Philippines

Private consumption has lost momentum this year, hurt by inflation that reached a 17-year high of 12.5% in August. Investment and exports also weakened, and GDP growth slowed to 4.6% in the first half of 2008, from a particularly robust 7.6% in the year-earlier period. The authorities started tightening monetary policy but eased fiscal policy to help low-income earners deal with rising prices. Forecasts for growth and the current account surplus are revised down, and inflation projections raised, for both this year and next.

Updated assessment

After expanding in 2007 at its highest rate in three decades, the economy has slowed this year. GDP growth decelerated from 8.3% in the second quarter of 2007 to 4.6% in the second quarter of 2008.

Two of the economy's main growth drivers, private consumption on the demand side and services on the production side, have lost momentum. Private consumption last year grew at about 6% every quarter. This year, its growth eased to 5.2% in the first quarter and pulled back to 3.4% in the second (Figure 3.8.1) as inflation accelerated and consumer sentiment cooled. Government consumption spending fell in the January–June period, possibly a result of larger than usual expenditure ahead of elections in the prior-year period.

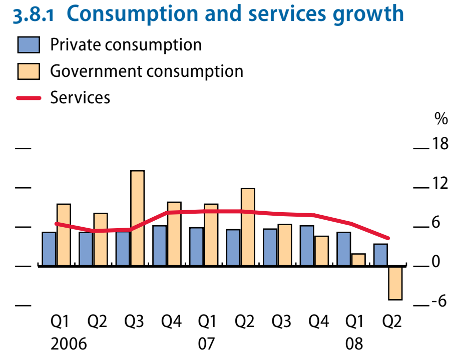
Growth in fixed capital formation slowed sharply to 4.3% in the first 6 months of 2008 from high levels a year earlier. In the first half, public investment was crimped by delays in implementing planned capital outlays. Private-sector housing remained robust. The ratio of fixed capital formation to GDP is low at 19.3%, though. Net exports of nonfactor services such as business process outsourcing more than offset a fall in net merchandise exports.

On the demand side, consumption, investment, and net exports all contributed to GDP growth of 4.6% in the first half (Figure 3.8.2). (The contributions are indicative only because a large statistical discrepancy of 2.4 percentage points is subtracted on the demand side to match the 4.6% half-year GDP growth.)

On the production side, services sector growth slowed to 5.4% in the first half, from 8.4% a year earlier. Weaker expansion was recorded for financial services, retail trading, and transport and communications, apparently related to the softening in consumption. Despite the slowdown, services still contributed more than half the total of GDP growth, reflecting its position as the biggest sector.

Industrial growth also decelerated in the first half, to 3.9% from 8.6% in the prior-year period. Manufacturing expansion picked up a little, although production of the important electrical machinery subsector fell, reflecting lower export demand. Mining output slipped, after a substantial

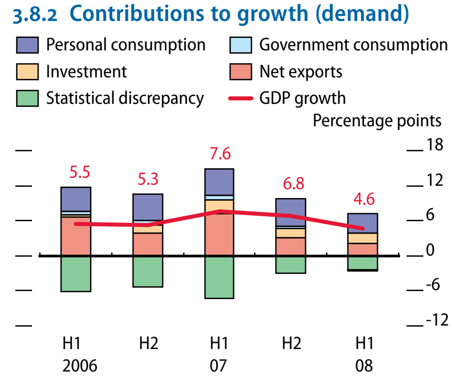
3.8.1 Consumption and services growth



Sources: National Statistical Coordination Board, available: www.nscb.gov.ph; CEIC Data Company Ltd.; both downloaded 28 August 2008.

Click here for figure data

3.8.2 Contributions to growth (demand)



Sources: Asian Development Outlook database; National Statistical Coordination Board, available: www.nscb.gov.ph, downloaded 28 August 2008.

