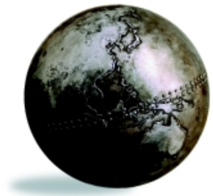


# Philippines

*Compounded by delays in implementing structural reforms, economic recovery in the Philippines has been slow compared to other crisis-affected countries. Measures to accelerate the implementation of reforms are critical to improve medium-term growth prospects, address the serious poverty problem, and arrest further environmental degradation.*

## RECENT TRENDS AND PROSPECTS

In 1999, the economy experienced a GDP growth rate of 3.2 percent. Slow growth was primarily due to the anemic performance of the industry sector, which grew only 0.5 percent. Agriculture experienced a strong recovery from the El Niño drought of 1998, and grew by 6.6 percent, the highest rate in decades. Services, which had remained resilient throughout the crisis, grew by 3.9 percent in 1999, based mainly on retail trade growth.

Poor industrial performance resulted from weak consumer demand for nonfood manufactured items, a mild contraction in the construction sector caused by overcapacity, and nonperforming loans (NPLs) that impeded growth in bank financing for new projects. Slow growth in industry has been symptomatic of economic performance in recent years. The industrial share in GDP has shrunk from more than 40 percent two decades ago to around 35 percent in 1998, in contrast to strong industrial growth in neighboring countries such as Malaysia and Thailand.

Despite the slow overall economic recovery, employment in the agriculture sector increased significantly. However, this was almost completely offset by declining employment in industry and rapid growth in the labor force. Consequently, the unemployment rate decreased only slightly and underemployment remained substantial. The investment rate further declined in 1999, following a severe contraction in 1998. Efforts to improve the investment climate by lowering interest rates were countered by a lack of investor confidence in the progress of economic reforms and in the policy framework itself.

Inflation gradually receded, averaging 6.6 percent for the year. The reduction in inflation reflects a strong supply of agriculture products as well as modest domestic demand and a relatively stable exchange rate.

The economic crisis and subsequent efforts to stimulate domestic demand resulted in a larger than planned fiscal imbalance. The fiscal deficit increased to about 3.6 percent of GDP in 1999, nearly double the 1998 level and substantially higher than targeted.

Lower-than-expected tax collections and higher spending were responsible for the increased deficit. The increase in the public debt did not seem to have any crowding-out effect on private borrowing, which remained weak. Despite easing monetary policy and lowering interest rates—the benchmark 91-day Treasury bill rate remained below 9 percent for the last three months of the year—there was no significant increase in bank lending activity. Money supply and credit growth were weak. Domestic credit shrank in the first half of 1999 before recovering slightly in the last six months as the private sector began to recover. Low credit growth in the early months of the year reflected slow economic recovery, low lending spreads, and borrowers' unwillingness to make commitments in a climate of general overcapacity and insufficient demand.

On the external front, the trade and the current account balances turned around sharply in 1999. The trade balance soared from a deficit of $19 million in 1998 to a surplus of more than $4 billion, while the current account surplus widened from $1.3 billion to nearly $6 billion. These surpluses primarily resulted from growth of nearly 20 percent in exports, particularly in electronics and components, which accounted for nearly 60 percent of export revenue. Imports grew slowly, reflecting sluggish domestic demand for both consumer and investment goods. On the capital account, the outflow of short-term private capital continued, although at a lower level than in 1998. However, this was more than offset by a variety of official inflows, including a two-year standby facility from the International Monetary Fund—supported by the Asian Development Bank, Japan, and the World Bank—as well as bond financing on international capital markets. The surplus in the balance of payments resulted in a substantial increase in international reserves to nearly $15 billion, exceeding the precrisis level by more than $2 billion. While the external debt-to-GDP ratio increased to around 65 percent mainly because of the peso's depreciation, the debt-service ratio was a comfortable 13 percent.

The overall macroeconomic situation continued to reflect the adverse effects of the economic crisis. Although the beginnings of a recovery were evident, it has yet to gather full momentum. Unemployment and the number of NPLs continued to be high, and industrial activity, demand for credit, investment

