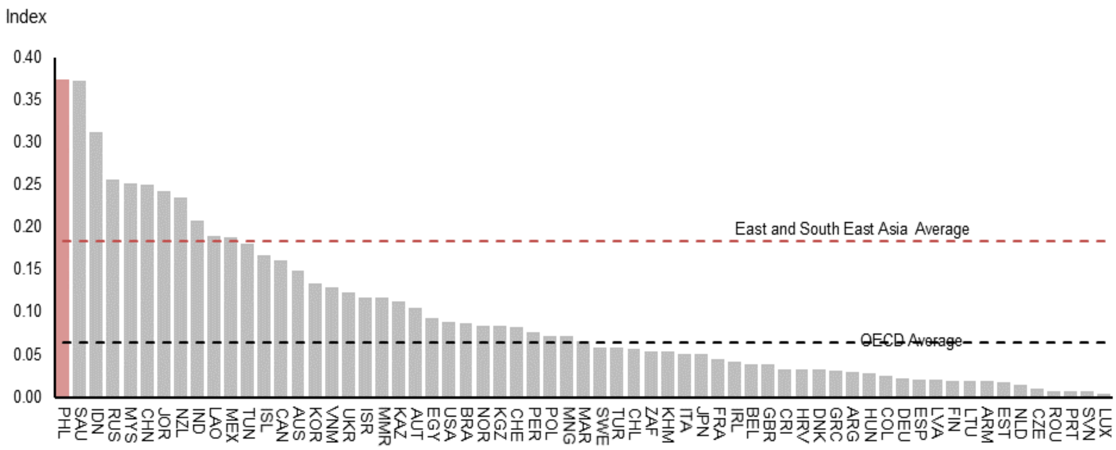
8. **While the improved policy framework and economic fundamentals provide the basis for more foreign investments, the composition and dynamics of different components are shaped more by idiosyncratic factors.** The dominance of debt instruments in FDI inflows and the relatively low level of equity capital in FDI inflows in the Philippines could be due to policy restrictions and distinctive financing arrangement to accommodate the underlying demand.

9. **Ownership limitations and burdensome reporting/registration procedures may have discouraged equity investment and encourage intercompany borrowing.** Although the Philippine government has been gradually lifting restrictions on foreign investment, the scope remains limited[22]. The Organization of Economic Cooperation and Development's

[22] The Philippines' 1991 Foreign Investment Act requires the publishing every two years of the Foreign Investment Negative List (FINL), which outlines sectors in which foreign investment is restricted. The latest FINL was released in October 2018. The most significant changes permit foreign companies to have a 100 percent investment in internet businesses (not a part of mass media), insurance adjustment firms, investment houses,

(OECD) FDI Regulatory Restrictiveness Index, a measure of statutory restrictions on FDI, ranks the Philippines as one of the most restrictive in the region and the countries covered (Figure A2.9). With high restrictions on ownership, existing companies have to resort to intercompany borrowings for expansion of operations when facing business opportunities. This tendency can be further strengthened when changing ownership structure becomes burdensome, or local partners have no willingness to do so, or have no willingness or capacity to increase capital in order to retain the original ownership structure. As a result, equity capital investment cannot expand as fast as intercompany lending (existing companies). This seems to fit the Philippines situation and also in line with empirical analyses. OECD (2019) found strong correlation between FDI policy restrictiveness and the level of FDI into the country, particularly with ownership restrictions[23].

Figure A2.9 FDI Regulatory Restrictiveness Index



Source: OECD; AMRO staff calculations

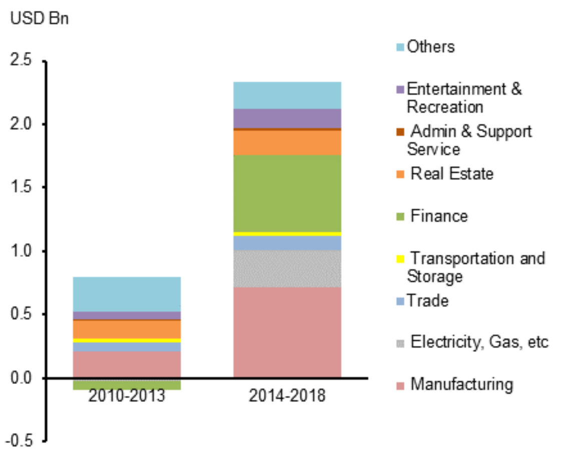
10. **The impact of ownership restriction on equity FDI inflow in the Philippines can also be found in the dynamics of sectoral FDI inflows.** The financial sector and the entertainment and recreation sector have registered strong net inflows following the government's approval of full entry of foreign bank in 2014 and operation of online gaming (POGOs) in 2016 respectively. In fact, relative to the period of 2010-2013, the net equity capital FDI inflows into financial and insurance services and arts, entertainment and recreation covering these two industries, on average, contributed to nearly half of the increase in total equity capital FDI inflows in the period of 2014-2018, when equity capital FDI started its moderate upward trend (Figure A2.10). If we exclude the equity capital investment into electricity, gas, steam and air conditioning, as it was only large in 2017, the contribution to the increase of equity capital FDI inflows due to the easing of ownership restrictions, would rise to near 60 percent. Except these two sectors, most of the increase came from inflows into

lending and finance companies, and wellness centers. It also allows foreigners to teach higher educational levels, provided the subject is not professional nor requires bar examination/government certification. The latest FINL now allows 40 percent foreign participation in construction and repair of locally funded public works, up from 25 percent. For details please refer to the 11th FINL.

[23] Fernando Mistura, Caroline Roulet. 2019. The determinants of Foreign Direct Investment: Do statutory restrictions matter, OECD Working Papers on International Investment.

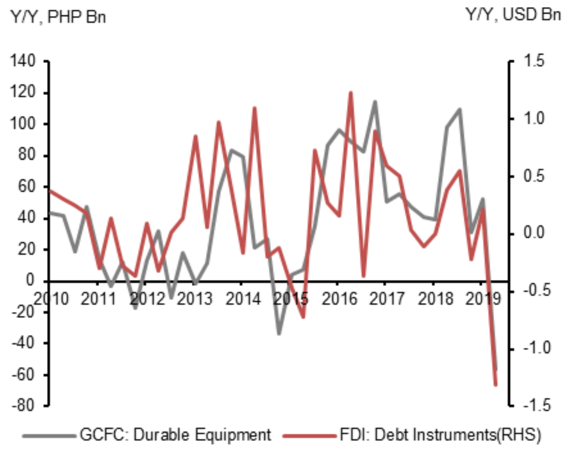
manufacturing, accounting for around 30 percent. The dynamics of sectoral FDI inflows indicate that ownership restrictions have had significant impacts on FDI inflows.

