

Philippines

Summary

GDP growth of 4.7% is expected for 2005, revised down from 5.0% in *ADO 2005*. The main reasons are that exports have been hit harder than foreseen by the global electronics downturn and that agriculture was set back by bad weather early in the year. Investment remains generally weak and for this reason projected GDP growth for 2006 is also slightly reduced.

Due to the sustained rise in oil prices internationally and to higher food prices (on agricultural weakness) domestically, inflation rose sharply in the first 7 months of 2005. This *Update* revises up by 1 percentage point the inflation forecasts for 2005 and 2006.

The Government has taken determined steps to repair its fiscal position with new revenue-raising measures and with tighter discipline on spending, which together helped bring in the first-half fiscal deficit below target. However, political and legal challenges to new tax measures have disrupted their implementation and injected uncertainty into the fiscal consolidation process.

Updated assessment

GDP growth slowed to 4.7% in the first half of 2005 from 6.4% in the first half of 2004 and 6.0% in all of that year. First-half growth in gross national product also decelerated, to 4.7%, from 6.2% in all of 2004, despite a 21.5% rise in remittances from overseas workers. All major sectors decelerated: agricultural output (representing about 20% of GDP) stagnated, showing the effects of a drought early in the year, while expansion in services (some 47% of GDP) and industry (about 33%) slowed to

6.5% and 4.4%, respectively. Transport and telecommunications, as well as finance, continued to lead the services sector, with both recording growth of around 10% in the first half.

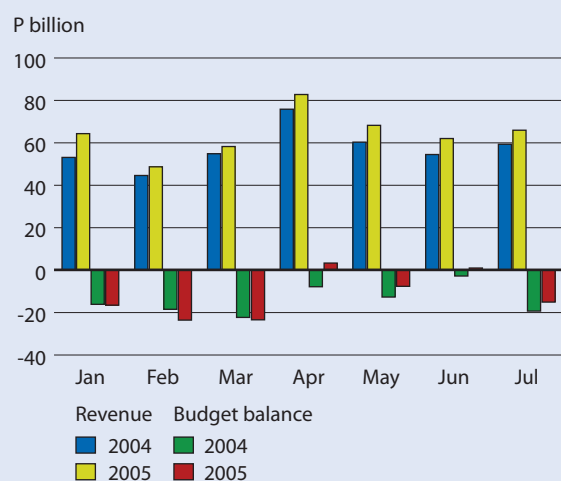
On the expenditure side, growth in private consumption spending, though supported by the inflows of remittances, slowed to 4.9% from 6.0% in the year-earlier period. Government consumption rose by 7.1%, boosted by cash payments for maintenance and other operating expenses. Capital formation, however, was dismal, contracting by 5.5%, with spending on durable equipment shrinking by 7.2% in the half. The GDP growth forecast for all of 2005 is lowered to 4.7% from 5.0% in *ADO 2005*.

Merchandise exports rose by 3.3% to \$19.4 billion in the first 6 months of 2005, slowing from 9.5% for the whole of 2004. The global slowdown in demand for electronic products hurt exports from this important subsector, which accounts for more than half of total merchandise exports. Electronics exports inched up by only 0.3% in the January–June period, a sharp deceleration from growth of 10.3% recorded in January–December 2004.

Merchandise imports fell by 1.5% to \$21.5 billion in the first half, resulting in a 31% narrowing in the trade deficit to \$2.1 billion. A sharp rise in the bill for oil imports (14% of the 6-month total) was offset by a fall in electronics imports (41% of the total) as softer international demand for finished information-technology products reduced imports of intermediate components.

The current account surplus for the first quarter of 2005 rose fivefold to \$546 million, mainly a result of the higher remittances. Gross international reserves reached \$17.7 billion at

Figure 2.7 Revenue and budget balance, Philippines, January–July, 2004 and 2005



Source: Bureau of the Treasury, available: http://www.treasury.gov.ph/statdata/monthly/mo_corsum.pdf.

midyear, from \$16.2 billion at end-2004, equivalent to 4 months of imports of goods and services and 3.2 times the level of short-term debt.

