PHILIPPINES

The global economic slowdown has led to a sharp decline in exports, although relatively robust domestic demand has partially offset this fall in the Philippines. GDP growth over the rest of the year is likely to be weighed down by continued external sector weakness. Decisive measures are needed to improve public finances if growth is to be sustained in the medium term.

Economic Indicator (percent)	**1998**	**1999**	**2000**	**2001**		**2002**	
				Current	***ADO 2001***	**Current**	***ADO 2001***
GDP growth	-0.6	3.4	4.0	2.7	3.1	3.0	4.2
Inflation rate	9.7	6.7	4.4	6.3	7.0	5.5	6.0
Current account/GDP	2.4	10.0	12.5	4.9	8.0	4.5	5.0

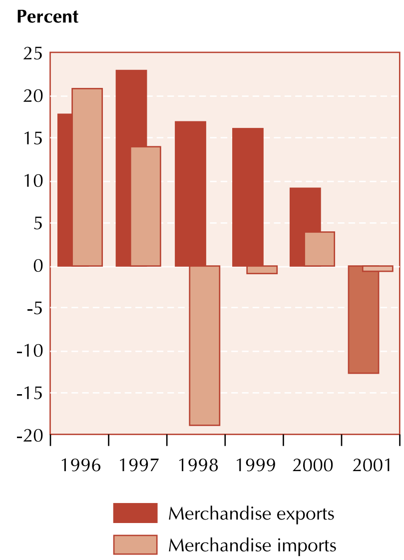
Economic Assessment. The global slowdown, which has been more pronounced than expected at the time of *ADO 2001*, has led to a steep decline in demand for exports from the Philippines. However, firm domestic demand has largely offset this weaker export growth, resulting in a year-on-year GDP growth rate of 3.3 percent in the first half of the year compared to a corresponding figure of 3.8 percent growth in the same period of 2000. On an expenditure basis, exports contracted by 4.1 percent year on year in the second quarter of 2001 after rising by 5.4 percent in the first. Although import growth has outpaced that of exports so far this year, continued weakness in the import-intensive export sector has led to a slowdown in imports in recent months. The weakness in net exports has been balanced to some extent by a pickup in public investment and continued steady growth in private consumption. The former is due to considerably higher government spending on construction activity, and the latter is due largely to higher agricultural incomes.

On a production basis, GDP growth was led by the services sector, especially in trade and private services, reflecting quite robust domestic demand. In the industry sector, growth averaged 2.7 percent year on year in the first half of 2001, compared to 3.9 percent growth in the corresponding period of 2000, reflecting a steep fall in manufacturing output due to the global economic slowdown. Favorable weather, the rehabilitation of irrigation canals, and the continuing adoption of better technology led to a year-on-year 3.0 percent increase in agricultural output in the first six months of the year, compared to 2.3 percent growth in the first six months of 2000. Against this backdrop of steady growth, the unemployment rate fell to 10.1 percent of the labor force in July 2001, from 11.2 percent in July 2000.

For the first nine months of the year, inflation averaged 6.6 percent. Although considerably higher than the 3.7 percent recorded in the corresponding period of 2000, inflation remained within the Government's target range of 6.0-7.0 percent for 2001. Generally stable food prices, due to sufficient supplies from domestic farmers and ample imports of rice, compensated for the rise in nonfood prices caused in part by the peso's depreciation against the dollar. In September 2001, year-on-year inflation at 6.1 percent was markedly below the year-on-year rate of 6.8 percent in July, due to an easing of food prices—after earlier typhoon-related disruption to production—and greater exchange rate stability.

During the first eight months of the year, merchandise exports posted a year-on-year decrease of 13.0 percent, due to the slowdown in the US and the slump in global electronics demand. Although merchandise imports have declined in recent months, reflecting slower export growth and domestic demand, for the first eight months of 2001 year-on-year imports declined by only 0.8 percent. As a result, the trade surplus fell to $704 million from $3.7 billion in the corresponding period of 2000. Data for the first seven months of this year indicate that the services and income surplus also declined, due to fewer tourist arrivals and lower worker remittances from abroad. As a result, in the first seven months of 2001 the current account surplus fell to $1.2 billion from $4.4 billion in the corresponding period of 2000.

Merchandise exports switched from growth to contraction in the first eight months of 2001...