Figure A2.10 Equity FDI Inflows to the Philippines by Sector



Source: World Economic Forum; AMRO staff calculations

Figure A2.11 Equipment Investment and Intercompany Lending in the Philippines



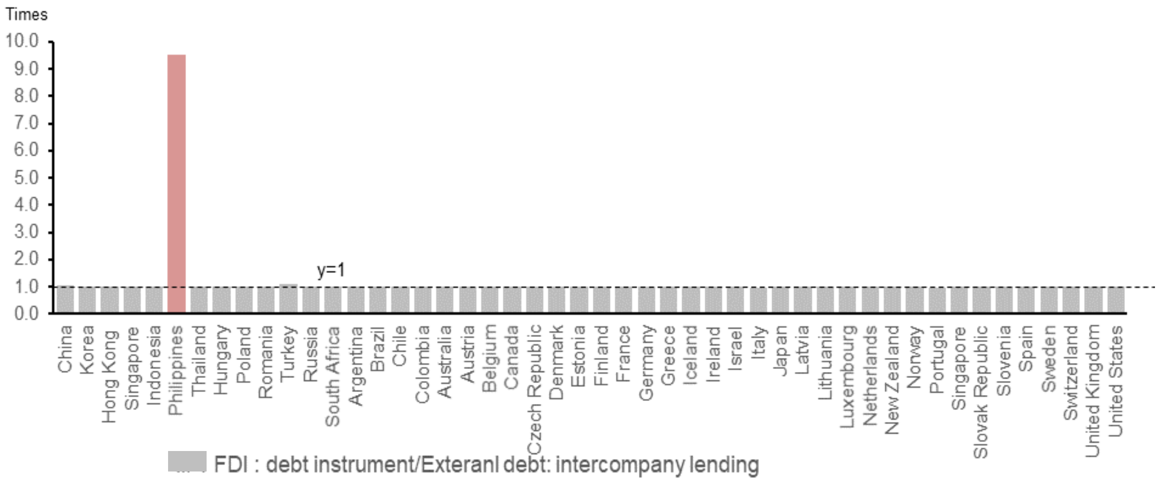
Source: World Bank Doing Business Report; AMRO staff calculations

11. **The rapid increase in intercompany lending could also reflect the special financing arrangements of foreign companies for capex-related, particularly infrastructure-related imports.** These investments usually involves imports of big-ticket equipment and machinery and it is common for the seller to provide financing arrangements to the buyer in order to facilitate the sales, such as trade credit and the like. In fact, the terms and conditions of the financing arrangements are often used by foreign contractors to compete for the investment projects internationally. Under the IMF's six edition of Balance of Payment Manual, these financing arrangements need to be recorded as debt instruments under FDI, though they may not be in the form of conventional loans per se. So naturally, as infrastructure investment grows larger, the financing for imported capital goods becomes bigger, and the debt instruments also become higher. In the case of the Philippines, the start of the rising trend of intercompany lending coincides with the start of the infrastructure investment push from 2013 onwards. Besides, the high correlation between the change of investment in durable equipment and the change of debt instruments in FDI (Figure A2. 11) also reveal the important role of (infrastructure) investment in pushing up intercompany lending.

12. **From the financial stability and statistical perspective, the continued increase in intercompany lending needs further investigation as well.** Although intercompany lending does not necessarily lead to financial risk, as this type of lending has different implications for risk and vulnerability compared with debt between unrelated parties. The discrepancy between the stock of debt instruments under FDI in International Investment Positions (IIP) and intercompany lending under FDI in external debt in the Philippines seems too large. By the end of Q3 2019, the Philippines has USD37.6 billion of debt instrument liability under FDI in IIP, whereas intercompany lending under FDI in external debt was only recorded at USD 3.8 billion. The discrepancy between the two statistics was equivalent to 40.9 percent of its

total external debt. According to the IMF's latest manual, the principle for identification of intercompany lending is the same in IIP and external debt statistics, so the intercompany lending statistics in IIP and external debt should be the same in principle. For most countries, the discrepancy between the two statistics is very small and only in some years. So, the discrepancy in the Philippines is probably the largest in the world. It is worth further investigation to understand whether it is due to statistical reasons such as misreporting or underreporting, and whether it implies financial stability concerns.

Figure A2.12 Comparison of Debt Instruments under FDI in IIP and Intercompany Lending in External Debt



Source: IMF; World Bank; AMRO staff calculations

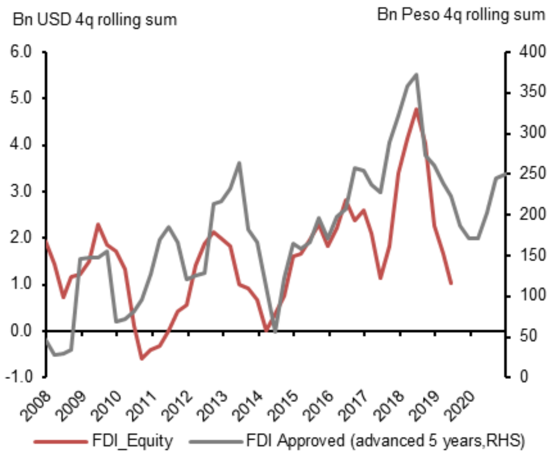
Prospects for FDI

13. **Although the relative importance of different factors driving FDI is not clear, we can still take advantage of the above analysis to get some sense of the prospect for FDI to the Philippines, particularly in the short term.** Given the relative stability and low share of reinvestment of earnings, FDI inflows are largely determined by new equity investment and intercompany lending. The policy restriction on equity investment implies new equity investment cannot increase sharply without a loosening of ownership restrictions as investors have to go through the restrictive procedures. Historically, the completion of an investment project after the FDI approval tends to be spread out over five years[24], thus creating a roughly five-year lead for the approved FDIs to be realized as equity inflows. Although new equity investment declined in 2019, it will recover in 2020 as more approved projects materialize (Figure A2.13). As for intercompany lending, by nature it is still debt, so funding cost is an important consideration. As global financial conditions turn more accommodative, lower funding cost will help encourage foreign investors to provide more financing to accommodate the investment demand as embedded in the larger fiscal budget in 2020, which means that intercompany lending is also likely to rise in 2020 (Figure A2.14). However, the relatively mild

[24] According to the Technical Note of Approved FDI on the PSA website, capital inflows from approved foreign investments are spread over or expected to be fully implemented after five years or more, based on the experience of investment promotion agencies.