Although economic activity slowed, inflation accelerated quickly in the first 7 months of 2005 from a year earlier, to 8.1%, largely the result of increases in food prices due to poor harvests and the rise in fuel prices. The inflation estimate for the full year is revised up to 7.5%, from 6.5% in *ADO 2005*, but this could well be exceeded if recent minimum-wage rises flow through into broader salary increases.

To contain inflationary pressures, the Bangko Sentral ng Pilipinas in April increased its policy interest rates by 25 basis points. In July, it raised bank reserve requirements to reduce excess liquidity, which it maintained was flowing into the foreign exchange market and ultimately contributing both to inflation and to peso weakness.

Unemployment and underemployment remained at high levels, reflecting generally weak investment. The combined unemployment and underemployment rate rose to 34.4% in April from 31.3% a year earlier. FDI approvals dropped by 73% in the first quarter of 2005 to P31.5 billion, while actual FDI inflows increased by 173% to \$417 million in the first 5 months of 2005, albeit from a very low base.

The main focus of government policy is shoring up the fiscal position. In the first 7 months of the year, total revenues rose by 11.8% while total expenditures grew by only 6.1%, or 6 percentage points below the target. Consequently, the fiscal deficit of P82.6 billion was much narrower than the target of P116.2 billion. The Government reported fiscal surpluses for April and June (Figure 2.7). The primary budget surplus (excluding interest expenses) through July 2005 was substantial, at P92 billion, an increase of 83% from the same period in 2004.

However, the sustainability of this performance is questionable, since it reflects compressed development spending and a large windfall of interest income for the Bureau of the Treasury. Despite the intense focus on the need for enhanced tax revenue, the Bureau of Internal Revenue and the Bureau of Customs both fell behind in their collection targets for the first 7 months, by 3.6% and 7.8%, respectively. Also, notwithstanding implementation of a revised “sin” tax law early this year that increased the excise tax rate on alcohol and tobacco products, the revenue-generating performance of these products was below expectations in the first 6 months of 2005, confirming concerns related to systemic weakness in the implementation capacity of revenue agencies.

In a major revenue-raising move, Congress in May approved an expanded VAT law (the EVAT), first, to extend VAT coverage from 1 July (to include domestic shipping and air transport, electricity, petroleum, and doctors’ and lawyers’ services) and second, to increase the rate from 10% to 12% from January 2006. The law also puts up the corporate income tax rate from 32% to 35% during 2006–2008, returning it to 30% thereafter.

However, on the day the law was to have come into force in early July, the Supreme Court suspended implementation of all of the law’s provisions due to a claim that some elements were not constitutional. In early September, the Supreme Court confirmed the law’s legality, with its implementation subject to the outcome of any appeal. These delays have cost the Government P5 billion a month in revenues.

Implementation of the EVAT would have a one-time impact on inflation. To mitigate this

Box 2.2 Responding to the oil price rise

The Philippines is one of the more susceptible countries in the region to high global oil prices. It imports 96% of its oil requirements, equivalent to 5.6% of GDP. The oil import bill (5.4% of total imports in 2004) jumped by 36% to \$2.4 billion in the first 5 months of 2005, even though import volumes declined by 2%. This cuts into its current account surplus, which was 2.4% of GDP in 2004.

The economy uses about 2.4 times as much oil per unit of GDP than the average OECD country. This relatively high intensity of petroleum use, common in developing economies, means that oil price rises flow strongly through the economy, raising inflation and damping consumer demand (which accounts for about 80% of GDP), thus eroding economic growth. Significantly though, the Philippines does not face direct pressure on its already precarious fiscal position from higher oil prices since the budget does not

provide for subsidies on petroleum products, but there is an element of indirect subsidy since retail petroleum product prices and electricity prices do not always reflect the full costs. Retail gasoline and diesel prices have risen much less steeply than international crude oil prices, and at best there is a lag in the power price adjustment under the regulatory process. Both public and private suppliers bear some additional costs because of this.

The Philippines has reduced the proportion of electricity generated from oil-based plants, from 41% in 1998 to 15% in 2004. This is supported by accelerating use of natural gas from the offshore Malampaya field for power generation, a field that will also meet the needs of the proposed increase to the fleet of buses running on compressed natural gas.