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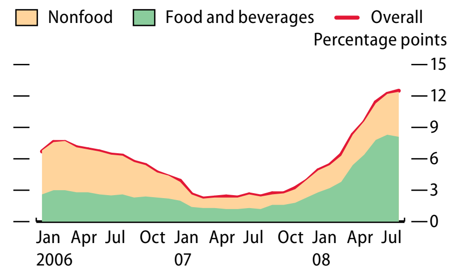
This chapter was written by Tomomi Tamaki of the Southeast Asia Department, ADB, Manila.

increase in 2007. Construction growth slowed sharply, mainly a reflection of the reduced outlays on public projects in the half year. Industry as a whole contributed 1.3 percentage points to GDP growth. Agriculture expanded by 3.7% in the first half, a shade faster than a year earlier. Crop production increased but forestry output declined, and expansion of fisheries slowed because of higher fishing-fleet fuel costs.

Inflation, at a subdued level of just 2.8% in 2007, accelerated during the first half of 2008 to average 7.6%, and reached its highest level in 17 years at 12.5% (year on year) in August (Figure 3.8.3). A rise in prices of food (which makes up half the consumer price index) and of oil pushed inflation higher (Box 3.8.1). The Philippines, currently the world's largest

3.8.3 Contributions to inflation



Source: CEIC Data Company Ltd., downloaded 5 September 2008.

Click here for figure data

3.8.1 Impact of food and fuel price increases

The Philippines is the world's largest importer of rice, buying 10–15% of its consumption needs from abroad. Imports jumped to 2.3 million tons in the first 8 months of 2008, (from 1.8 million tons in all 2007), when the Government decided to build stocks at a time when some exporters were restricting shipments. As for oil, the country imports 93% of its requirements of 336,000 barrels a day.

The surge in prices of both commodities this year has driven up inflation, eroded the external current account surplus, and added substantially to fiscal spending.

The Government—through its National Food Authority—buys rice from abroad at market prices and sells it, subsidized, to low-income groups, incurring a loss that could reach $1 billion this year. Longer term, it plans to invest the equivalent of $96 million over 3 years in expanding the acreage planted to rice and in irrigation, as a way to increase rice self-sufficiency to 98%.

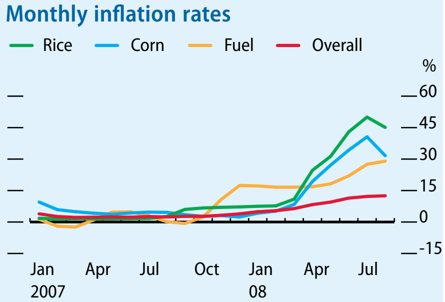
There are no subsidies for petroleum products, other than a small diesel subsidy for public transport. In fact, as petroleum products are subject to a 12% value-added tax, the price rise has generated much stronger tax receipts from this source. The Government has used them to fund various subsidies targeted at the poor. It also introduced fertilizer subsidies for small-scale farmers when global fertilizer prices rose.

The impact of higher rice prices on inflation is stark, since rice has a weight of 9.4% in the consumer price index. The retail price in August was 45% higher than a year earlier (Box figure), and this accounted for 4.2 percentage points of the 12.5% inflation rate that month.

The price rise particularly hurts poor households, who may spend much of their incomes on this staple. A survey conducted in June by Social Weather Station showed that 49% of families considered themselves "food-poor," an increase from 37% at end-2007. For their part, higher fuel prices in August contributed 0.7 percentage points to inflation.

The import bill for rice in the first half of 2008 was $858 million, nearly four times as high as the prior-year period. The import bill for mineral fuels and lubricants, including crude oil and excluding coal, amounted to about $6.4 billion, up by 60% from a year earlier and a major contributor to the trade deficit.

Monthly inflation rates



Source: CEIC Data Company Ltd., downloaded 5 September 2008.

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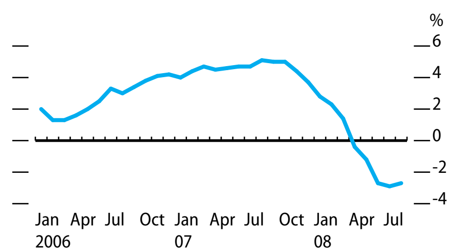
3.8.4 Real lending rate



Note: The rate shown is the middle rate of commercial banks' lending rates.

Sources: Bangko Sentral ng Pilipinas, available: www.bsp.gov.ph; Datastream; both downloaded 5 September 2008.