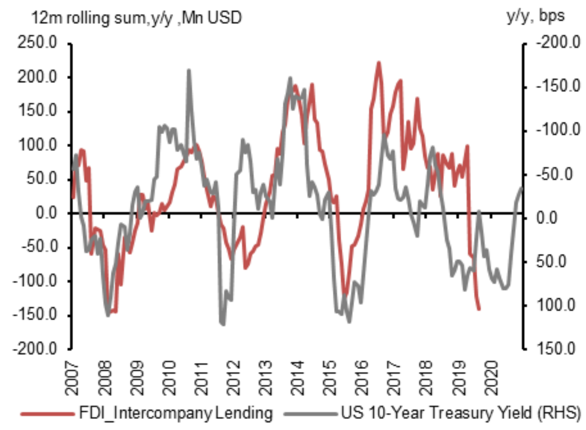
decline in funding cost and elevated uncertainties in the external environment will dampen the magnitude of the upside. As a result, the recovery of FDI in 2020 will likely be moderate.

Figure A2.13 Realized Equity FDI and Approved FDI in the Philippines



Source: BSP; PSA; AMRO staff calculations

Figure A2.14 Intercompany Lending in the Philippines and Borrowing Costs



Source: BSP; Fed; AMRO staff calculations

14. **For the long term, the sustainability and the prospect of FDI inflows will depend on new equity investment.** No country can rely on inter-company lending indefinitely as the dominant form of financing for foreign investment. Its status as direct investment relies on existing direct investment relationship between the parties, which means that it can only occur in existing foreign resident companies with affiliates in other countries. Thus, it faces the limit of the level of FDI stock and the willingness of foreign investors to continue to inject resources into the company without increasing their ownership. If it is mainly for the financing of capital goods imports due to the infrastructure investment boom, it may continue for several years but will likely diminish after the boom ends.

Sustaining the Trend and Unlocking the Potential

15. **Looking ahead, there are several favorable developments and many positive signs for the future of investment in the Philippines.** Externally, a new wave of industrial relocation is occurring. In light of China's rising cost structures, prolonged global trade tensions, and secular low interest rates and returns in the advanced economy, foreign investors are looking to shift production to new locations with lower costs and the Philippines is one of those locations with high potential as it is endowed with abundant labor and a relatively large domestic market. Domestically, the Philippine government has made attracting FDI a key policy objective. A series of reforms have been passed, with a number of others still in the process of legislation[25]. The aim is to address investment constraints and enhance the ease of doing business. For example, the Ease of Doing Business and Efficient Government Service Delivery Act, passed in 2018, legislates standardized deadlines for government transactions, a single business application form, a one-stop-shop services, the automation of business

[25] One of the key reforms is the second package under the Comprehensive Tax Reform Program, to lower corporate income tax and rationalize incentives.

permit processing, a zero-contact policy, and a central business databank. The government has also created the Anti-Red Tape Authority under the Office of the President to oversee national policy on anti-red tape issues and implement reforms to improve the country's competitiveness ranking. The Philippine government is rallying not only national agencies but also local governments, in a bid to be among the world's top 40 percent of economies in terms of the ease in doing business. With continued reform momentum, the investment prospects should continue to brighten.

16. **Despite these encouraging trends and prospects, the government needs to take into account the characteristics of the new FDI trend when designing policies.** The rapid FDI expansions in the 1980s and the late 1990s to early 2000s were characterized by the relocation of industries from high-cost to low-cost countries, the fragmentation of production, and the development of the regional supply chain. This has led to a rising trend of FDI during each period. However, there are indications that the production fragmentation process may be peaking, as indicated by the flattening of the global value chains. Hence, going forward, industry relocation is probably more of diversification of production chains of relatively complex products and only some relocation of low value-added products to take advantage of low factor cost. This means overall FDI may not expand much, thus countries have to compete more with their peers. This highlights the importance for governments to constantly benchmark their investment regime against peers to ensure their economy is more appealing to foreign investors if they would like to continue attracting foreign investment. The considerable efforts to liberalize FDI further by economies such as Indonesia, and Vietnam recently, suggest that the Philippine government may need to move faster in liberalizing restrictions on FDI.

Annex 3. Optimal Policy Mix for Handling the Macro-Financial Effects of Capital Flows: The Philippine Experience[26]

1. **It is well known that while, in theory, international capital flows can bring potential benefits to emerging economies, in reality, such flows may also lead to macroeconomic imbalances as well as induce financial sector vulnerabilities (see, for example, Ghosh, Ostry and Qureshi 2017).** For emerging markets such as the Philippines, freer capital flows have the potential to deepen the financial markets, lower the costs of funding, enable greater risk-sharing, facilitate technology transfer, and enable the central bank to build up reserve buffers against external shocks. On the other hand, unmitigated tides of capital inflows can also lead to economic overheating, exchange rate appreciation and loss of competitiveness, maturity and currency mismatches, excessive leverage build-up, and credit boom, in addition to exposing the economy to disruptive volatility and "sudden stops". Thus, the emerging consensus is that the international flow of capital into an emerging economy needs to be actively managed. Doing so requires the careful calibration of a country's monetary policy, exchange rate policy, capital flow management, and micro- and macroprudential policies.[27]

2. **This note attempts to chronicle the Philippines' experience with capital inflows, its effects on the macroeconomy and financial sector, the policy measures adopted by Philippine authorities to manage the capital flows, and the effects of such policy measures.**

