Philippines

GDP growth reached its highest rate in three decades, reflecting continued robust consumption growth as well as expansions in net exports and investment, though manufacturing remains a weak spot that inhibits job creation. External demand will slow this year to bring growth back toward trend, and inflation will rise to moderate levels. Further progress in repairing the fiscal position is needed, for greater spending on infrastructure and social programs both to improve the investment climate and to address issues of poverty.

Economic performance

In perhaps its best performance for 30 years, the economy grew by 7.3% in 2007, well above its 5.2% average rate over the previous 5 years. Moreover, inflation fell to low levels, the fiscal position improved, the peso strengthened, and the current account recorded a large surplus.

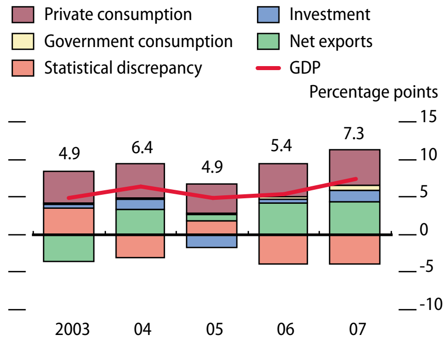
All demand-side sectors made substantial contributions to GDP growth (Figure 3.27.1). Private consumption, supported by $14.5 billion in remittances from Filipinos working abroad, rose by 6.3%, led by increased spending on food and beverages and on transportation and communications. Automobile sales, for example, increased by 18.5% last year in terms of units sold, compared with an increase of just 2.5% in 2006. Government consumption rose by 10.0%, spurred by spending ahead of national elections in May and facilitated by the improved fiscal position.

Total investment turned up after a weak performance in recent years, to grow by 9.3% in 2007. This was largely the result of increased government capital outlays and a surge of private sector real estate development, induced by tight supply of office space and by largely remittance-financed residential building. Gross fixed capital formation as a ratio to GDP rose for the first time since 1997 (Figure 3.27.2), although it remains low. Investment in plant and equipment recorded a slight upturn of 2.7% (from a decline in 2006). Net exports drove GDP growth in the first 9 months of 2007, but the contribution waned later in the year as exports weakened. Exports of electronics, which account for about 62% of total merchandise exports, were damped by a slowdown in global demand in the second half. The peso's appreciation also hurt some exports, such as clothing.

From the production side of the economy, the services sector, which accounts for about half of GDP, grew by a robust 8.7% in 2007 and was the main contributor to GDP growth (Figure 3.27.3). Mobile phone services, retail trading, finance, hotels and restaurants, and business process outsourcing all picked up strongly. Industry expanded by 6.6%, although this relied on a burst of growth in mining and construction,

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

3.27.1 Contributions to growth (demand)



Sources: Asian Development Outlook database; National Statistical Coordination Board, available: http://www.nscb.gov.ph, downloaded 4 February 2008.

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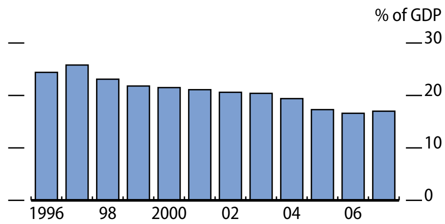
3.27.2 Gross fixed capital formation



Sources: Asian Development Outlook database; National Statistical Coordination Board, available: http://www.nscb.gov.ph, downloaded 4 February 2008.

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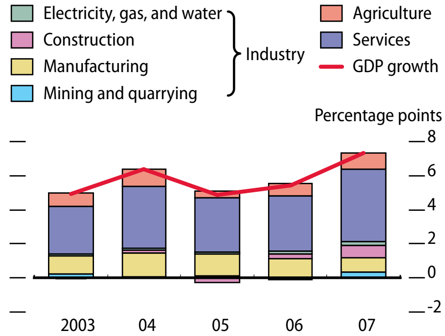
3.27.3 Contributions to growth (supply)



Sources: Asian Development Outlook database; National Statistical Coordination Board, available: http://www.nscb.gov.ph, downloaded 4 February 2008.

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while the important manufacturing subsector grew by a modest 3.3%. Strong global demand for nickel, copper, and coal lifted production of these minerals, supported by expanded gold mining and crude oil production (production levels for minerals and oil are still relatively low). Construction surged by 19.5%, reflecting increased public sector spending on infrastructure and the private sector real estate development boom. One reason for the weakness in manufacturing was a 5.6% fall in production of electrical machinery (including semiconductors), mainly due to soft external demand in the second half. Agriculture, benefiting from generally better weather than in the previous 2 years, expanded by a healthy 5.1%.