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importer of rice, faced soaring global rice prices in the first half. Prices of fruits and vegetables rose because of typhoons, and meat prices increased as animal-feed costs moved up. Core inflation, excluding food and energy, rose from 3.4% in January to 7.0% in August, suggesting that underlying price pressures have broadened. The surge in inflation turned real lending rates negative in the second quarter (Figure 3.8.4 above).

Merchandise exports on a customs basis and in United States (US) dollars rose by only 4.1% to $25.6 billion in January–June. The value of electronic products, the biggest export items, fell slightly because of weaker global demand. Exports of some agricultural products rose, supported by robust global prices. Growth in merchandise imports on a customs basis, of 15.8% to $29.5 billion, far outpaced that of exports, mainly a reflection of higher global prices for oil, food, and other commodities. That left a first-half trade deficit of about $4 billion.

Deficits in goods trade in recent years have been more than covered by large inflows of remittances from Filipinos working abroad, resulting in current account surpluses. Earnings from the developing business process outsourcing industry have started to contribute to current account surpluses. In the first quarter of 2008 (the latest available data), a current account surplus of $1.2 billion was seen, helped by such earnings. Remittances rose by 17.2% to $8.2 billion in January–June, although in peso terms the increase was only 3.1% because the peso was stronger on average against the US dollar in the first half of 2008 than a year earlier (Figure 3.8.5). Almost 60% of the growth in overseas jobs in the past 2 years has been in the Middle East, providing some diversification of remittance sources. Yet despite this, the biggest source remained the US (49%), followed by Saudi Arabia (8%), Canada (7%), and United Kingdom (5%).

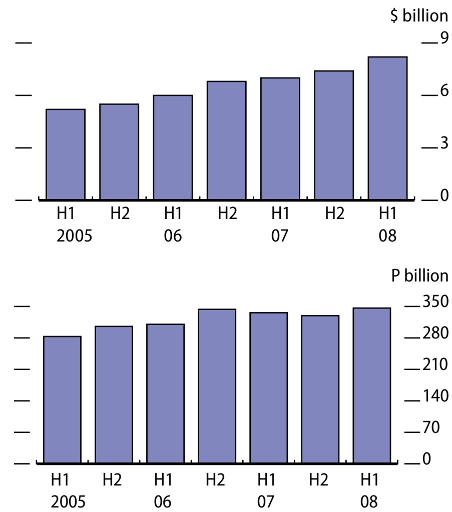
Portfolio investment posted a net outflow of $417 million in the first half, compared with a net inflow of $2.6 billion a year earlier, in part reflecting heightened international risk aversion stemming from the global credit squeeze. Yield spreads between Philippine and US Treasury bonds have widened significantly this year (Figure 3.8.6). Between 31 December 2007 and 30 June 2008, the peso depreciated by 7.5% against the US dollar, after appreciating by 19% in 2007 (Figure 3.8.7).

Job creation remains insufficient, even after several years of economic growth that averaged over 5%. The sum of the unemployment and underemployment rates was 27.8% in April 2008, compared with 26.3% a year earlier. A lack of productive employment opportunities within the country is one reason that a rising number of Filipinos (8.7 million at end-2007) work abroad.

Bangko Sentral ng Pilipinas, after lowering its policy interest rates five times between July 2007 and January 2008, changed tack in mid-2008 after inflation had climbed well above the Government's target range of 3–5% for several months. The central bank raised its policy rates in June, July, and August, by a total of 100 basis points, bringing the overnight borrowing rate to 6.0% and the overnight lending rate to 8.0% (both still below the inflation rate).

Fiscal policy was also adjusted. The national Government's emphasis under a fiscal consolidation program in recent years has been to rein in the fiscal deficit (it achieved a reduction from 5.3% of GDP in 2002 to 0.2% in 2007—Figure 3.8.8) and bring down the high levels of its

3.8.5 Overseas workers' remittances



Source: Bangko Sentral ng Pilipinas, available: www.bsp.gov.ph; downloaded 5 September 2008

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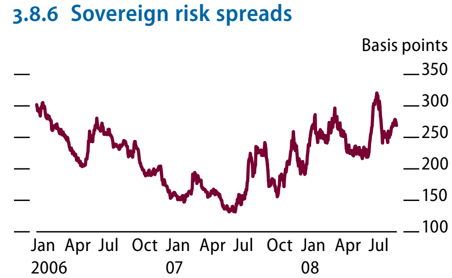
3.8.6 Sovereign risk spreads



Note: JPMorgan Emerging Markets Bond Index sovereign stripped spreads.

