

Philippines



The outlook for 2006 has brightened. GDP is forecast to grow by 5.4%, faster than expected in *Asian Development Outlook 2006 (ADO 2006)*; inflation is likely to be slightly lower and the current account surplus larger than earlier projected; and long-standing fiscal weaknesses are starting to be addressed. Some problems remain: fixed investment is weak and job creation is inadequate to make a meaningful dent in unemployment and underemployment. Looking ahead to 2007, the economy is seen expanding by about the same rate as this year. A sustainable acceleration in growth would require further progress on fiscal consolidation (enabling higher development spending) and a durable improvement in investor sentiment.

Updated assessment

The economy expanded by 5.6% in the first half of 2006, faster than the 4.8% rate of a year earlier. The acceleration followed a turnaround in agricultural production, which accounts for about a fifth of GDP, and better performance of the industry sector (about one third of GDP). Net factor income from abroad remained strong and gross national product rose by 6.5%, over a percentage point higher than a year earlier.

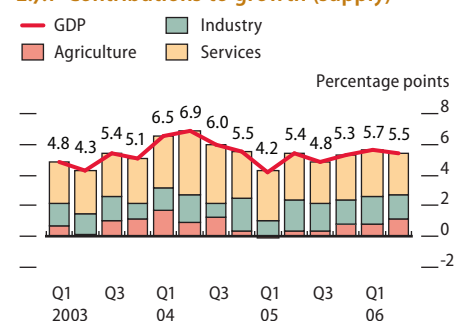
As the effects of the drought induced by the El Niño weather phenomenon in early 2005 receded, output of major crops—rice and corn (maize)—increased sharply. Concerns subsided during the first half that La Niña, which brings torrential rains and floods, would reduce farm production. Expansion of agricultural output contributed 1 percentage point to GDP growth in the first half of 2006. In contrast, agriculture had subtracted from aggregate growth in the first quarter of the previous year and made only a minor contribution in the second (Figure 2.7.1).

Industrial expansion also picked up from a year earlier as output in manufacturing, which accounts for about three quarters of industry, was boosted by stronger exports and domestic demand. The services sector (nearly half of GDP) was again the main contributor to GDP growth in the first half, but this sector grew at a more moderate rate than a year earlier.

On the demand side, personal consumption (about three quarters of GDP) contributed 4.2 percentage points to growth in the first half of 2006 (Figure 2.7.2). A modest improvement in labor market indicators and higher farm incomes shored up consumption, as did continued strong inflows of remittances from overseas workers. Net exports contributed much more significantly to GDP growth than in the first half of 2005. Investment continued to decline, for a sixth consecutive quarter.

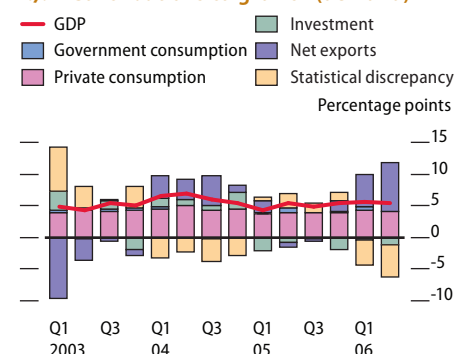
A rebound in export expansion has been a welcome feature of the

2.7.1 Contributions to growth (supply)



Sources: Asian Development Outlook database; National Statistical Coordination Board, available: <http://www.nscb.gov.ph>, downloaded 31 August 2006.

2.7.2 Contributions to growth (demand)



Sources: Asian Development Outlook database; National Statistical Coordination Board, available: <http://www.nscb.gov.ph>, downloaded 31 August 2006.

economy so far this year. Merchandise exports, in US dollar terms, rose by about 17% in the first 6 months, much stronger than a year earlier (Figure 2.7.3). A major reason was a revival in exports of electronic products (57% of total exports), comprising primarily semiconductors, which rose by 12.5% in the 6 months to June, compared with less than 1% a year earlier. Merchandise imports rose by 8.4% in the January–June period, reflecting faster domestic economic growth, higher world oil prices, and the import-intensity of electronic products, offset in part by a reduced need for food imports and weak demand for equipment investment. The merchandise trade deficit narrowed by about half in the first 6 months to \$1.8 billion from a year earlier.