The robust economy was reflected in the labor market. The average unemployment rate declined to 7.3% in 2007 from 8.0% in 2006 and the underemployment rate to 20.1% from 22.6%. Construction and services provided many of the new jobs. (There are also more than 8 million Filipinos working abroad, equivalent to 23% of the total labor force within the country.)

Despite the improvement in activity generally, inflation in 2007 slowed to average 2.8%, the lowest in 21 years. A 19% appreciation of the peso against the United States (US) dollar during the year helped; the real effective exchange rate climbed by 14.7% (Figure 3.27.4). Since October 2007, inflation has been edging up because of rising prices of food and fuel (Figure 3.27.5). But with inflation largely contained, the Bangko Sentral ng Pilipinas cut its overnight policy interest rates four times between July and December 2007, lowering its lending rate by 250 basis points to 7.25%. It cut rates again in January 2008, trimming the lending rate to 7.00%. These cuts were targeted at stimulating investment and reducing upward pressure on the peso.

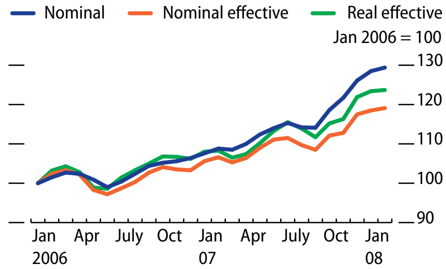
The authorities also took steps to rein in high money supply growth caused by inflows of remittances and portfolio investment. Starting in May, the central bank allowed banks and government-controlled corporations to deposit funds in its relatively high-yielding special deposit accounts. These measures drained liquidity and pulled down M3 money supply growth from 26.1% in April to 9.0% in December (Figure 3.27.6).

Financial markets performed well in 2007: the Philippine Stock Exchange index rose by 21.4% (Figure 3.27.7) and capital raised through the stock exchange jumped by 57%. Spreads between foreign currency-denominated Philippine bonds and comparable US Treasury bonds narrowed. Bank lending grew steadily, except that to manufacturing.

Maintaining the trend set in recent years, the fiscal deficit narrowed in 2007, although this was achieved with the help of sales of government assets. The national government fiscal deficit fell to the equivalent of 0.2% of GDP, down significantly over 5 years from 5.3% (Figure 3.27.8). Tax collections increased, but did not reach target. Total revenues rose by 15.8%, including privatization receipts of nearly $2 billion (Figure 3.27.9). Expenditures rose by 9.5%. Importantly, interest payments on the large national debt declined by 14.0%, thanks to the peso's appreciation (41% of the debt is external) and lower interest rates, helping make room for increased public capital outlays.

The improved fiscal position, stronger economic growth, and currency appreciation enabled the national Government to reduce its outstanding

3.27.4 Exchange rate indexes



Note: The nominal rate is against the US dollar while effective exchange rates are against a basket of foreign currencies.

Source: Bangko Sentral ng Pilipinas, available: http://www.bsp.gov.ph, downloaded 17 March 2008.

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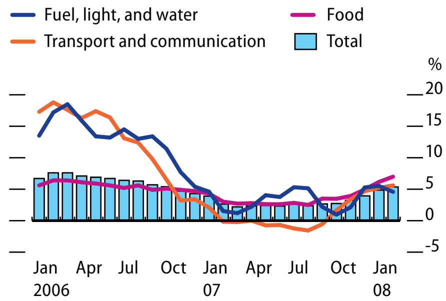
3.27.5 Monthly inflation



Sources: National Statistics Office, available: http://www.census.gov.ph; CEIC Data Company Ltd.; both downloaded 7 March 2008.

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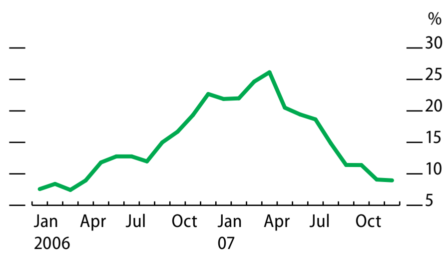
3.27.6 Growth of domestic liquidity (M3)



Source: Depository Corporations Survey, Bangko Sentral ng Pilipinas, available: www.bsp.gov.ph, downloaded 5 February 2008.

