

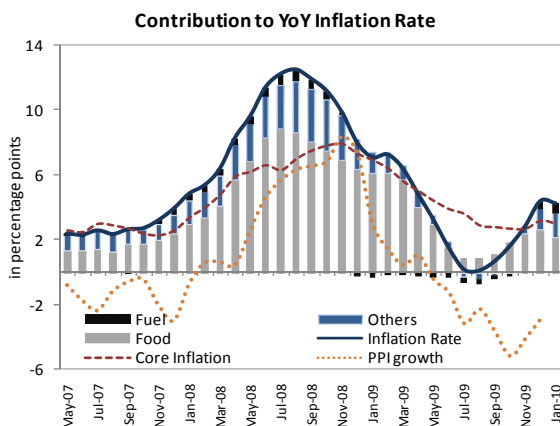
## Policies

### Monetary Policy

16. **Overall inflation eased in 2009 but upticks were seen in the latter part of 2009 as recovery gathered pace and the base effects from the 2008 price shocks faded** (Figure 19). After average inflation reached 9.3 percent in 2008, it receded to 3.2 percent in 2009, in part driven by a 7.7 percent fall in fuel prices. Core inflation dropped from 6.2 percent in 2008 to 4.1 percent in 2009, following weak domestic and international demand. After bottoming out in August 2009, inflation edged up, partly due to the base effect from the 2008 global food and fuel price shock fading out, but also due to typhoon-induced temporary supply shocks. As a result, year-on-year inflation in December 2009 reached 4.4 percent—still within the BSP’s target inflation for 2009 of 2.5-4.5 percent (Figure 20). In both January and February, headline inflation decelerated slightly, to 4.3 and 4.2 percent, respectively, due to slower price increases of food, beverage and tobacco, housing repair, and services.

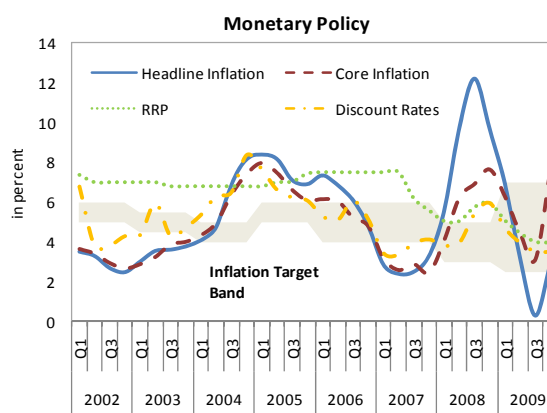
17. **The BSP has begun a prudent and paced exit from conditions of exceptional liquidity by raising the rediscount rate.** At the height of the crisis, the central bank implemented liquidity-support measures and interest-rate stimulus (see previous *Philippines Quarterly Updates* for details). As concerns on the financial system and liquidity have eased, the central bank decided in January to increase and realign the rediscounting facility rate (which was reduced by 50 basis points at the height of the crisis) to the overnight RRP rate. However, the BSP kept its policy rates unchanged as economic growth remained weak and well below potential so that inflationary pressures remain manageable, notwithstanding risks of a return to global price shocks (e.g., to rice due to the El Niño phenomenon). It is notable that, while the BSP has aggressively cut rates at the onset of the global recession, banks have only partially passed on the BSP rate cuts (Figure 21). It is therefore unclear how quickly and fully banks would transmit future rate hikes (though experience points to an asymmetry in the response to rate cuts and rate increases).

Figure 19. Inflation troughed as the fuel and food price shocks disappeared, core remains subdued



Source: National Statistics Office

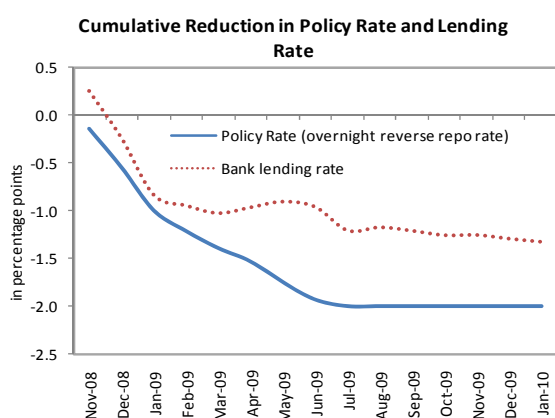
Figure 20. Inflation remains within the BSP announced target band