Overall, the outlook for 2006 has improved. Growth momentum through the second half should be supported by agriculture and exports, and by the likelihood that an enhanced fiscal position will support consumer and investor sentiment. On these factors, the GDP forecast for this year is revised up to 5.4%.

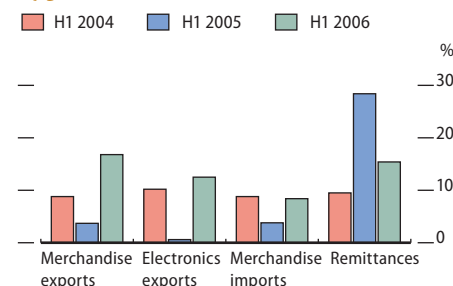
Balance-of-payments data available for the first quarter indicate that buoyant remittances from overseas workers and a smaller deficit on the services account—partly reflecting healthy growth in net travel receipts and in call center income—bolstered the current account surplus to 4.4% of GDP from 3.3% a year earlier. In the first half of the year, remittances rose by about 15% to \$6.0 billion. These developments have led to an upward revision in the forecast for the 2006 current account surplus to 2.9% of GDP.

Net inflows of portfolio and direct investment were recorded on the capital account. However, net foreign direct investment totaled just \$398 million in the first quarter, mainly as a result of increased intercompany loans, suggesting that investment is geared more toward expansion of existing operations rather than establishment of new ones. The overall balance-of-payments surplus exerted some upward pressure on the currency, which the central bank sought to keep down by accumulating foreign exchange reserves. Gross international reserves rose to \$21.1 billion in June, providing 4.3 months of import cover (Figure 2.7.4).

Consumer price inflation slowed a little to average 7.0% in the first 7 months of the year from the same period in 2005 (Figure 2.7.5). The increase in farm production helped, by slowing the rise in food prices. The full-year inflation forecast is lowered marginally to 6.7% from that made in *ADO 2006*. With the moderation in inflation as well as a lower risk premium, as reflected in narrower spreads of Philippine bonds over US treasuries and a stronger peso (Figure 2.7.6), the central bank has kept policy rates steady since November 2005.

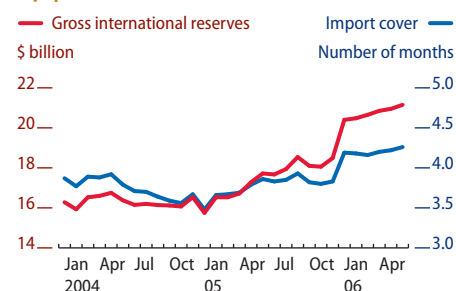
An improved fiscal performance saw the national Government's deficit narrow to P31.5 billion in the January–June 2006 period, less than half the level of a year earlier, and two thirds below the target deficit for this period (Figure 2.7.7). Of this two thirds, and relative to the targets, 25% reflected higher revenue, 55% lower noninterest expenditure, and 19% lower interest payments. Encouragingly, total revenue was up by 21% year on year, 3.3% above target, as receipts of the bureaus of Customs and the Treasury exceeded targets. Receipts of the Bureau of Internal Revenue (68% of the total) were slightly below the first-half

2.7.3 Growth in trade and remittances



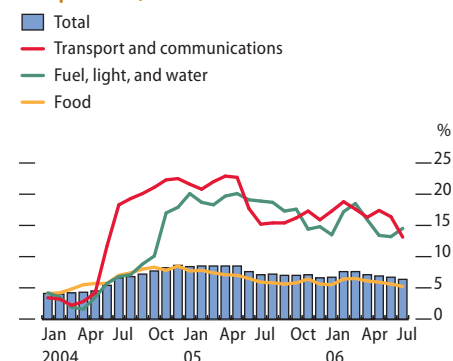
Sources: CEIC Data Company Ltd., downloaded 2 August 2006; National Statistics Office, available: <http://www.census.gov.ph>, downloaded 25 August 2006.

2.7.4 Reserves



Source: Bangko Sentral ng Pilipinas, available: <http://www.bsp.gov.ph>, downloaded 2 August 2006.

2.7.5 Monthly inflation (total and selected components)



Sources: National Statistics Office, available: <http://www.census.gov.ph>; CEIC Data Company Ltd., downloaded 4 August 2006.

target, though they were 22% above the year-earlier level, following implementation of a new value-added tax (VAT) law and an increase in the VAT rate from 10% to 12%.