**Table 2.11 Major Economic Indicators, Philippines, 1997-2001**
**(percent)**

| Item | 1997 | 1998 | 1999 | 2000 | 2001 |
|---|---|---|---|---|---|
| GDP growth | 5.2 | -0.5 | 3.2 | 3.8 | 4.3 |
| Gross domestic investment/GDP | 24.9 | 20.4 | 18.8 | 19.5 | 20.0 |
| Gross domestic savings/GDP | 19.6 | 22.3 | 19.8 | 20.0 | 21.0 |
| Inflation rate (consumer price index) | 5.9 | 9.8 | 6.6 | 6.5 | 6.0 |
| Money supply (M3) growth | 20.9 | 7.4 | 19.3 | 17.0 | 18.0 |
| Fiscal balance/GDP | 0.1 | -1.8 | -3.6[a] | -1.8 | -2.0 |
| Merchandise exports growth | 22.8 | 16.9 | 18.8 | 14.0 | 14.0 |
| Merchandise imports growth | 14.0 | -18.8 | 4.1 | 14.0 | 16.0 |
| Current account balance/GDP | -5.3 | 1.7 | 9.1[b] | 6.3 | 5.6 |
| Debt-service ratio | 11.6 | 12.7 | 13.1[c] | 14.3 | 14.5 |

a. January to September 1999.
b. Projection from Bangko Sentral ng Pilipinas.
c. January to November 1999.

*Sources:* ADB (1999f); IMF (2000); National Economic and Development Authority; National Statistical Coordination Board; staff estimates.

demand, and foreign private capital inflows were all low. However, inflation has been controlled, interest rates have been lowered, and export demand is strong. The pace of economic reforms, however, has been slow. Concerns include reduced revenue, quality of public expenditures, delayed reforms in the banking and financial sectors, and slow progress in legislation required for capital market reforms and in the privatization program. Many of the pending reforms are close to implementation, and will send positive signals to investors when implemented. The government expects the Securities Act and the Omnibus Power Sector Reform Bill to be passed by the legislature by mid-2000.

In 2000, GDP growth may reach 3.8 percent as the economy continues its moderate recovery, although return of investor confidence is pivotal. For 2001, growth will depend to some extent on weather conditions and their effect on the agriculture sector. Improved growth prospects are contingent on several factors. First, continuing prudent macroeconomic management is required, along with progress in reforms. The government expects that budgetary deficits will continue at least until 2001. These deficits may be necessary to impart the needed boost to the economy in an environment of flagging aggregate demand, and to maintain vital social sector expenditures. However, care must be taken to ensure that financing these deficits does not push up interest rates and crowd out much-needed private investment. Second, strong export growth momentum must continue. However, because the export basket is composed of a narrow range of products—electronics, transport equipment, machinery, garments, and textiles—it is sensitive to shifts in market sentiment and price volatility. Diversification of the export basket and encouraging small and medium-size enterprises in areas where the Philippines has a comparative advantage will help maintain export dynamism, and would ensure future export growth. Finally, a continued favorable regional environment is necessary for recovery.

## ISSUES IN ECONOMIC MANAGEMENT

So that recovery can be sustained and growth further accelerated, action on several fronts is necessary. Restoration of investor confidence clearly requires the government's commitment to reform, as well as social consensus for its policies and programs. At the beginning of 1999, changes in various important departments were announced, and the Economic Coordination Council was formed to begin implementing stalled reforms. The business community and the public welcomed a renewed commitment to improving government efficiency, and these changes raised hopes that the stalled reform process will gather speed.

One issue is the size of the budget deficit required to stimulate the economy without causing inflation or a rise in interest rates. In 1999, the deficit exceeded the P100 billion target, but did not affect prices and interest rates. In 2000, the deficit target is much lower, which is appropriate considering the expectations of recovery. Nevertheless, care must be taken to ensure that private sector investment is not discouraged. Should the recovery be delayed, a larger role for public investments may be warranted, particularly to impart further stimulus to the economy and to augment badly needed social expenditures.

Better fiscal management can provide government resources in the short term to fund priority investments without resorting to higher deficits. Investment projects, especially those assisted by donors, have lagged, and this is a critical issue. Better project implementation can improve the productivity of investments and allow efficient use of scarce investable resources. The government has taken initiatives to improve implementation, such as setting up the Presidential Committee on Flagship Programs and Projects. Speedy action is needed to improve project implementation and expenditure monitoring and management, and to increase vitally needed social and infrastructure expenditures.

On the revenue side, measures are being taken to revamp tax administration to improve collections. The government has upgraded the bureaus of internal tax and customs and is considering other administrative measures, such as focusing first on large delinquent taxpayers to improve revenue collections. However, the process has been slow and needs more vigorous efforts.

On the monetary front, the main concern is the number of NPLs in the banking system, currently around 15 percent of total loans. This is much smaller than in other crisis-affected countries, but the con-

### Box 2.1 Dimensions of Poverty

More than a third of the population of the Philippines—36.7 percent in 1997—is poor. An Asian Development Bank study based on the 1998 Annual Poverty Indicators Survey offers insights into the nature of poverty (see figure 2.11).