Source: Datastream, downloaded 1 September 2008.

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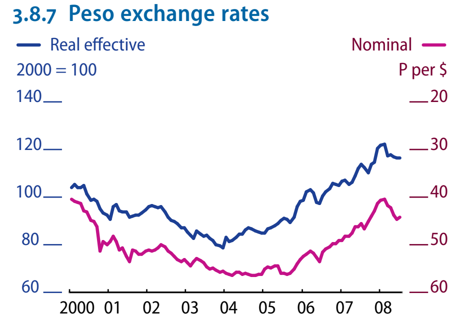
3.8.7 Peso exchange rates



Source: CEIC Data Company Ltd., downloaded 28 August 2008.

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debt (from 78% of GDP in 2004 to 57% in June 2008—Figure 3.8.9). The stress this year is on assisting those vulnerable to rising prices for food and other essentials and spending more on social services, allowing the deficit to expand to the equivalent of about 1% of GDP, after including privatization receipts. Expenditure fell behind schedule in the first half, partly because budget approval was delayed until May, but also because of capacity constraints in government agencies. Revenue benefited from rising value-added tax collections on the higher prices of fuel.

Prospects

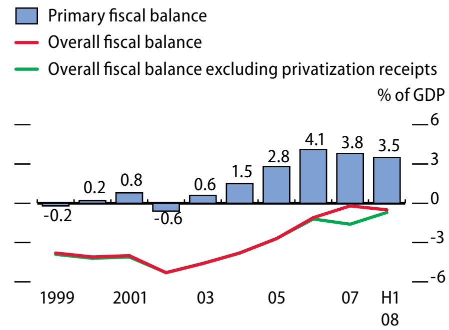
The outlook for 2008 and for 2009 has deteriorated from the one given in *Asian Development Outlook 2008* (*ADO 2008*) in April, when GDP growth of about 6% and inflation of 4% were expected for this year. Since then, inflation pressures have built up and the environment for exports and international investment has worsened.

Private consumption is now projected to grow by 4% or less for all this year, slowing from 5% last year. Higher prices for food, fuel, and transport will continue to damp spending on other goods and services. Consumption growth is expected to pick up from low levels in the second half of 2009, if inflation eases as projected. The trend in remittances will be a key factor for consumption spending. Remittance inflows could slow if labor markets that employ Filipinos, in particular the US, continue to weaken. Alternatively, remittances would get a boost in local currency terms if the peso depreciates further against the US dollar and job markets abroad remain reasonably firm.

Investment growth in the second half of this year should get support from a pickup in public spending on development projects, after the delays of the first 6 months. However, investment in private housing will be hurt by steeply rising prices of construction materials and by higher interest rates. Moreover, business sentiment weakened for the third quarter of 2008, in the first negative reading in the business confidence index since 2005. Surveyed firms cited rising costs and wages and the global slowdown as main reasons for the downturn in sentiment. Consequently, investment growth in the second half of this year is likely to slow to about 6%. Next year, it is projected to be somewhat higher if inflation subsides and global demand improves for electronic products and if the Government increases capital spending as planned. The expected pickup in investment, though, is now projected to be at a more moderate pace (6.5%) than was forecast in *ADO 2008*.

The weak first-half export performance and downward revisions in the baseline assumptions for world trade have led to a reduction in the forecast for Philippine export growth. Exports of electronic products fell in the first half of 2008 and are unlikely to rebound until late 2009. This weakness, combined with stronger growth in imports that largely reflects high prices for imported oil and fuel, is pushing out the trade deficit. Taking these factors into account, the forecast for GDP growth in 2008 is revised down to 4.5%, and for 2009 to 4.7% (Figure 3.8.10). Current account surpluses are still expected in both years, but in the order of 1–2% of GDP (Figure 3.8.11) rather than about 4.5% as forecast in *ADO 2008*, mainly because of wider trade deficits.