Fiscal gains enabled a moderate expansion in first-half expenditure. Noninterest outlays rose by 10% year on year in the first half, but remained about 9% below target, implying room for still-higher spending, especially on social and physical infrastructure, without jeopardizing the objective of fiscal consolidation.

With a significant gain in receipts and a likely shortfall in expenditure, the fiscal deficit for the full year is expected to undershoot the Government's target of P125 billion (2.1% of GDP), continuing its trend decline from a peak of 5.3% in 2002. These narrower deficits, and the associated increases in the primary surplus, have contributed to falling interest rates, an appreciating peso (against the dollar), and declining debt ratios (Figure 2.7.8). However, the debt burden is still high—the national Government's debt was equivalent to 71% of GDP in March, excluding contingent liabilities of 10.2% of GDP. Interest payments on the debt still consume more than one third of government income, so a sustained increase in tax collection will be needed to finance necessary development expenditure over the medium term.

Although the labor market strengthened somewhat, the rate of employment creation remains below the Government's annual target of 1.5 million new jobs. Employment rose by 2.5% in April from a year earlier, or barely matching the rate of increase in the labor force, with agriculture and services the main sources of new jobs. The unemployment rate edged down to 8.2% in the 12 months to April, as did the underemployment rate, but to a still-high 25.4%.

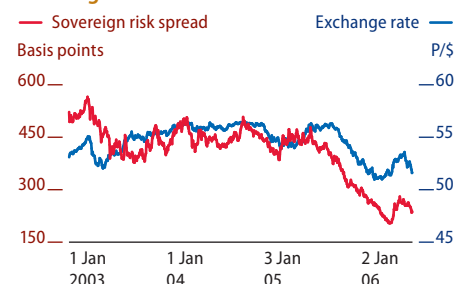
Prospects

The outlook for 2007 is for GDP growth to stay on around the same modest trajectory as 2006. This forecast is predicated on the assumption that the fiscal position's trend improvement will continue, thereby helping maintain investor confidence and setting the stage for much-needed development spending in subsequent years. In the near term, fiscal policy is likely to be biased toward stability rather than growth, considering the high level of debt. Monetary policy, too, offers limited room for maneuver as domestic–international interest rate differentials are already narrow (Figure 2.7.9). The actual growth outturn will thus depend to a large extent on external developments and the weather.

Growth impetus from the production side will originate in the services sector, which is expected to expand at around its 5-year trend of about 6%, increasing its share in total output. In industry, export-oriented manufacturing is likely to benefit from continued, though slower, expansion of world trade. Agriculture should grow at its trend rate of close to 4%, assuming normal weather conditions. On the demand side, personal consumption will remain the main contributor to growth, partly supported by remittances of around 11–12% of GDP.

Assuming a slowdown in world trade growth, exports and imports are both likely to decelerate next year. The trade deficit is projected to be 7–7.5% of GDP and the current account surplus will likely increase to 3.1%

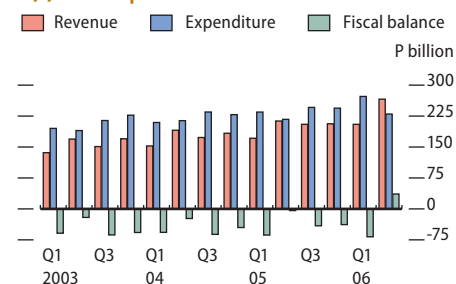
2.7.6 Sovereign risk spread and exchange rate



Note: Sovereign risk spreads are yield spreads of Philippine sovereign bonds over US treasury bonds.

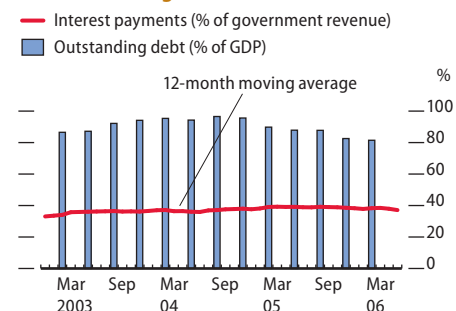
Source: Datastream, downloaded 3 August 2006.

2.7.7 Fiscal performance



Source: Bureau of the Treasury, available: <http://www.treasury.gov.ph>, downloaded 4 July 2006.

