



Philippines

Despite the currency crisis, economic performance in the Philippines was satisfactory in 1997. The current account deficit was kept manageable, supported by high receipts in the service sector, particularly from remittances of overseas contract workers, and inflation was unexpectedly low. However, the full impact of the currency turmoil will become apparent in 1998.

RECENT TRENDS AND PROSPECTS

The Philippine economy performed satisfactorily in 1997 despite disruptions caused by the regional currency turmoil in the latter half of the year. GNP and GDP registered relatively high growth rates of 5.8 and 5.1 percent, respectively, in 1997, which were, however, lower than the 6.9 and 5.7 percent, respectively, achieved in 1996. The difference between GNP and GDP was largely due to the remitted earnings of overseas Filipino workers, and the convergence of their growth rates in 1997 reflects the stabilization of these earnings. The industry and service sectors recorded reasonable growth rates of 5.7 and 5.6 percent, respectively. Notwithstanding pessimistic expectations based on the El Niño phenomenon, which caused adverse weather conditions, including severe droughts, the agriculture sector posted a growth rate of 2.8 percent, which was better than anticipated.

Overall aggregate employment growth slowed down to around 2 percent in 1997, with the agriculture sector affected most severely. The labor force grew similarly, but with 40 percent of the labor force employed in agriculture, the unemployment rate is estimated to have risen marginally to 8.7 percent in 1997.

Gross national savings as a percentage of GNP have tended to hover around 15 to 19 percent in the 1990s, with 1997 being no exception at around

19 percent. Private savings accounted for roughly 60 percent of total savings. Gross domestic investment fluctuated within a band of 20 to 24 percent of GNP during 1990-1996. After sluggish performance in 1995, investment activity picked up significantly in 1996, and this trend continued right up to the third quarter of 1997, when the high interest rates that prevailed at that time because of the currency turmoil dampened investment activity. Gross domestic investment as a percentage of GNP was 24 percent in 1997, with public investment accounting for roughly one fifth.

The government has succeeded in its efforts to achieve budget surpluses since 1994, and the trend continued in 1997. However, the public sector as a whole posted a deficit because of deficits in government corporations.

Broad money (M2) grew by about 20.5 percent in 1997, up from about 16 percent in the preceding year. Nevertheless, inflation was kept in check at 5.1 percent in 1997, mainly because of satisfactory output growth early in the year.

Export growth has been strong in recent years, increasing from a mere 4.7 percent in 1990 to 29.4 percent in 1995. Some slowdown in export growth was evident in 1996 as a result of slackening global demand for electronic components; however, 1997 saw a resumption of high export growth of 22.8 percent. Imports had maintained even higher growth rates throughout the 1990s, but slackened

Table 2.9 Major Economic Indicators: Philippines, 1995-1999
(percent)

| Item | 1995 | 1996 | 1997 | 1998 | 1999 |
|---------------------------------------|------|------|------|------|------|
| Gross domestic product growth | 4.8 | 5.7 | 5.1 | 2.4 | 4.0 |
| Gross domestic investment/GNP | 21.6 | 23.3 | 23.9 | 20.0 | 22.0 |
| Gross national saving/GNP | 16.8 | 18.8 | 19.2 | 17.0 | 19.0 |
| Inflation rate (consumer price index) | 8.1 | 8.4 | 5.1 | 10.0 | 8.0 |
| Money supply (M2) growth | 25.2 | 15.8 | 20.5 | 17.0 | 17.0 |
| Fiscal balance/GDP | 0.6 | 0.3 | 0.1 | 0.2 | 0.3 |
| Merchandise exports growth | 29.4 | 17.7 | 22.8 | 21.0 | 21.0 |
| Merchandise imports growth | 23.7 | 20.8 | 14.0 | 9.0 | 10.0 |
| Current account balance/GDP | -4.4 | -4.7 | -5.2 | -3.8 | -1.3 |
| Debt-service/exports | 15.8 | 12.0 | 10.4 | 11.4 | 11.0 |

Sources: Bangko Sentral ng Pilipinas (1998a,b); National Statistical Coordination Board (1997, 1998); Department of Budget and Management, Fiscal Planning Service data; and Bureau of Treasury data. Projections are entirely staff estimates.

in 1997, when merchandise imports rose by 14 percent.

The trade deficit increased during 1990-1996, rising from \$4 billion in 1990 to 11.3 billion in 1996. In 1997 the trade deficit was virtually unchanged at \$11.4 billion. The increase in the trade deficit could have been lessened had the appreciation of the real exchange rate not been so significant. Between 1990 and September 1997, the real effective exchange rate appreciated by 28 percent against the currencies of major trading partners and by 20 percent against competing countries' currencies.

The current account deficit was kept at manageable levels in the 1990s, with the highest deficit reaching 5.5 percent of GDP in 1993. In 1997 the figure was 5.2 percent. This was largely a result of high receipts in the services sector, particularly remittances from overseas contract workers. Even though the major share of remittances is from outside the region, some slowdown is likely in the medium term if overseas workers in other Asian countries are retrenched as a result of the regional economic contraction that has followed on the heels of the currency instability. This highlights the fact that the Philippines cannot rely on such remittances as a sustainable source of support for bolstering the current account.