- Poverty in the Philippines is predominantly rural. A main cause of rural poverty is low productivity of agricultural employment. The highest incidence of poverty exists among households whose head is employed in the agriculture sector, and is far higher than among those engaged in services or industry.
- Low labor productivity and returns from labor—rather than unemployment—are the main determinants of poverty. More poor are employed than nonpoor, but the wages are not ample to lift them out of poverty. The labor market has a large informal segment capable of keeping wages low.
- Little difference exists in primary school enrollment rates between children of poor and nonpoor households. The net enrollment rates for secondary school, however, show a significant gap between the poor and nonpoor at this level.
- The self-reported rate of sickness is similar for the poor and nonpoor. The poor, however, are more likely to seek treatment at a local public health facility, usually a public rural health clinic, than the nonpoor. The nonpoor more frequently access private medical facilities, private hospitals, and clinics, particularly private clinics. The nearby barangay or village health centers staffed by a midwife or health worker remain underused.
- Compared to the other East Asian countries, population growth in the Philippines is high, which is reflected in higher family size. Average household size among the poor is even higher. While reported awareness of family planning methods is high, contraceptive use is still relatively low, and even lower among poor women. Access to maternal care is low, as evidenced by the low percentage of pregnant women receiving iron and other supplements. These rates are lowest among poor women and those living in certain regions.
- The poor have less access to clean water supply, piped water, and tube wells than the nonpoor, and hence are more likely to use contaminated sources of water such as dug wells. Despite less access to clean water, however, the gap is modest between poor and nonpoor in access to toilets, whether personal or communal.
- The poor have even less access to electricity than to clean water. Nationally, less than half of the poor live in premises connected to a national or cooperative system, while almost 90 percent of the nonpoor have such a connection.

These results have significant policy implications. They confirm that greater rural development is critical to poverty reduction and that raising labor productivity in all sectors, including the informal sector, can be an important step.

In terms of human resource development, while educational policies have been relatively successful at promoting primary education, reforms are needed to increase secondary education among the poor.

In health, as the poor generally access basic public health facilities more often, further improvement in these services would greatly benefit the poor. Additional efforts and reforms are needed to promote the use of the barangay or village health centers. The low contraceptive prevalence rate needs to be increased, and maternal health improved by more pervasive distribution of needed prenatal supplements.

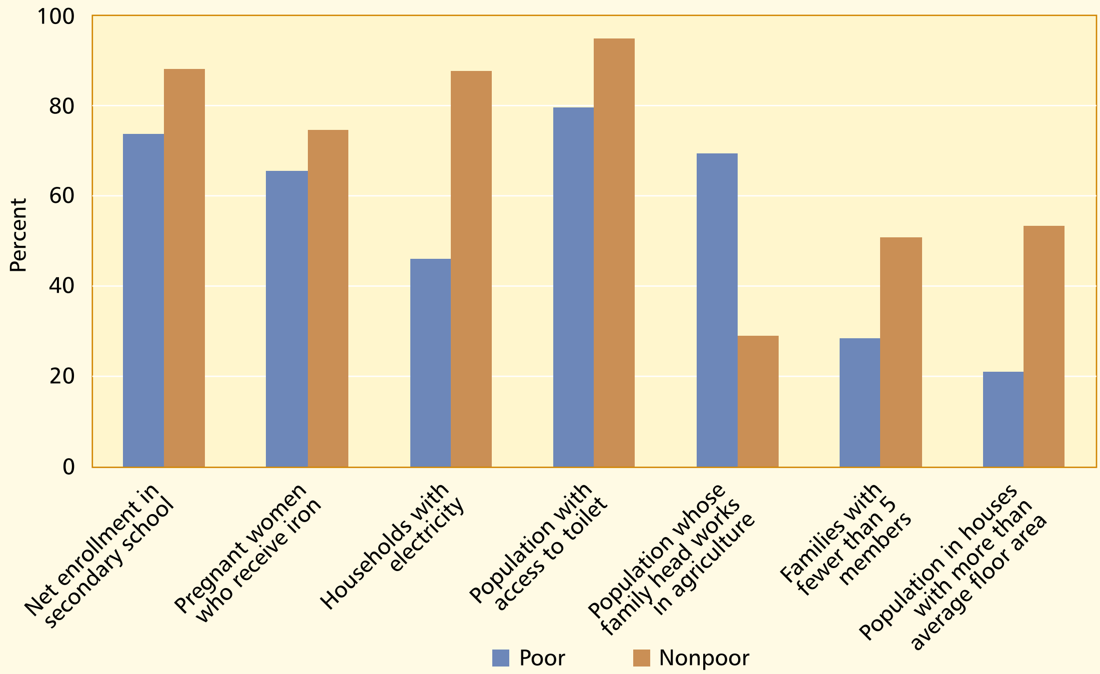
Other services such as providing clean water remain a high priority, particularly for the poor, and in view of the implications for sanitation and hygiene. The large inequity in access to electricity suggests that expanding electricity distribution in rural areas can result in considerable benefits.