Source: Bangko Sentral ng Pilipinas

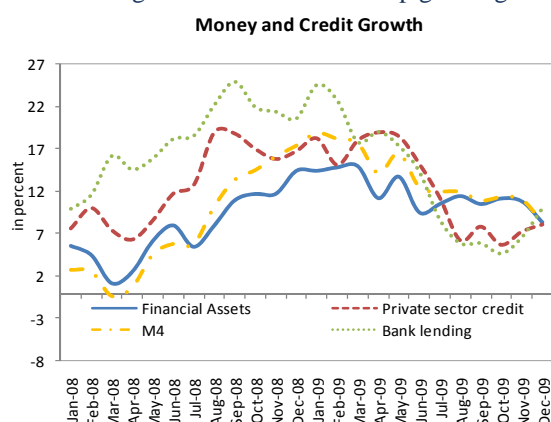
18. **Bank lending and private sector credit growth is rising again, after a period of rapid deceleration since the onset of the global crisis** (Figure 22). From an average growth of 22.6 in August 2008 to January 2009, outstanding loans of universal and commercial banks grew at a slower pace through most of 2009, partly due to tightening of lending standards. However, in late 2009, a temporary recovery in lending emerged, with lending growth reaching double digit again in December. Most of the increase in bank lending was driven by loans for the transportation, storage and communication sector. Meanwhile, construction and manufacturing loans continued to decline on a year-on-year basis, by 27.4 percent and 16.7 percent respectively in December. On the consumption side, the biggest drivers were car financing and credit cards. The January figures reveal, however, that bank lending growth moderated to 5 percent, mainly due to a deceleration of loans to production activities.

Figure 21. BSP's rate cut were initially broadly matched by the banks till April



Source: Bangko Sentral ng Pilipinas

Figure 22. Private credit and bank lending growth are fading but financial assets keep growing



Source: Bangko Sentral ng Pilipinas

## Fiscal Policy

19. **The magnitude of the fiscal stimulus implemented in 2009 was unprecedented in recent Philippines history.** The 2.6 percentage points of GDP in fiscal easing of the overall fiscal balance (GFS basis) from 2008 to 2009 was the largest one recorded since the 1986 People Power revolution (Table 5). By comparison, during the Asian financial crisis, the 1997-98 fiscal easing (the second largest after 2008-09) amounted to 2.0 percent of GDP. The large fiscal stimulus helped buffer overall economic activity in 2009. The large fiscal stimulus, however, pushed the national government's primary fiscal balance (i.e., excluding interest payments) into its first deficit since 2002, the estimated public sector balance into its first deficit since 2005, and led to the first increase in the non-financial public sector debt-to-GDP ratio since 2003 (Figure 23 and Table 5).<sup>9</sup> Such a large counter-cyclical and timely fiscal stimulus contrasts with past fiscal behavior which had been pro-cyclical (Zakharova, 2006; Botman, 2009<sup>10</sup>). The

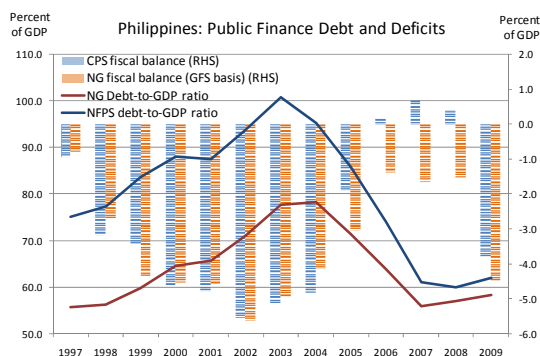
<sup>9</sup> The National Government debt increased for the second year in a row in 2009.

<sup>10</sup> Zakharova, D., 2006, "Cyclically-Adjusted Balances and Fiscal Sustainability in the Philippines", *IMF Country Report No. 06/181*; Botman, D., 2009, "Fiscal Policy During Downturns and the Pros and Cons of Alternative Fiscal Rules", *IMF Country Report No. 09/63*.

government was able to launch the ERP thanks to the combination of (1) fiscal space created in previous years and (2) the strong balance of payments position resulting from large and sustained OFW remittances.

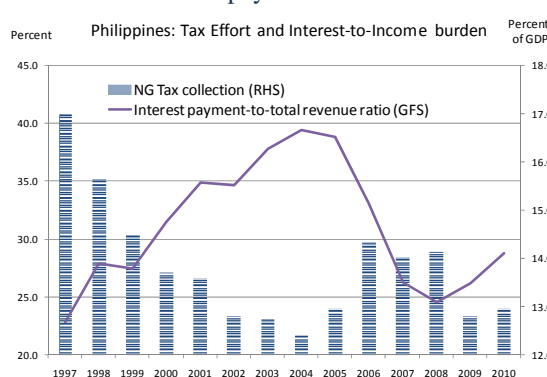
20. **The fiscal deficit reached 4.1 percent of GDP in 2009, the highest level since the implementation of fiscal reforms in 2005-2006** (Figure 23). The worsening of the fiscal balance was broadly evenly divided between higher spending (1.4 percentage points of GDP), and lower revenue (1.2 percentage points of GDP). On the spending side, 40 percent of the increase was due to discretionary primary spending (related to the Economic Resiliency Plan) and more than 20 percent due to the increases in the wage bill due to the adoption of the Salary Standardization Law (SSL III). On the revenue side, the decrease stems from a sharp drop in the tax effort (1.3 percentage points of GDP) so that the tax effort is now lower than in 2005 (the year of tax reforms). As a result, indicators of fiscal sustainability, such as the share of interest payments to total revenue is growing rapidly even though the country is currently borrowing at record low rates (Figure 24).