Capital Inflows and Their Macro-financial Impacts

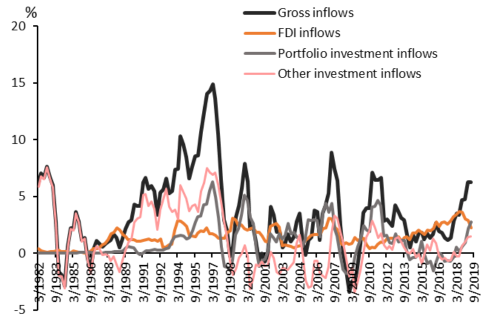
3. **Like many emerging economies, gross inflows[28] to the Philippines came in episodes of surges and sudden reversals.** Figure A3.1 shows the capital inflows to the Philippines by type of flows, namely foreign direct investment (FDI), portfolio investment and other investment flows. Cross-border debt flows were the most volatile, followed by portfolio inflows and lastly FDI inflows, with coefficients of variation of 4.4, 3.0, and 1.3, respectively, between Q1 1982 and Q2 2019. Capital surges tended to precede the country's macroeconomic crises and downturns, as exemplified in the 1983 Marcos debt crisis, 1998 Asian financial crisis (AFC) and 2008-09 global financial crisis (GFC). The composition of the flows has also changed, from one dominated exclusively by *other investment* inflows during the Marcos debt-driven growth pre-1983 debt crisis, to surges in *other investment* and *portfolio investment* flows immediately prior to the AFC, to surges in all three types of flows prior to the GFC, and finally to more FDI-dominated flows starting 2013.

4. **While several push and pull factors are at play, supply-side push factors appear to have been more significant in the pattern of surges and sudden reversals of capital**

[26] This selected issue is prepared by Ruperto Pagaura Majuca (Senior Specialist).
[27] Although in theory, fiscal policy has also been mentioned as one of the policy measures that can be employed to manage capital flows (see, for example, International Monetary Fund 2012), it is rarely used by countries in practice (Ghosh, Ostry and Qureshi 2017).
[28] Following standard terminology in recent literature (see, for example, Blanchard et al 2015) we use "gross inflows" to refer to the net incurrence of liabilities by the Philippines, that is, foreign investors' inflows less foreign investors' outflows. This captures the changes in non-residents' holdings of Philippine assets, which could be negative. "Gross outflows" refer to Philippine residents' net acquisition of foreign financial assets.

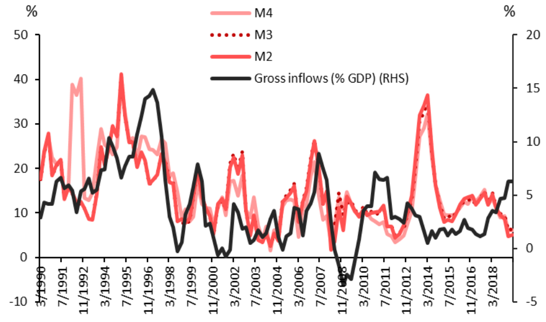
flows into the Philippines. The ebb and flow of cross-border capital flows to the country has generally followed the boom and bust pattern in emerging markets, such as during the debt build-up in the lead to the 1983 debt crisis, the pre-AFC and pre-GFC debt and portfolio flows surges. The surges usually occur during periods of abundant global liquidity and easy global financing conditions, indicating push factors at play. The pull factors include foreign exchange (FX) liberalization measures and greater financial integration, advances in technology and available financial instruments, strengthened macroeconomic frameworks, and growth-enhancing structural reforms.

Figure A3.1 Gross Inflows by Flow Type



Note: Figures are as percentages of GDP, four-quarter rolling averages
Source: CEIC; AMRO staff calculations

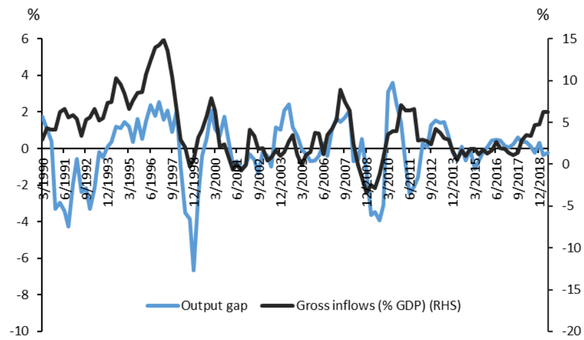
Figure A3.2 Gross Inflows and Domestic Liquidity



Source: CEIC; Haver Analytics; BSP; AMRO staff calculations

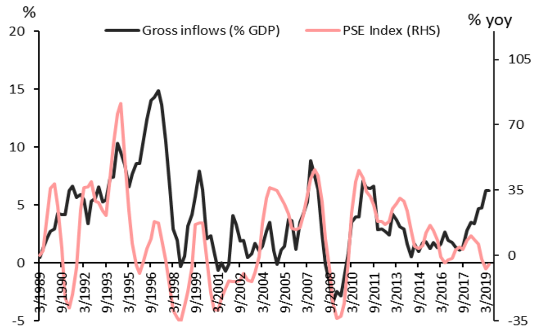
5. **Similar to the impact of capital flow surges to emerging markets (see Ghosh, Ostry and Qureshi 2017), the episodes of capital flow surges in the Philippines are associated with increased domestic liquidity and credit, overheating risks, volatility in the financial markets, asset price booms, and FX appreciation, which contributed to an erosion of export competitiveness.**

Figure A3.3 Gross Inflows and Output Gap



Source: CEIC; PSA; AMRO staff calculations

Figure A3.4 Inflows and Stock Exchange



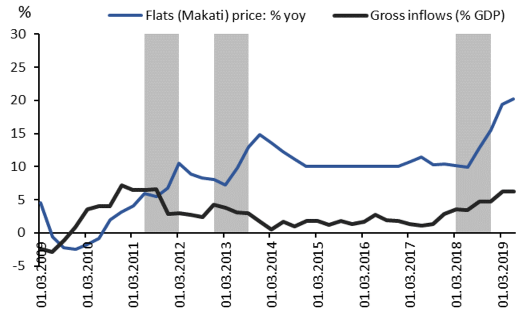
Note: Figures are calculated as 4-quarter moving average
Source: CEIC; PSE; AMRO staff calculations

6. **During periods of capital flow surges, the Philippines would experience a domestic credit boom and upswings in the business cycle.** Domestic liquidity tends to swell during episodes of capital inflow surges, and contracts just as significantly in times of capital flow retrenchment (Figure A3.2). The Philippine business cycle expansions and downturns are significantly correlated with the ebb and flow of capital inflows (Figure A3.3). On at least three occasions – the debt crisis of 1983-85, the economic crisis during the AFC, and the economic

downturn[29] during the GFC – Philippine macroeconomic downturns were preceded by surges of capital inflows, although there was also a crisis episode – the electric power crisis of 1991 – that had originated domestically.