*Sources:* ADB (1999f); NSCB(1998).

tinued increase and persistence is a cause for concern. Faced with stagnant sales volumes, firms are cutting costs, reducing indebtedness, and selling assets. Applications to the Securities and Exchange Commission to suspend debt payments slowed considerably in 1999 from 1998. Nevertheless, the level of NPLs has acted as a drag on the financial system and restrained credit growth. The authorities must continue efforts to stimulate corporate activity and at the same time ensure that loan-loss provisions remain adequate.

The financial crisis and slow economic recovery has exacerbated the problems local government units face in delivering social services. Resources are often inadequate and financial management of these re-

**Figure 2.11 Socioeconomic Indicators, Poor versus Nonpoor, Philippines, 1998**




*Source:* NSCB (1998).

sources has been poor. The national government could help by making its transfers to local governments more predictable and basing them on transparent criteria, such as good governance and effective revenue mobilization. Further, the revenue-sharing formula should be broadened to include other parameters, such as the incidence of poverty and levels of education and health. The national government can also organize training for local government units and publicize how the most efficient units have generated local revenue and used their funds efficiently.

## POLICY AND DEVELOPMENT ISSUES

The economy faces three structural challenges required to achieve sustained growth: poverty reduction, proper environmental management, and adequate infrastructure. Continuing high poverty shows that the development process has not succeeded, and that large sections of the population, impeded by poverty, are unable to contribute. Environmental protection is essential for sustaining growth and ensuring livelihood for some of the poorest segments of society. Both are major structural constraints to development, and unless tackled urgently, will impede its progress.

Data released by the government indicate that poverty incidence has fallen slowly over the past decades but remains high, particularly in rural areas. Little progress has been made in raising living standards for the poorest of the poor, who are below the subsistence income threshold. Poverty reduction programs have failed to effectively target the needs of these people.

The government considers poverty reduction one of the major planks of its development strategy. However, the Medium Term Philippine Development

Plan has a modest target for reducing the overall incidence of poverty by at most 7 percent in 1997-2004. This is no different from earlier targets, and reflects no major additional emphasis on poverty reduction. As poverty alleviation efforts progress, bringing the remaining poor above the poverty line becomes increasingly difficult. Special measures are necessary to address the needs of the very poor, and far more effort is needed to address this seemingly intractable problem. The government has begun annual poverty surveys, which will help better monitor and delineate the dimensions of poverty and guide efforts to address the needs of the poor (see box 2.1).

Indications are clear that rapid environmental degradation is under way. The annual rate of deforestation, for example, is among the highest in Southeast Asia, and the protected forest area as a percentage of total land area is among the lowest in Southeast Asia. Conservation International, a reputed nongovernment organization, has ranked the Philippines first among 25 countries classified as Priority Biodiversity Hotspots needing urgent attention.

The cost of environmental degradation to the economy is high. Health and productivity losses from air and water pollution in Metro Manila alone have been estimated at about 1 percent of gross national product annually. However, because of difficulties in measuring the full cost of pollution and environmental damage, it is difficult for policymakers to make informed decisions and take appropriate action. More analysis is needed. The government also needs to devote more attention to capacity building of national government agencies that handle environment matters, and to improving their capability for enacting and enforcing environmental regulations. This involves obtaining the cooperation of all stakeholders, including local governments and communities as well as nongovernment organizations.

The Philippines has lagged behind many of its neighbors in physical infrastructure to support the industrialization and general development effort. Poor roads, inadequate port facilities, and unreliable and expensive power have increased costs and reduced economic efficiency. Many of these deficiencies in infrastructure have been addressed in the past few years, but much remains to be done. The Medium Term Philippine Development Plan calls for the private sector to be more involved in accelerating project implementation and restructuring the electricity sector through privatization, which is projected to improve efficiency, and lower costs. Costs of electricity are higher than in neighboring countries, which puts exporters at a disadvantage. A program of specific targets for achieving this objective would be welcome.