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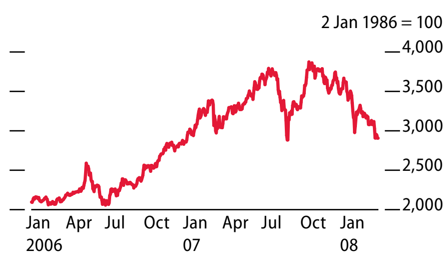
3.27.7 Philippine Stock Exchange composite index



Source: Datastream, downloaded 17 March 2008.

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debt to $79.8 billion (55.8% of GDP) at end-2007 from a recent peak of 78.2% in 2004 (Figure 3.27.10). Public sector debt, including guarantees on state-owned enterprise debt, is heading to below 70% in 2008, from as high as 118% in 2003. Yet despite progress achieved, the debt level remains elevated and interest payments still consume more than a quarter of national government revenues. The Government is changing the borrowing mix in favor of domestic borrowings, which now total 58% of national government debt.

Merchandise exports in nominal US dollars grew by 6.0% in 2007, decelerating sharply from 2006 in part because of weakness in electronics (up by 4.5%) and garments (down by 13.1%). Merchandise imports grew by 8.1%, widening the trade gap to $8.2 billion. After taking into account a small surplus in services and buoyant remittances, a current account surplus of $6.4 billion was generated in 2007 (4.4% of GDP). The capital and financial account recorded net inflows of $3.9 billion (Figure 3.27.11), largely reflecting development loans and, to a lesser degree, net portfolio investment.

Net foreign direct investment by nonresidents edged up by just 0.2% to $2.9 billion, after accounting for $1.5 billion in debt repayments by foreign-owned companies to foreign creditors or parents. (In an encouraging sign, gross foreign direct equity inflows rose by 28.2% to $2.2 billion.)

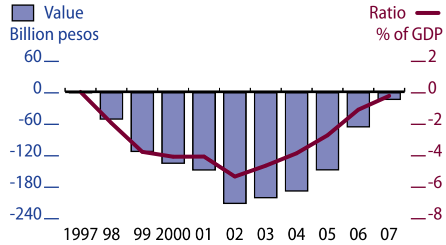
The overall balance-of-payments surplus more than doubled from 2006 to $8.6 billion, putting upward pressure on the currency. Gross international reserves soared by 47% to $33.7 billion as of end-2007 (or 4.9 times the country's short-term external debt). This significant accumulation of reserves was attributed to US dollar buying by the central bank to smooth the appreciation of the peso, income from central bank investments abroad, and a rise in the value of the gold held in the reserves.

Economic prospects

The projections assume that fiscal reform efforts will be maintained and that monetary policy remains accommodative. On this basis, domestic demand is expected to hold up fairly well for the rest of the year. Consumption growth is forecast to drive GDP expansion again this year, although the pace will ease as higher prices for food and fuel reduce discretionary spending in other areas and growth of remittances could well ease from the rapid rate of recent years as the global economic environment softens. Remittances rose by 13.2% last year in US dollar terms (they soared from $6.0 billion in 2001 to $14.5 billion in 2007). This growth rate could fall by about half in the forecast period.

Investment is expected to expand in 2008. The improved fiscal position is allowing the Government to raise investment in much-needed infrastructure. It has drawn up a $44 billion infrastructure program for the 5 years to 2010, mainly for transportation, power, and water projects. In the private sector, the reductions in interest rates and an enhanced willingness of domestic banks to lend due to strengthened balance sheets will support investment. Residential real estate, a prime target for remittance inflows, is likely to attract much of it. Growth of

3.27.8 Fiscal balance



Sources: CEIC Data Company Ltd.; Bureau of the Treasury, available: http://www.treasury.gov.ph; both downloaded 14 February 2008.

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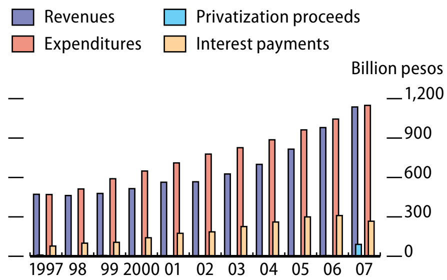
3.27.9 Budget indicators



Sources: CEIC Data Company Ltd.; Bureau of the Treasury, available: http://www.treasury.gov.ph; both downloaded 14 February 2008.