The Philippines has experienced large capital inflows in recent years: net capital inflows increased from \$1.8 billion in 1990 to \$8.6 billion in 1996. Following the currency instability, foreign investment inflows and capital inflows to commercial banks dropped sharply, and in 1997 the resulting capital account surplus could not cover the current account deficit. The overall balance-of-payments deficit exceeded \$3 billion, financed through a draw-down of reserves, which dropped to \$8.8 billion by the end of 1997.

GNP growth will slow down considerably to 2.9 percent in 1998, and will be accompanied by a significant rise in unemployment. High liquidity growth and rising import costs will be evident in 1998, and the inflation rate is likely to reach double digits. The savings rate is likely to fall as higher debt-service costs and inflation affect the savings capability of both the public and private sectors. The current account deficit is projected to improve to 3.8 percent of GDP in 1998, largely because of a reduced trade deficit.

As lower GDP growth will likely affect government revenues in 1998, they are unlikely to grow much beyond the levels achieved in 1997. Thus the national budget is not expected to yield a significant surplus in 1998. Expenditure will be trimmed to

match available revenues, and as the government is unlikely to reduce its current operating expenditures significantly in an election year, cuts are expected in maintenance and capital expenditures that will probably affect the public sector development program in 1998.

The full impact of the monetary expansion, the peso depreciation, and the El Niño weather phenomenon will be felt with a lag in 1998. In addition, unemployment is likely to rise in 1998 as agricultural employment falls further. The government's ability to maintain public investment levels will be an important determinant of economic performance in 1998. With conditions stabilizing in the rest of the region, recovery is expected to begin in 1999.

CRITICAL ISSUES IN SHORT-TERM ECONOMIC MANAGEMENT

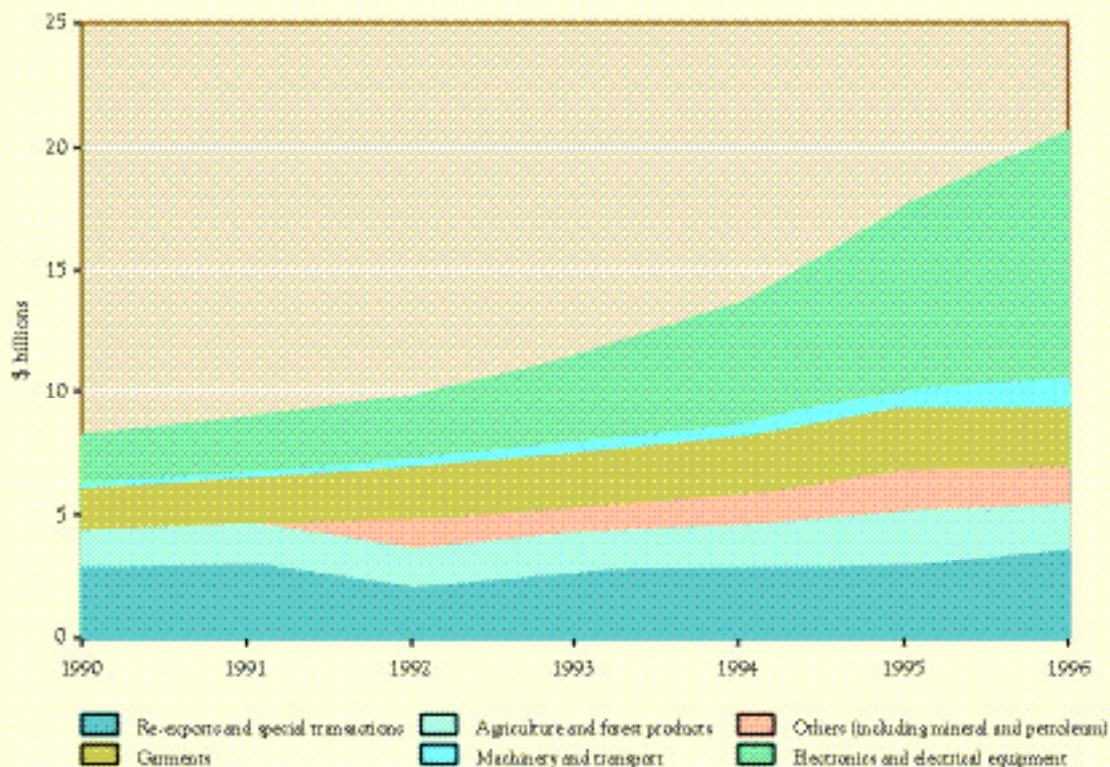
The year 1998 is likely to be crucial for the Philippine economy. Successful containment of the economic impacts of the currency turmoil and the pace of eco-

nomical recovery will depend on such policies as maintaining aggregate investment levels, preventing disruption in banking and financial services, managing corporate indebtedness, enabling the export sector to take maximum advantage of the opportunities created by the currency depreciation, and effecting a smooth political transition after the elections. The continuation of economic reforms is crucial and will be closely monitored by foreign investors.