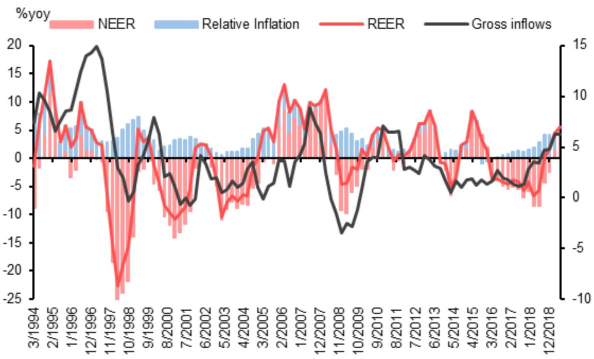
7. **Capital flow surges are also associated with asset price booms.** The stock market index tends to increase significantly during periods of heavy capital inflows, and also falls significantly during capital flow reversals (Figure A3.4). Similarly, commercial and residential property prices in the central business district are also prone to being influenced by capital inflows. Figure A3.5 shows condominium prices in Makati tend to increase faster two or three quarters after the period of higher capital inflows.[30]

Figure A3.5 Inflows and Residential and Commercial Prices



Source: Colliers Philippines; CEIC; AMRO staff calculations

Figure A3.6 Gross Inflows and REER



Source: CEIC; BSP; AMRO staff calculations

8. **Leverage also builds up leading to financial sector fragility during boom times, followed by a rapid deterioration of banks' balance sheet during the subsequent busts (see Figure A3.10 below).[31]**

9. **Another concern about capital flows relates to their impact on both the volatility and appreciation of the Philippine peso.** The correlation coefficient between the real effective exchange rate and gross inflows as a percentage of GDP during Q1 1994 to Q2 2019 is 0.38 (Figure A3.6). Heavy capital inflows, such as during the pre-AFC and pre-GFC periods are associated with an appreciation of the Philippine peso against the basket of currencies of trading partners.

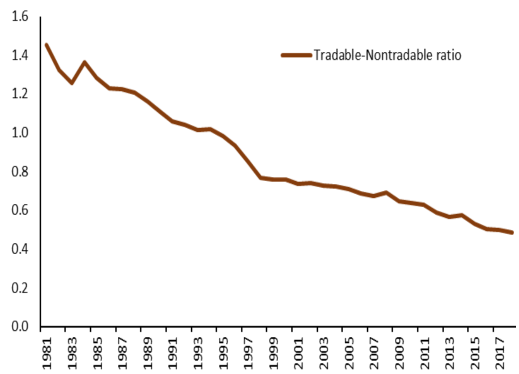
10. **However, capital inflows is not the only factor that affected the exchange rate; the structural shift in the current account balance also contributed to appreciation pressures on the peso.** The current account deficit as a percentage of GDP narrowed post-AFC and, starting 2002-03, turned into a surplus that increased to as high as 8.7 percent of GDP in Q4 2006, just prior to the outbreak of the GFC. Several factors accounted for this structural shift in

[29] Technically, the Philippines was not in recession during the GFC, as growth was still marginally in positive territory.
[30] Conceptually, capital flows can influence real estate prices through various channels. Foreign nationals' acquisition of condominium units are classified as FDI flows. Cross-border lending and portfolio investments in domestic real estate corporations can affect real prices as well. Capital flows can also influence real estate prices through their effects on domestic credit and interest rates. In addition, the higher economic growth induced by capital flows may also increase demand for housing or lead to higher expectations of house prices, while higher stock prices may increase available purchasing power for real estate purchases (Chow and Xie 2016).
[31] Evidence suggests that, in general, capital flows may fuel credit growth, loosen credit standards, lead to asset price inflation, and decrease loan quality (Ghosh, Ostry and Qureshi 2017).

the current account balance. On the savings side, one major factor was the significant increase in remittances by overseas Filipinos. Since remittances are recorded as secondary income in the balance of payments (BOP), secondary income receipts rose from 1.1 percent of GDP in 1998 to 9.8 percent in 2002. Another factor on the savings side was the increase in business process outsourcing receipts which grew from 0.9 percent of GDP in 2004 to 7.1 in 2018. To top it off, on the investment side, post-AFC investment rates fell from 22.1 percent of GDP in 1997 to 18.8 percent in 2011, resulting in the imports ratio decreasing from 39.8 percent of GDP to 26.3 percent during the same period.

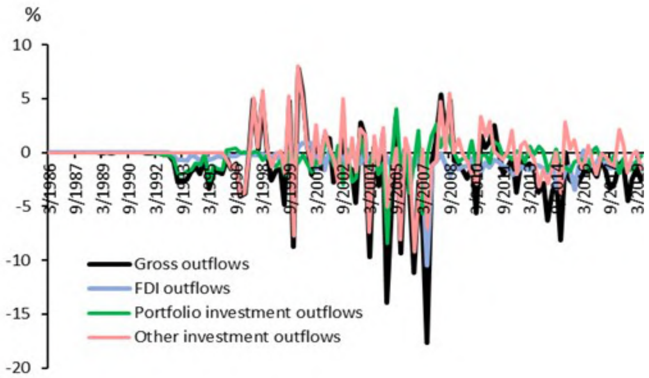
11. **Thus, there were concerns that the strong remittance inflows and the consequent strengthening of the current account balance might result in Dutch disease effects, which could be intensified by the episodes of capital flow surges.** The Dutch disease effects of remittances in emerging economies with high remittance flows like the Philippines are well known (see, for example, Acosta, Lartey, and Mandelman 2009; Medalla, Fabella and de Dios 2014). The concern is that large remittance inflows and strong capital inflows may combine to bring a rapid appreciation of the Philippine peso and loss of export competitiveness, and lead to a decline of the manufacturing and other tradable sectors. As Figure A3.7 shows, the Philippines' non-tradable goods sectors have expanded at the expense of its tradable goods sectors over the last two and a half decades.

