



Philippines

Economic Assessment

Exceeding the expectations of *ADO 2004*, GDP growth came in at 6.3% in the first half of 2004. Unusually for the Philippines, the rise in gross national product (GNP) at 6.1% was less than in GDP, mainly reflecting a drop in the growth rate of remittances from overseas workers. Personal consumption (two thirds of aggregate demand) rose by 5.9% and remained the main driver of domestic demand in the first half, contributing 4.6 percentage points to the rise in GDP. Tight public expenditure controls to reduce the budget deficit resulted in government consumption expenditure growing by just 0.5%, making virtually no contribution to the GDP expansion. Gross capital formation, which accounted for 2.1 percentage points of GDP growth, increased by 9.4%, with a pickup in both construction and durable equipment. Exports grew by 13.0% and imports by 5.7%, resulting in a net export contribution to GDP growth of 2.3 percentage points.¹ On the production side, good weather helped agriculture, fisheries, and forestry (together accounting for 20% of GDP) to grow by 6.3%. The industry sector (33% of GDP) climbed by 5.6%, with manufacturing and construction the leading sources of sector strengthening. Services (47% of GDP) grew by 6.9%. All subsectors in services posted gains; election-related activities peaked in the second quarter.

However, the economy did not generate enough jobs for the growing workforce, as seen in high rates of unemployment (13.7% in April) and underemployment (18.5%). The deployment of workers overseas, after a slowdown in 2003, grew by 7.2% in January–June.

Congress has not passed the proposed 2004 budget, and the Government will operate on the reenacted 2003 budget for the rest of the year. The budget retains the full-year deficit target of

P197.8 billion (4.2% of projected GDP), while revised quarterly cumulative deficit targets were set to track the 2003 actual levels, except for the last quarter, given this year's projected 0.4 percentage point reduction in the deficit-to-GDP ratio from 2003. The tight targets and the reenacted budget limit opportunities for financing new initiatives.

In the first half of the year, the actual fiscal deficit of P80.1 billion was 0.7% higher than the target. A 3.0% overrun against the expenditure target was matched by a proportionate increase of revenues over target. However, the low revenue-to-GDP ratio continues to force the Government to borrow to meet its operational needs, and the national Government's debt stock was P3.5 trillion at end-June (74.6% of GDP), up from P3.3 trillion (78.0% of GDP) at end-2003. During the period January–June 2004, foreign public borrowings (equal to 41.2% of total public borrowings of P233.3 billion) breached the programmed borrowing mix of 84% domestic and 16% foreign.

Domestic liquidity (M3) decelerated somewhat to 5.7% in the first half of 2004 from 5.9% in the same period in 2003. Corporate demand for credit remained subdued. On the credit supply side, although there was a slight improvement in the NPL ratio from 14.1% at end-2003 to 13.8% in June 2004, weak asset quality continued to limit the ability of commercial banks to expand lending. With the monetary policy of the Bangko Sentral ng Pilipinas anchored in inflation targeting, key overnight policy rates have been unchanged since July 2003, at 6.75% for borrowing and 9.0% for lending. High demand for deficit financing saw 91-day treasury bill rates increase to an average 7.0% in the first half, from an average 6.1% in 2003.

Inflationary pressures have been more pronounced than expected in *ADO 2004*, with the CPI rising by 5.1% in June and 6.0% in July,

Table 2.9 Selected Economic Indicators, Philippines, 2004–2005, %

Item	2004		2005	
	ADO 2004 Update	ADO 2004 Update	ADO 2004 Update	ADO 2004 Update
GDP growth	5.0	5.5	5.0	5.5
Inflation (CPI)	4.5	5.2	4.5	5.5
Current account/GDP	3.0	3.0	2.8	2.8

Source: Staff estimates.

the fastest pace since October–November 2001. The acceleration was caused by higher prices for food, fuel products, and rises in transport fares, all linked to world oil prices. The peso slid slightly against the dollar in the first half of the year, adding to domestic price pressure, though the slide in the real effective exchange rate index as measured against a regional currency basket was less marked. In the external sector, reflecting a healthier current account, the balance of payments recorded a \$68 million surplus in the first half, marking a turnaround from the \$609 million deficit a year earlier. Merchandise exports rose by 8.5% to \$18.7 billion, led by increases in electronics. Imports grew by 7.2% to \$19.9 billion, on the back of higher demand for equipment and intermediate goods primarily for the export-oriented electronics industry, which augurs well for future exports. Higher oil imports were also a factor. The merchandise trade balance was in deficit by \$1.2 billion, down slightly from a year-earlier deficit of \$1.3 billion. Remittances from overseas workers rose by 2.6% to \$4.0 billion over January–June. On the capital and financial accounts, capital outflows continued to exceed inflows, by \$30.4 million in the first quarter.