In efforts to conserve energy, the Government is considering reductions in the use of electricity in government offices and cor-

porations, including the possible reintroduction of a 4-day working week; launching public information campaigns to encourage less use of electricity-intensive appliances such as air conditioners; and encouraging the use of fluorescent lighting. Officials have raised the possibility of reducing the import duty on oil products to lower energy costs. Experience in other countries, though, suggests that administrative measures aimed at limiting energy consumption are unlikely to work over a sustained period and may create new distortions.

A long-term approach to reducing vulnerability requires the following: continued efforts to develop indigenous energy supplies further, increases in the efficiency of oil use, reflection by retail prices of the full supply costs, and greater public awareness of how energy use affects both the individual's finances as well as those of the economy.

impact, a provision was added to reduce the excise tax on petroleum products. However, that could hinder movement toward an efficient long-term energy mix.

Quantitative analysis indicates that the EVAT burden will be borne proportionately less by the poor, in large part because of expenditure patterns, including items not subject to the tax.

Prospects

This *Update* lowers projected GDP growth in 2006 to 4.8% from 5.0% in *ADO 2005*. Investment is likely to remain weak through 2006, and the constrained budget position effectively rules out any major fiscal stimulus. Remittances from overseas workers will continue to assist consumption, and the expected upturn in the global electronics cycle will help industrial

production and exports. Growth in 2007 is expected to pick up to 5.0%, provided that the global economy expands as projected and that weather conditions in the Philippines allow a sustained, modest recovery in agricultural output.

Forecasts for inflation are revised up by 1 percentage point, to 7.0% in 2006 and 6.5% in 2007. Although mitigated by improved weather after mid-2005, the impact of the weaker agricultural production on food prices will continue into 2006, while the higher than expected oil prices are likely to lead to demands by suppliers for higher power tariffs and transport fares, and by labor groups for wage increases. This would create a second round of upward pressure on prices. In this context, the Government faces strong pressure to balance economic efficiency, and financially remunerative product and service pricing, with social equity.

Table 2.7 Selected economic indicators, Philippines, 2005–2006, %

Item	2005		2006	
	ADO2005	Update	ADO2005	Update
GDP growth	5.0	4.7	5.0	4.8
Inflation (CPI)	6.5	7.5	6.0	7.0
Current account/GDP	3.0	4.0	2.2	3.6

Source: Staff estimates.

Administrative price caps should be avoided to minimize subsidy demands on the budget, while nonprice, targeted redistribution tools could be used to provide safety nets for vulnerable consumers.

The current account is projected to remain in surplus in the next 2 years, supported by remittances from overseas workers. Efforts to improve the investment climate will take time to show results, especially since high-profile events continue to cloud investor perceptions, including a prolonged delay in resolving the dispute over Manila's new airport and FedEx's announcement in July that it would move its Asia-Pacific regional hub from the Philippines to the Pearl River Delta in the PRC by end-2008.

Fiscal consolidation is the overriding economic policy challenge, and perhaps the most important proxy for assessing confidence in economic management and prospects. The fiscal deficits and large stock of government debt, of which nonfinancial public sector debt had grown

from 84% of GDP in 1999 to just over 100% of GDP by end-2004, leaves the economy highly vulnerable to changes in investors' views. Any fiscal slippage could attract credit downgrades and higher debt service costs. The prospects for fiscal consolidation depend on the success of a range of government initiatives, including tax reform (the new taxes and improved administration of the system), improved efficiency of public service delivery and reduction of costs, debt management to reduce the interest burden, improved financial performance of government corporations, acceleration of privatization (especially for the power sector), and enhanced revenue mobilization by local governments.

The Government considers that it may be able to achieve a balanced budget 2 years ahead of the current target of 2010, but it may well be prudent to consider retaining the initial target, after front-loading the consolidation effort but allowing for higher development spending subsequently. While the revenue-generation efforts need to be pursued with vigor over the next 2 years, and expenditure monitored closely, retaining the original target would provide greater fiscal space for urgent spending on public infrastructure and social sectors—all essential to long-term growth prospects.

Forecasts on the Philippines are subject to a greater than usual degree of uncertainty, given the impact that rising global oil prices have on the economy (Box 2.2 above), disruptions to the tax legislation, and political uncertainty.