With high interest rates prevailing to stabilize the currency, private investment demand is likely to be sluggish. Unless public investment levels are maintained, overall investment and growth will be severely affected. Rising interest and debt servicing costs as a result of the sharp depreciation of the peso; the lack of flexibility in major items of current expenditure, such as salaries; and absence of buoyancy in revenue generation because of reduced growth are going to pose a challenge to government efforts to sustain public development expenditures.

The possibilities of corporate defaults and consequent difficulties for the banking sector are likely,

Figure 2.7 Exports by Commodity Classification: Philippines, 1990-1996



Source: Bangko Sentral ng Pilipinas (1998b).

and need careful attention. Official estimates of the banking sector's exposure to the real estate sector have been revised upward, and currently stand at 13.7 percent of total loans. The current estimate of the share of nonperforming loans is 4.7 percent; however, this will rise given the much greater excess capacity in the real estate sector likely to be experienced in 1998. The capabilities of the Bangko Sentral ng Pilipinas (the Central Bank) and the Philippine Deposit Insurance Corporation to supervise the banking system, and of the Securities and Exchange Commission to supervise the corporate sector need to be enhanced, and policy measures should be put in place to allow these agencies to play a more effective supervisory role. In addition, the monetary authorities need to develop effective hedging instruments to protect those with foreign currency loans.

POLICY AND DEVELOPMENT ISSUES

Despite its improved economic performance since the mid-1990s, the Philippine economy exhibits several weaknesses, namely: the domestic savings rate remains low and stagnant; the growth in agricultural production has been weak and variable, and is subject to large output fluctuations as a result of weather changes because irrigation remains insufficient; the industry sector's technological progress has been slow, especially in small and medium enterprises; the integration of manufactured exports with local manufacturing has been weak, which has prevented the surge in exports from having a significant impact on local industry; and the physical infrastructure needs considerable upgrading. The high rate of population growth has reduced the gains that resulted from economic growth, and GNP per capita growth was negative from 1990 to 1993. However, since 1994 GNP per capita has shown some improvement. The provision of social services is still inadequate, especially in health and education. In addition, the distribution of the benefits of growth has also been uneven across income classes and regions. Concerted action to overcome these weaknesses is necessary for sustained development.

The major medium-term policy concern is to address the economic vulnerabilities exposed by the current currency turmoil and to find ways to improve the economy's resilience in the context of its further globalization. This involves implementing

further reforms in the financial and capital markets, promoting the sustainability of export growth, and reappraising the exchange rate policy.

Reform in Financial and Capital Markets

Central to the reform process are measures to boost domestic savings and to restore the confidence of foreign investors. Reforms under way on the equity side of the capital market include improving the functioning of the stock market, increasing transparency, ensuring the protection of shareholders' interests, introducing international standards and practices, and ensuring better supervision and regulation.

In addition, further development of the debt market is necessary. Treasury bills dominate the bond market; corporate debt is confined mainly to short-term commercial paper; municipal and project bonds are largely underdeveloped; and domestic institutional investors, such as pension funds and insurance companies, prefer to hold risk-free government paper. Reforms are needed to enable all these entities to play a more meaningful role in augmenting savings. In addition, considerable policy and institutional reforms are required to develop the domestic debt market to cater to the economy's long-term investment needs. These measures include changing the tax treatment of and regulations concerning debt instruments; strengthening secondary market and credit rating institutions; and building the capacity of agencies, financial institutions, and local governments.

Export Development

Although the export growth the Philippines has experienced is among the most impressive in the region, the authorities need to take steps to ensure that the growth performance is sustainable over the long term. These include paying more attention to traditional exports that have not experienced much buoyancy, such as garments and food processing, and trying to diversify manufactured exports and increase their local content, particularly of electronics exports. Accomplishing this calls for a wide array of policy and capacity building measures in the areas of trade, foreign investment, and industry. These include upgrading the skills of the work force,

improving the technology base of the economy, removing infrastructural bottlenecks, paying greater attention to credit provision for exports, promoting small- and medium-size enterprises, and adopting specific capacity building measures for government agencies concerned with export promotion.

The exchange rate policy should be viewed not only in the context of assisting exporters, but also of overall macroeconomic management. Although the Bangko Sentral maintains that the exchange rate is determined by the market with only occasional limited intervention to provide indicative guidance,

before the onset of the currency turmoil the peso-dollar nominal exchange rate had experienced unusual stability. However, despite some depreciation of the nominal effective exchange rate, the real effective exchange rate had witnessed a steady appreciation. The gains from the current steep nominal depreciation of the peso could similarly be quickly reversed unless fiscal and monetary policy were used effectively to keep inflation under control. The attainment and maintenance of appropriate real effective exchange rates is necessary to sustain the momentum of growth in exports and output.