As of 30 June, gross international reserves amounted to \$16.2 billion, down from \$16.9 billion 6 months earlier, and were equivalent to about 4.4 months of imports of goods and services. The decline was caused by the debt service requirements of the Government and the central bank. The three major global credit rating agencies retained their sovereign ratings for the Philippines at two notches below investment grade with a negative outlook, implying substantial credit risk but with expected access to financing. Although the country has access to international capital, the cost of foreign sovereign debt has been high

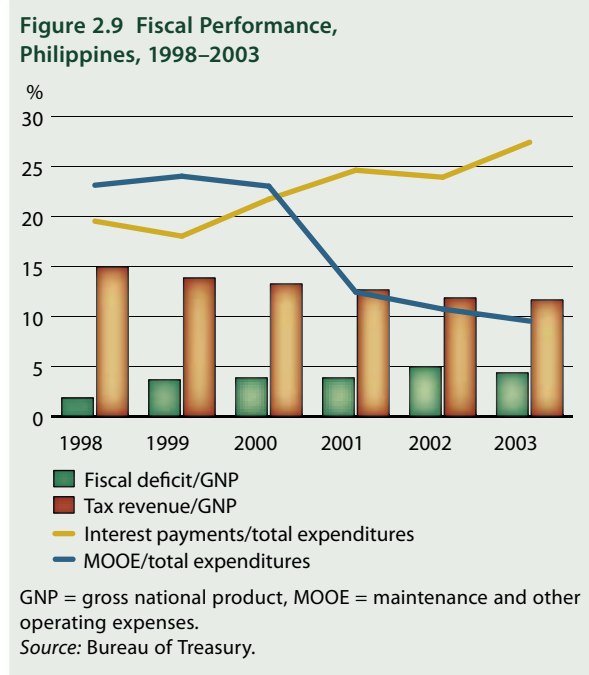
(for 10-year sovereign bonds, currently about 450 basis points over US treasury bill rates), partly reflecting the low credit ratings.

Policy Developments

President Arroyo’s “five-point reform package” and “10-point agenda” highlight broad goals such as job creation, economic growth, and good governance. Greater detail and coherence are expected from the new Medium Term Philippine Development Plan (2005–2010) being prepared for cabinet consideration in mid-October. An important omission is any serious message about tackling high population growth; subsequent statements have indicated that the national administration intends to leave this issue to the initiative of local governments.

Economic targets outlined so far are ambitious. A goal of creating 6 million jobs over the next 6 years compares with the record of an average 800,000 net jobs created each year during 1999–2003. Even if this target is achieved, unemployment is expected to remain high. Given an average of 1.4 million additions to the labor force each year, it is estimated that unemployment could reach 6 million by 2010, up from its present 5 million. A major hurdle to achieving these targets is that they require higher spending during a period when strict fiscal consolidation will be needed. To balance the budget by 2009, while allowing expenditures to increase by 10% per year, the Government needs to increase revenues by at least 15% per year (from 1999 to 2003 revenues grew by an average 6% annually). Overall, strict fiscal discipline, in revenue collection and in managing the level and effectiveness of public expenditures, will be required to implement the economic and social agenda.

The new Government has made the precarious fiscal position a high priority for action. Declaring the country to be in a “fiscal crisis” and identifying the budget deficit as the “most urgent problem,” in August the President noted that “sometimes stamping out deficits can slow growth. But ignoring them can kill the economy.” The problem is mirrored in rising public debt and interest costs, with a consequent lack of discretionary expenditure for infrastructure, health, and education. Interest payments as a share of total expenditures have steadily increased (Figure 2.9) as have other



nondiscretionary expenditures including those on personnel services and allocations to local governments, and the indications are that there will be no respite under the 2005 budget being formulated.

Acknowledging that chronically low revenues are a fundamental cause of the budget deficit, the Government announced a package of measures to increase annual tax revenues by more than 10% (P80 billion). Bills filed with Congress include a two-step increase in VAT; reimposition of a 3% franchise tax on telecommunications companies; adoption of gross income taxation for corporations and self-employed individuals to simplify the tax procedure; rationalization of fiscal incentives for investors; and adjustment in the excise tax and tariff on petroleum products. Aside from these legislative measures, the Government is also pushing for improved tax administration. If approved, these measures are expected to yield an additional P130 billion in revenues yearly. The efficacy of some proposals, such as returning to gross income tax and sales tax, needs careful scrutiny. Also, the Government faces a difficult challenge in convincing the public of the urgency of the measures and so securing its support, and in encouraging Congress to approve the legislation. The challenge is made even harder by recently publicized failures of tax agencies to

collect existing taxes effectively, and consequent large losses in revenues.

On the budget expenditure side, initiatives under government consideration include a reduction in the annual P20 billion Priority Development Assistance Fund that provides nonaudited allocations to each member of the Senate and Congress; a reduction in the Internal Revenue Allotment to local governments; and a change to the cost-sharing formula between the national Government and local governments to eliminate the grant-financed element now provided to poorer local governments. As part of the reforms of local government financing, the Municipal Development Fund Office (the agency through which aid funds are channeled to local governments, and through which grant financing is provided) is being corporatized, with the aim of making it a commercially oriented financing vehicle for local governments. Local governments also are being encouraged to enhance their own revenue bases and seek commercial financing for projects.