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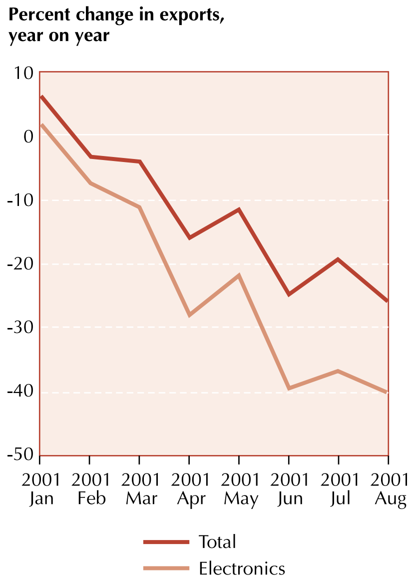
Economic Management Issues. Fiscal and monetary policies will be used to support domestic economic activity, but a large public debt burden, relatively high inflation, and exchange rate volatility constrain the extent to which countercyclical policies can be used to stimulate domestic demand. After two years of budget deficits exceeding P100 billion, the Government has committed itself to a deficit-reduction program, which should lead to a balanced budget by 2006. For 2001, the budget deficit has been set at P145 billion, or 4.0 percent of GDP. Although the deficit in the first seven months of the year was P11 billion better than target, this was achieved almost entirely by reduced expenditures since revenues remained below target.

The aim for 2002 is for the fiscal deficit to be further reduced to P130 billion (3.3 percent of GDP). Consistent with the Government's objective of maintaining lower interest rates and preventing crowding out of the private sector, a higher proportion of budgetary financing in 2002 is to come from foreign sources. While a greater emphasis is to be placed on concessional official development assistance, the Government will nevertheless continue to rely heavily on market sources. This, together with rising yield spreads, raises some concern over the sustainability of external borrowing as a means of financing. In the medium term, fiscal consolidation will only be sustainable if it is based on enhanced revenue-raising measures. Expenditures will remain severely constrained by existing debt service obligations (amounting to over 30 percent of expenditures in 2000), limiting the extent to which resources can be used for social and infrastructure investment.

Having raised interest rates sharply in 2000 to defend the peso, the central bank has steadily lowered policy rates this year mirroring, to a degree, rate cuts by the US Federal Reserve. By 18 May 2001, the central bank's overnight borrowing and lending rates had come down to 9.0 percent and 11.25 percent, respectively, from 13.0 percent and 15.25 percent in January 2001. However, following a sudden depreciation of the peso in June and July, monetary policy was tightened to stabilize the currency. With this achieved, a

...largely due to declining external demand for electronic products



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relatively moderate inflationary outlook for the rest of the year and a continued easing bias of the Federal Reserve have once again provided the central bank with greater flexibility to reduce interest rates. On 2 October, it cut interest rates by a further 25 basis points. Lower rates will ease pressure on the commercial banks that face a rising incidence of nonperforming loans. As of July 2001, the ratio of nonperforming loans to total loans had increased to 17.7 percent from 14.0 percent in early 2000. This has put a drag on loan growth as risk-averse banks generally choose to invest in Treasury securities rather than to lend.

Forecast. Given the sharper than expected global slowdown, together with the loss of confidence and heightened uncertainty generated by the recent terror attacks on the US, GDP growth for 2001 is expected to slow to 2.7 percent compared to the forecast of 3.1 percent made in *ADO 2001*. In 2002, GDP growth is likely to pick up to around 3.0 percent on the back of an anticipated gradual recovery in global growth. Although domestic demand will remain relatively robust, government consumption will slow in line with a planned reduction in the fiscal deficit. For 2001, inflation is likely to average 6.3 percent (under the assumption that oil prices do not increase in the fourth quarter). In 2002, inflation is likely to come down to around 5.5 percent, assuming that weather patterns are normal, oil prices remain at $22-$28 per barrel, and the exchange rate is fairly stable. On the external front, the current account surplus is expected to narrow to 4.9 percent of GDP in 2001 due to a smaller trade surplus, reduced numbers of tourists due to security concerns, lower worker remittances, and higher net interest payments. In 2002, the current account surplus is forecast to narrow further to 4.5 percent of GDP as import growth continues to outpace export growth.