3.8.8 Fiscal performance



Source: Bureau of the Treasury, available: www.treasury.gov.ph, downloaded 22 August 2008.
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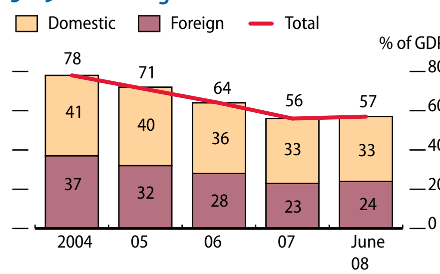
3.8.9 National government debt



Note: Debt excludes contingencies.
Source: Bureau of the Treasury, available: www.treasury.gov.ph, downloaded 11 September 2008.
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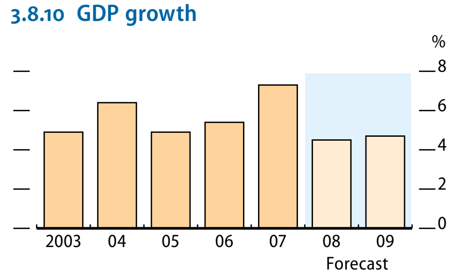
3.8.10 GDP growth



Sources: CEIC Data Company Ltd., downloaded 22 August 2008; staff estimates.
Click here for figure data

3.8.1 Selected economic indicators (%)

	2008		2009	
	ADO 2008	*Update*	*ADO 2008*	*Update*
GDP growth	6.0	4.5	6.2	4.7
Inflation	4.0	10.5	3.6	8.0
Current acct. bal. (share of GDP)	4.3	1.9	4.5	1.6

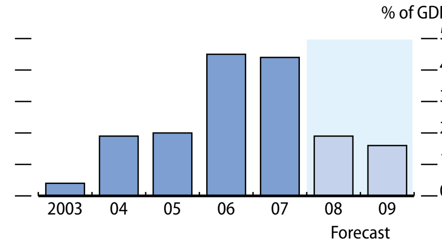
Source: Staff estimates.

Price pressures in the first half of 2008 were stronger than expected, and higher food and oil prices are still filtering through to consumer prices. Year-on-year inflation could peak in the third quarter. The inflation forecast for full-year 2008 is raised to 10.5% (Figure 3.8.12), from 4.0% in April. The pace of increase in both food and fuel prices is expected to ease in 2009 and the interest rate hikes will gradually damp domestic demand. Inflation next year is expected to average 8.0%, or well above the Government's target and over the 5.2% average actual rate seen in 2003–2007.

The budget planned for 2009, if approved, would boost total spending by 15% and outlays on infrastructure by 20% relative to this year's budget. The Government also wants to exempt minimum-wage workers from income tax next year, and corporate income tax rates are already scheduled to fall in 2009 from 35% to 30%, measures that could impede efforts to lower the budget deficit. (The aim is to achieve budget balance by 2010, defined to include privatization receipts.)

There is a risk that lower than expected economic growth may prompt a more expansionary fiscal policy, which would raise concerns about fiscal consolidation. Efforts to strengthen tax revenues will need to be stepped up to fund higher spending, particularly if weak global financial markets make it more difficult to achieve targeted privatization receipts. Higher revenue growth is required over the medium term, both to achieve fiscal consolidation, which is a key to maintaining global investor confidence, and to pave the way for greater spending on infrastructure and social services.

3.8.11 Current account balance



Sources: CEIC Data Company Ltd., downloaded 22 August 2008; staff estimates.

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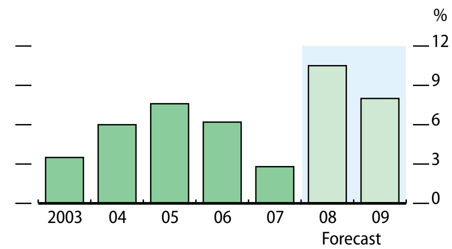
3.8.12 Inflation



Sources: CEIC Data Company Ltd., downloaded 22 August 2008; staff estimates.

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