Figure A3.7 Ratio of Tradable Sectors to Non-Tradable Sectors[32]



Source: CEIC; PSA; AMRO staff calculations

Figure A3.8 Gross Outflows By Flow Type



Note: Figures are as percent of GDP, 4-quarter rolling averages
Source: CEIC; AMRO staff calculations

Policy Framework to Deal with Surges in Capital Inflows: the Philippines' Approach

12. **Philippine authorities employed several measures to deal with the adverse effects of capital flows.**

1987-1996

[32] Tradable-non-tradable ratio is defined as the sum of the agriculture, mining and manufacturing sectors' gross value added divided by the services sector (as a percentage of GDP).

13. **Prior to the AFC, the authorities engaged in FX intervention (with or without sterilization), reduced foreign borrowing, encouraged more stable FDI flows, undertook reforms to strengthen the financial sector, tightened measures against undue speculation in the FX markets,[33] and instituted measures to reduce costs to exporters.[34]** The authorities engaged in sterilized intervention in an attempt to prevent the exchange rate from overshooting and becoming overvalued (see Box A3.1. FX Intervention during Periods of Capital Inflows). To lessen FX supply, the authorities reduced their Paris Club loan rescheduling requests, and removed requirements for the surrender of export proceeds and minimum remittance by overseas Filipinos. To change the composition of capital flows in favor of the more stable FDI flows, the Philippines passed the Foreign Investment Act in 1991, which liberalized foreign investment. The government also privatized several state-owned enterprises and liberalized some sectors of the economy, such as banking and telecommunications. To strengthen the financial sector, it passed a new central bank charter, removed control on interest rates, and abolished double taxation on dividend income (Lamberte 1995).

1997-2007

14. **After the AFC, the authorities continued with the same approach of FX intervention, reduction of foreign borrowing, and lowering of costs to exporters;[35] in addition, they focused on promoting the efficiency and stability of the financial system, improving the surveillance and transparency of capital inflows,[36] and starting a series of initiatives to liberalize FX regulations, including rules of capital outflows.** The banking law was revised in 2000, which enhanced the framework for supervision of the banking system, including an increase in the allowable ownership participation of foreign banks to 100 percent.[37] To address the banking system's rising non-performing loan (NPL) ratio post-AFC, the Special Purpose Vehicle Act was enacted in 2002, which allowed asset management companies to purchase the NPLs, thereby enabling banks to strengthen their balance sheets (Tetangco 2005). A series of FX liberalization reforms were also started in 2007.[38] In addition, the authorities conducted financial literacy campaigns for overseas Filipinos, encouraging them to channel their remittances into investment instead of consumption (Yap 2008).

2008-2019

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[33] To guard against undue FX speculation, the authorities lessened the banks' allowable oversold position to 5 percent of unimpaired capital, from 15 percent previously (BSP Circular No. 1327 dated 30 January 1992). The limit was later changed to the lower of USD50 million or 20 percent of the unimpaired capital (BSP Circular 561 dated 08 March 2007).

[34] To reduce the cost to exporters, the authorities permitted them to access FX loans by foreign currency deposit units and established the Exporters Dollar Facility (EDF) (BSP Circular No. 57 dated 19 December 1994). The EDF was later renamed as Exporters Dollar and Yen Rediscounting Facility (BSP Circular No. 199 dated 27 April 1999). .

[35] To reduce the cost to exporters, the authorities promoted the use of hedging, gave export promotion grants, and continued set aside budgets to provide rediscount facilities tor exporters (Gonzalez 2008).

[36] The authorities participated in the Special Data Dissemination Standards, Reports on the Observance of Standards and Codes, and Financial Sector Assessment program, in order to enhance the transparency and surveillance of capital flows.

[37] The authorities also implemented a risk-based approach in its supervision of banks, adopted a consolidated approach in the assessment of financial conglomerates, and enhanced surveillance of banks.

[38] The first phase included capital outflows liberalization initiatives to increase the limit of outward investment that residents could engage in without prior approval and registration from USD6 million to USD12 million, as well as the FX they could buy from banks without supporting documents for non-trade current account transactions from USD5,000 to USD10,000 (BSP Circular 561 dated 08 March 2007)..

15. **After the GFC, in addition to continuing with the same approach of FX intervention, reduction of foreign borrowing and lowering of costs to exporters, the authorities intensified the series of FX liberalization reforms they had started in 2007, and complemented it with strengthened macro-prudential regulations and surveillance to promote market discipline.**

16. **As mentioned above, beginning 2007, the authorities implemented a series of intensified FX liberalization measures[39].** These efforts were continued post-GFC. In phases, the authorities successively relaxed FX regulations, aiming to reduce the cost of doing business, encourage the use of formal channels instead of the black market for FX transactions, stimulate the flow of funds, promote financial deepening, and enhance price discovery, while at the same time, enhancing data capture, governance, and oversight in the FX market. Thus, the requirement to receive prior approval from the central bank, the Bangko Sentral ng Pilipinas (BSP), was successively removed for many types of transactions, but the data reporting system was also simplified and migrated to an electronic platform to increase access to data and transparency.[40] The amount of FX that residents can buy from banks for both current account transactions and outward investments has also been increased in phases.

17. **Post-GFC, the authorities also implemented several Basel standard banking sector reforms and strengthened macro-prudential frameworks (see Table A3.1).**

Table A3.1 Macro-prudential Measures Introduced Post-GFC

Year	Measures Introduced
2008	The authorities imposed a limit of 20 percent on real estate loan exposures by banks[41]
2011	The authorities introduced higher risk weights and limits to gross exposures of banks to peso non-deliverable forward (NDF) transactions in order to check undue speculation against the peso[42]
2013	Guidelines were issued for a capital conservation buffer that aligned with Basel III standards
2014	Regulations on domestic systematically important banks were released[43]
2014	To identify potential vulnerabilities associated with the real estate exposure of banks, the Real Estate Stress Test Limit was adopted[44]
2015	Regulations on the leverage ratio framework followed were issued
2016	Banks were required to maintain the appropriate liquidity coverage ratios[45]
2018	The authorities implemented the framework for a countercyclical capital buffer[46]