The Government is vulnerable to high levels of contingent liabilities, primarily for underwriting the finances of government-owned and controlled corporations, government financial institutions, and the public pension system. The Department of Finance has submitted proposals to reduce the limits on borrowings by such corporations and to lower the Government's contingent exposure to the public pension system (which faces insolvency and the prospect of negative cash flows as early as 2008) through an increase in members' contributions and review of benefits.

The fiscal imbalance cannot be corrected without addressing the financial losses of the public power sector. Currently, the liabilities of the National Power Corporation (NPC) represent about 65% of the Government's total contingent liabilities. A recently approved NPC rate hike of P0.98 per kilowatt-hour, while less than the amount requested, will reduce future losses by about 30%. The President has reconfirmed the Government's intention to privatize state-owned power generation and transmission assets. After two failed biddings for the sale of the assets of the national transmission agency in 2003, the Government is assessing expressions of interest from bidders for a 25-year concession for the operation and maintenance of the transmission

grid. In addition, 35 of the NPC's generation plants are scheduled for sale later in 2004.

A "fighting target" has been set by the Government of increasing investment as a proportion of GDP from 16.6% in 2003 to 25–28% in 2005–2010. Given the public sector's fiscal constraints, most of the increase will need to come from private investors. Steps to improve the investment climate include amending the build-operate-transfer law and its implementing regulations to promote wider private participation; generating more transparency in public sector purchasing through wider use of electronic procurement; and resolving infrastructure bottlenecks. A judicial reform agenda is also ready for implementation. Politically, the timetable for finalizing a peace agreement with the Moro Islamic Liberation Front in Mindanao remains uncertain, though this is a government priority and the outcome will have an important influence on investor perceptions for the country as a whole.

Outlook for 2004–2005

The need for fiscal consolidation and the adverse impact of continued high international oil prices and increases in interest rates are likely to slow the economy in the second half of 2004. GDP in 2004–2005 is expected to strengthen to a range of 4.7–5.7%, higher than forecast in *ADO 2004*, while GNP growth is projected to rise to 5.4–6.0%. Agriculture will show stronger growth than forecast in *ADO 2004*, at 4.7–5.7%, as a result of rapid expansion in the first quarter of 2004 and continuing good weather. Industry is forecast to grow by 4.0–4.5%, led by exports. The services sector is expected to maintain its growth of 5.5–6.3%.

Exports look likely to grow by 10.0% in 2004, faster than envisaged in *ADO 2004*, and will be supported by the first-half recovery of semiconductor shipments and exports of nonfactor services arising from the income of ICT-related services, call centers, and business outsourcing services. Imports are projected to rise by 7.0%.

Following the steeper than anticipated price rises in June and July, inflation in 2004 is expected to be in the range of 5.2–5.9%, exceeding the Government's target of 4–5% and higher than forecast in *ADO 2004*. The increase accommodates

the impact of the continuing high oil prices and expected pass-through rises in the costs of transportation and some wages. Monetary policy is unlikely to be tightened in the near future as the price pressures stem mainly from the supply side.

International oil prices and interest rates will have an important bearing on whether targets will be met, given the country's high dependency on energy imports and large stock of foreign debt. For example, an extra \$10 a barrel in the oil price for all of 2005 could translate into a decline in that year's GDP growth rate of 1.9 percentage points and a rise in inflation of 1.4 percentage points. (Oil scenarios are discussed further in Part 3.) Rising interest rates, both domestic and foreign, would have a direct impact on public debt service payments, which totaled P270.0 billion in the first half, or 64% of government expenditures and 79% of government revenues for that period. Higher debt service requirements compress the resources available for much-needed public investments, and this, in turn, compromises the attainment of long-term economic growth targets. Consumer spending is expected to fuel growth; however, this is vulnerable to any disruption in remittances from overseas workers, likely to be more than \$8 billion in 2004.

Achieving the forecasts for 2004–2005 requires adjustments to be carried out promptly. While some analysts have disputed the President's "fiscal crisis" assertion (on the basis of a technical definition related to the country's current capacity to service debt and access international capital markets), the central point is the Government's clear recognition of the need for action to prevent an already precarious fiscal position from worsening. However, key elements of the Government's recovery plan will be unpopular with the electorate. The ability of the administration to convince stakeholders of the need for necessary action will be as important as in the actual implementation. The longer the consensus building takes, the less likely the macroeconomic targets will be met.

1 The contributions to GDP growth are indicative only because a large statistical discrepancy of 2.6 percentage points is subtracted on the demand side to match the 6.3% GDP growth. The contribution of personal consumption expenditure, in particular, may be overstated.