2.7.8 National government debt



Sources: CEIC Data Company Ltd.; Bureau of the Treasury, available: <http://www.treasury.gov.ph>, downloaded 2 August 2006.

of GDP, buoyed by remittances, after allowance for a modest deficit on the service and income accounts.

Successive improvements in the current account from a deficit of 3.8% of GDP in 1999 to a surplus since 2003 stems partly from weakness in investment. Its share in GDP has fallen from 18.8% in 1999 to about 15% in 2005, the lowest among the larger countries in Southeast Asia, as political uncertainties and deteriorating public finances damped investor sentiment. Efforts in recent years to reduce the fiscal deficit also entailed cutbacks in development spending, which further compressed investment.

If the improvement in government revenue continues, it would allow scope to boost spending on physical and social infrastructure over the medium term. Coupled with an improvement in bank balance sheets (Figure 2.7.10) and the likelihood that this will eventually stimulate loan growth, the higher public spending could arrest the decline in the investment rate and thus relieve an increasingly binding constraint to future growth.

Inflationary pressures may moderate further, given that world oil prices are expected to remain stable, albeit at high levels, and as the effect of the rise in the VAT rate moves out of the picture. An increased supply of foodstuffs, based on agricultural production maintaining trend growth, and an expected moderation in world prices of nonfuel commodities would also limit pressures. The *Update* forecast for inflation in 2007 is revised to 6.0% from 6.5% in *ADO 2006*.

The national Government has set a budget deficit target for 2007 at 0.9% of GDP. On this basis, further improvement on this year's revenue goal will be necessary—including efforts to expand the tax base and to improve collection—to allow for a significant increase in development expenditure while keeping the fiscal consolidation program on track, especially as the impact of the VAT rate increase recedes.

Better financial performance of government owned or controlled corporations has helped lower the consolidated public sector deficit (a wider measure of the deficit) alongside that of the national Government. Losses incurred by state-owned National Power Corporation, in particular, were a cause of fiscal deterioration in previous years. The financial performance of 14 monitored government corporations has continued to improve in 2006, largely generated by a better result from the National Power Corporation, following an increase in electricity tariffs last year. However, significant privatization of power-sector assets, which has been on the drawing board for some time, has yet to push through. In addition to progress on fiscal consolidation, a significant power asset sale could be a powerful catalyst for improving investor sentiment, or a confidence damper if delays are further prolonged.

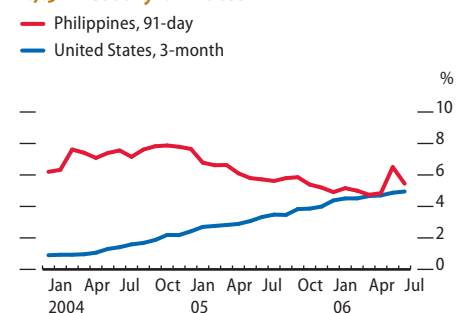
The main risk to the outlook centers on maintaining the pace of reforms. Continued improvement in the fiscal position and in banking, as well as reforms in the power sector, will likely be necessary to lift investor confidence, given that political noise is likely to increase ahead of midterm elections in May 2007.

2.7.1 Selected economic indicators, %

	2006		2007	
	ADO 2006	Update	ADO 2006	Update
GDP growth	5.0	5.4	5.3	5.3
Inflation	6.8	6.7	6.5	6.0
Current acct. bal. (share of GDP)	1.9	2.9	1.8	3.1

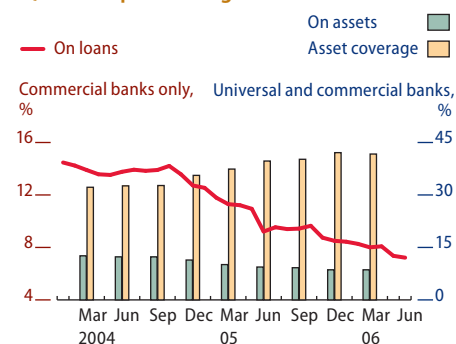
Source: Staff estimates.

2.7.9 Treasury bill rates



Source: Datastream, downloaded 2 August 2006.

2.7.10 Nonperforming loan and asset ratios



Sources: CEIC Data Company Ltd.; Bangko Sentral ng Pilipinas, available: <http://www.bsp.gov.ph>, downloaded 2 August 2006.