18. **The Philippines also increased investment spending starting 2012, which had the effect of boosting demand for FX.**

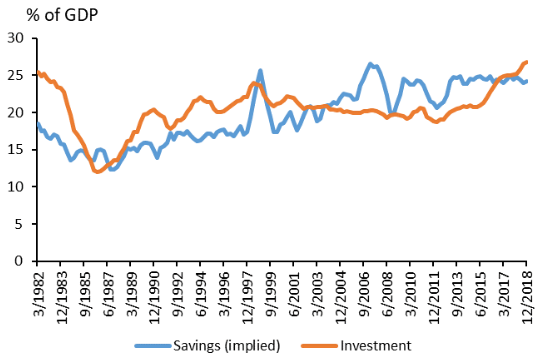
[39] As early as the 1990s, the BSP initiated liberalization of the country's FX regulatory framework, which was pursued more vigorously starting 2007. To date, the BSP has initiated 11 waves of FX reforms since 2007. The latest wave of reforms under Circular No. 1030 dated 5 February 2019 further liberalized rules on foreign investments and allowed the electronic submission of supporting documents for: (a) the registration of private sector foreign loans without public sector guarantee; (b) registration of inward investments; and (c) sale of FX for various transactions. The current policy thrust of the BSP remains geared towards liberalization of FX regulations, facilitating access to the banking system's FX resources for legitimate transactions, and further streamlining of procedures and documentary requirements for FX transactions.
[40] For example, prior approval for purely private-sector FX loans (those which are not publicly-guaranteed) is no longer required. Registration is required only if the FX needed to service the loan will be purchased from banks. Moreover, some private sector loans (e.g., foreign currency loans of resident borrowers from banks operating in the Philippines, and short-term loans in the form of export advances from buyers broad of resident exporters/borrowers) no longer require prior BSP approval and subsequent registration, but subject only to reporting to the BSP.
[41] BSP Circular No. 600 (dated 4 February 2008).
[42] BSP Circular No. 740.
[43] BSP Circular No. 856.
[44] BSP Circular No. 839. Memorandum No. M-2012-046.
[45] BSP Circular No. 905.
[46] BSP Circular No. 1024. This is currently set at 0 percent, but in principle it can be raised countercyclically during periods of expansion.

Effects of the Policy Measures

19. **The foreign investment liberalization and debt management strategies helped change the composition of capital inflows towards more stable flows.** The authorities' phased foreign investment liberalization facilitated the change in composition of capital inflows in favor of the more stable FDI flows, whose share in the total capital inflows increased from almost nil in the early 1980s to around 60 percent in 2018. The debt management strategy also resulted in a lower proportion of short-term and foreign debt and towards a greater proportion of long-term and domestic debts, which implies more stable flows and reduced FX supply, thereby putting less upward pressure on the peso.

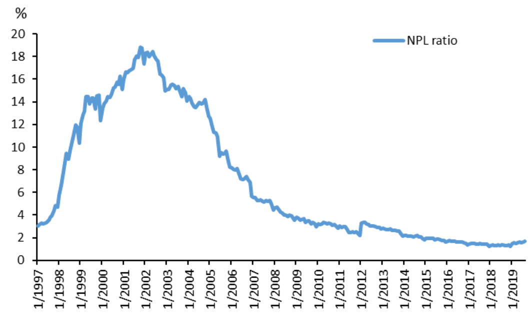
20. **The authorities' efforts to liberalize outflows and increase domestic investment have also been effective.** Figure A3.8 shows that since the mid-1990s,[47] outward FDI, portfolio investment, and other investment by residents have been on the rise, with brief reversals only during the AFC and GFC as home bias set in. Figure A3.9 also shows that the domestic investment rate has been increasing since 2012. Both of these conditions would have the effect of raising demand for FX and easing the appreciation pressure on the local currency.

Figure A3.9 Savings and Investment Rate



Note: Figures are as percentages of GDP, four-quarter rolling averages
Source: CEIC; AMRO staff calculations

Figure A3.10 Banks' NPL Ratio



Note: There was a data series break in 2013
Source: CEIC; BSP

Box A3.1. FX Intervention during Periods of Capital Inflows

Recent research suggests that although a more flexible exchange rate can sometimes act as shock absorber, it can also, in some cases, function as an amplifier of shocks, particularly for countries with less developed financial markets and higher FX liabilities.[48] Econometric evidence suggests that FX intervention can be a valid policy tool in managing capital flow surges.[49] In this box, we examine the Philippine authorities' use of FX intervention as a macroeconomic management tool.

Like many Asian countries, the Philippines does not publish intervention and sterilization data. This necessitates the use of proxy estimates for these variables. So, here we infer some liquidity adjustments as sterilization. We use standard econometric methodology to estimate FX

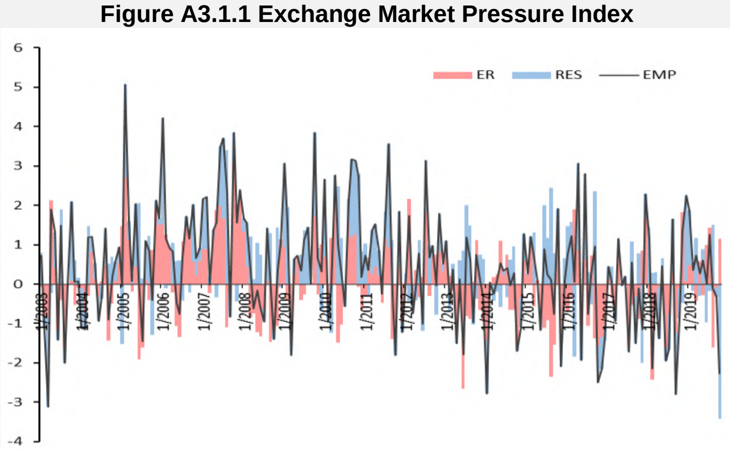
[47] Gross outflows have been virtually non-existent prior to 1993.
[48] International Monetary Fund. 2019. "Facing the Tides: Managing Capital Flows in Asia," https://www.imf.org/~/media/Files/ Publications/ DP/2019/English/FTDEA.ashx.
[49] Blanchard, Olivier, Gustavoe Adler, and Irineu de Carvalho Filho. 2015. "Can Foreign Exchange Intervention Stem Exchange Rate Pressures from Global Capital Flow Shocks?," https://www.nber.org/papers/w21427.