Figure 23. Gapping fiscal deficits and rising debt



Source: Department of Finance.

Figure 24. Rapidly declining tax effort, and rising share of interest payments to total revenue



Source: Bureau of Treasury.

21. **The change in fiscal balances from 2008 to 2009 was mostly due to a sharp deterioration of the structural fiscal balance, and structural revenue in particular.** While the structural fiscal balance (i.e., excluding cyclical component and one-off items) had significantly improved from 2006 to 2002. From 2006 to 2007, the balance remained broadly unchanged. However, in 2009 it deteriorated markedly (Figure 25). Most of the deterioration stems from the revenue side. Since the global food and fuel price shocks in 2008, Government and Congress have responded to the global shocks by introducing permanent tax cuts or exemptions. As a result, a large share of the gains from the 2005 reforms (e.g., eVAT) has been undone (Figure 26).<sup>11</sup>

<sup>11</sup> The most important recent tax eroding measures—which have been described in details in previous issues of our *Quarterly Update*—are the following: 0.5 percentage points of GDP originate from the reduction in the corporate income tax (from 35 to 30 percent), 0.3 percentage points of GDP stem from the cut in personal income tax, and 0.15 percentage points of GDP are due to the replacement of the VAT by a lower-yielding franchise tax on power transmission.

22. **Recently, cyclical and one-off factors have been more pronounced on the fiscal balance (oil and rice price shocks; financial crisis and recession; typhoons)—Figure 25.** In 2008, the rapid increases in oil prices has allowed the government to collect a large revenue windfall (notably on the VAT), though some of it was offset by increased rice price support (but only a small part of the fiscal support to NFA is on-budget). The global financial crisis and recession led the government to introduce a temporary fiscal stimulus, the Economic Resiliency Plan. Finally, the impact of typhoons Ondoy and Pepeng on public finances, both revenue and expenditure, will remain noticeable in the short- to medium-term.

Figure 25. A sharply deteriorating structural fiscal balance... 1/

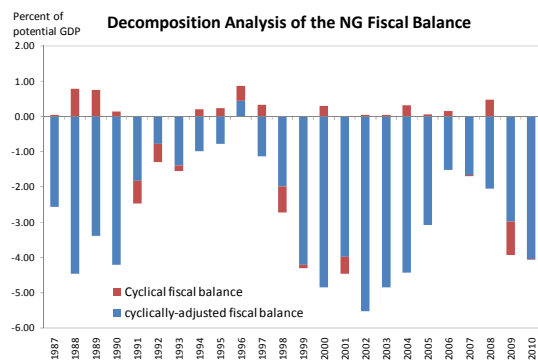
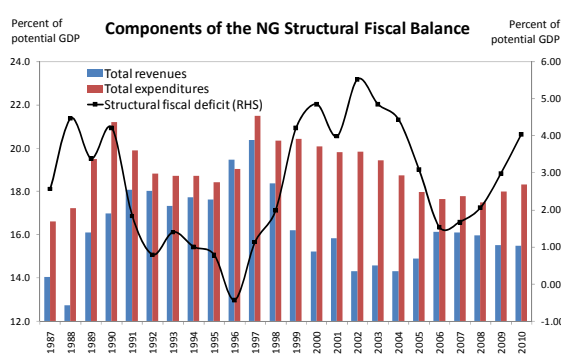


Figure 26. ...mostly due to a structural decline in the BIR's tax effort



Source: WB staff calculation based on the second method presented in Fedelino et al., 2009, "Computing Cyclically Adjusted Balances and Automatic Stabilizers", IMF, FAD Technical Notes and Manual, Washington DC.

1/ The small share of cyclical factors in the overall fiscal balance is common in developing and emerging markets as automatic stabilizers are rather modest.

23. **Notwithstanding weaker public finances and renewed global sovereign risk aversion (Dubai, Greece), the Philippine has accessed global bond markets on favorable terms.** Thanks to ample domestic liquidity and continued strong demand for emerging Asia global bonds, the country has been able to tap the markets at record low rates and long maturities (Figures 16 and 17). In particular, the government raised \$1.5 billion in global bonds in early January—the first Asian issuer in 2010—in two durations: 10 and 25-year dollar-denominated bonds whose yields were 184 and 195 basis points over US Treasuries, respectively. In February, the government issued \$1.1 billion worth of Samurai bonds. With these two operations, 40 percent of the total planned foreign borrowing for 2010 has already been accomplished in the first quarter. The remaining foreign financing is planned to come from non-market sources (bilaterals and international financial institutions) though the government has also announced it is preparing to issue its first Diaspora bond (raising \$500 million and €100 million) for March 2010.