intervention and sterilization.[50][51] To estimate the degree of FX intervention, we calculate the exchange market pressure index as:

$$EMP_t = \frac{1}{\sigma_{\Delta RES_t}} \Delta RES_t + \frac{1}{\sigma_{\%\Delta ER_t}} \%\Delta ER_t,$$

where ΔRES_t is the month-on-month change in the BSP's net foreign assets, $\%\Delta ER_t$ is the month-on-month percentage change in the USD/PHP rate, and $\sigma_{\Delta RES_t}$ and $\sigma_{\%\Delta ER_t}$ are the standard deviations of ΔRES_t and $\%\Delta ER_t$, respectively. To estimate the degree of sterilization, we calculate the coefficient of correlation by using the slope coefficient of the regression on the percentage contribution of net domestic asset to the base money growth on the percentage contribution of net foreign assets to base money growth.

Figure A3.1.1 Exchange Market Pressure Index



Source: CEIC; BSP; AMRO staff calculations

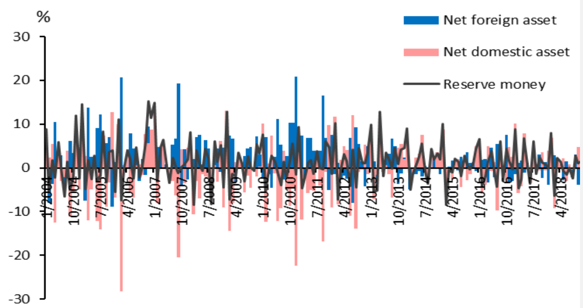
The authorities have engaged in intervention with adjustment in liquidity (sterilized or non-sterilized). As the exchange market pressure (EMP) index in Figure A3.1.1 shows, the BSP conducted at least partial FX intervention during periods of heavy inflow and upward pressure on the peso, but not as much during periods of depreciation.

Figure A3.1.2 suggests that the periods of FX intervention also tended to be at least partially sterilized, as net domestic asset growth tends to be negative during times of FX purchases. More formally, Table A3.1.1 shows that the sterilization coefficient during January 2004 to September 2019 was -0.9, suggesting that the BSP's FX intervention might be mostly sterilized in the said period. It also suggests that sterilization was stronger during periods of heavy inflows such as between January 2006 and December 2007 and between January 2010 and December 2012.

Recent research reveals that, consistent with the portfolio balance channel, the exchange rate appreciation for FX interveners like the Philippines, is in general lower than those of FX floaters. This suggests that intervention can be a valid policy response for managing capital flows (Blanchard, Adler and Filho 2015)[52]**.**

[50] See International Monetary Fund (2007), "Sterilized Intervention in Emerging Asia: Is it Effective?" Chapter III of *Regional Economic Outlook, Asia and the Pacific*; and International Monetary Fund (2007), Managing Large Capital Inflows" Chapter 3 of *World Economic Outlook*, Washington.
[51] However, this is an imperfect estimate of sterilization, since reserve money may be changing owing to, say, shifts in money demand.
[52] That said, the BSP is of the view that the country's flexible exchange rate system acts as an automatic stabilizer to restore macroeconomic balance for a small open economy like the Philippines and that a flexible peso provide cushion against shocks.

Figure A3.1.2 Base Money Growth Decomposition



Source: CEIC; BSP; AMRO staff calculations

Table A3.1.1 Sterilization Coefficient

Period	Characteristics	Sterilization Coefficient
M1 2004-M9 2019	Full sample	-0.9
M1 2006-M12 2007	Heavy inflows	-1.1
M1 2010-M12 2012	Heavy inflows	-1.0

Source: AMRO staff calculations using data from CEIC and BSP

21. **Efforts to strengthen the domestic financial system also seem to have had some positive effects.** The NPL ratio of the banking system, which had increased post-AFC, has declined significantly in the subsequent years (Figure A3.10). This shows that the enactment of the Special Purpose Vehicle Act, and the banking reforms discussed previously have helped to clean up the banks' balance sheets and strengthen the banking system.[53]

Summary of Findings

22. **Similar to many emerging markets, the Philippines has experienced waves of capital inflows and sudden reversals.** Like other emerging markets, the country witnessed domestic credit booms, overheating risks, asset price booms, leverage build-up, and currency appreciation during capital inflows surges, and rapid NPL deterioration during the bust that followed.

23. **In order to guard against the potential adverse effects of unmitigated capital inflows, while maximizing their benefits, the Philippine authorities have employed a combination of monetary, exchange rate, macroprudential, and FX regulation measures.** To reduce the supply of FX inflows, the authorities relied more on domestic markets than on foreign borrowing, and liberalized FX outflows. They also promoted those measures that tended to change the composition of inflows toward more stable FDI flows and away from the more volatile short-term debt. To increase demand for FX, the authorities intervened in the FX market and increased the investment to GDP ratio, and along these lines, encouraged investment by overseas Filipinos. To raise the capacity of the financial system to intermediate the capital flows, banking and capital market reforms were pursued, in addition to increasing the surveillance of the flows and their impact. To address residual risks to the banking sector's balance sheets, prudential measures such as liquidity coverage and caps on the leverage ratio were put in place. Notwithstanding the significant liberalization of FX rules, measures such as risk weights on NDF transactions and limits on net open FX positions remain in place to guard against undue speculation on the peso.

[53] At the very least, it can also be said that the series of current and capital account FX opening measures starting 2007 did not result in the deterioration of banks' asset quality, as these FX liberalization measures were complemented by a series of prudential regulations.

24. **The available evidence seems to suggest the policy measures adopted by the Philippines have achieved at least some measure of success.** The shift away from foreign debt and towards more FDI flows, changed the composition of capital flows towards more stable sources and reduced the supply of FX. The rise in investment rate also helped to increase the demand for FX.[54]

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[54] However, some of the policies were only embraced in hindsight, after the painful experiences of the 1983-85 debt crisis, and the 1997-98 AFC. Nonetheless, the delayed implementation of some of the measures notwithstanding, the accumulated body of reforms put in place through the years, should enable the Philippines to more effectively take advantage of capital inflows, while avoiding its pitfalls.