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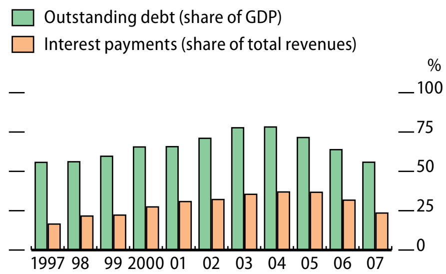
3.27.10 National government debt



Sources: CEIC Data Company Ltd.; Bureau of the Treasury, available: http://www.treasury.gov.ph; both downloaded 17 March 2008.

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3.27.1 Selected economic indicators

	2008	2009
GDP growth	6.0	6.2
Inflation	4.0	3.6
Current account balance (% of GDP)	4.3	4.5

Source: Staff estimates.

business process outsourcing services (Box 3.27.1) is also stimulating demand for office space.

In contrast, investment in manufacturing, needed to boost employment, is expected to remain weak, given the slowdown in the global economy and, more particularly, in demand for electronics goods. A prolonged problem is the domestic investment environment. International surveys show the country to be in a relatively poor position. For example, the World Bank's *Doing Business* survey ranks the Philippines 133 of 178 economies in terms of the ease of doing business. Other studies show the country scoring poorly on control of corruption, political stability, and rule of law. Foreign direct investment, an important source of funding and technology for manufacturing, is low compared with countries such as Malaysia and Thailand.

Net exports are expected to contract in 2008 and slow GDP growth somewhat, given the weaker outlook for exports and high prices for oil and food (the Philippines is one of the world's largest rice importers). Taking these factors into consideration, GDP growth is forecast to decelerate to 6.0% this year and then edge up to 6.2% in 2009 (Figure 3.27.12).

On the supply side, services sector growth is expected to slow by a little over 1 percentage point to 7.5% in 2008 as retailing and finance growth slip. Construction is forecast to continue to benefit from expansion in public investment and demand for offices and housing. Mining production is also projected to rise as a result of new investments in nickel and copper mines as a response to high global metal prices, but at a more moderate rate than in 2007. Agricultural production is likely to revert to its trend growth rate of about 4%, assuming reasonable weather, and manufacturing growth will likely ease to about 3%, given the weaker prospects for its exports.

Inflation is seen accelerating from last year's low rate to average 4.0% in 2008, lifted by rising prices for imported rice and oil. (This would keep it within the central bank's 3–5% target range.) In the first 2 months of 2008, inflation averaged slightly over 5%.

Merchandise exports will be constrained by weaker global demand, but rising prices for food and oil will contribute to a widening of the trade deficit this year. The current account surplus is projected to stay over 4% for the forecast period, underpinned by remittances. The national budget for 2008 raises the allocation for infrastructure by about 20% from the 2007 budget. The focus is on investing in transportation, agricultural infrastructure, and school buildings. Even if the infrastructure investments are fully implemented, however, the rate of public investment at 2.8% of GDP would still be relatively low. The target is a balanced budget this year, including planned privatization receipts.

Slippage in fiscal reform is the main domestic risk to the prospects. The share of tax revenues in GDP has edged up, from 12.4% in 2004 to 14.0% in 2007 (Figure 3.27.13), and this momentum needs to be maintained if the Government is to sustain infrastructure spending and keep its budget from sliding back into deficit, with the associated pitfalls of a rising country risk premium and higher interest rates. Fiscal gains so far have been supported by substantial privatization, which is not sustainable, and favorable interest-rate and currency trends, which

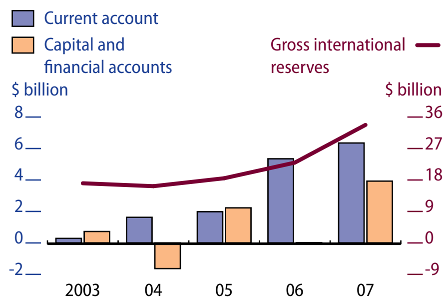
3.27.1 Business process outsourcing

The business process outsourcing industry in the Philippines is one of the world's biggest, with a 5% market share in 2006 of global offshore outsourcing. This new business has expanded rapidly because many local people have a knowledge of English and wages and office rents are relatively low.

Revenues grew by 48% a year between 2004 and 2006. The industry has contributed to GDP growth through expansion of the services sector and of demand for office space; it has become an important foreign exchange earner; and it provides jobs for college graduates. It aims to double its global market share to 10% by 2010, which it believes would create 1 million more jobs.

Such expansion will require the nurturing of higher value-added services such as software development and medical transcription, as well as a supply of labor with the appropriate skills. Lack of skills is a constraint, and greater cooperation between education institutions and business-process outsourcing operators would be beneficial. Lastly, the industry is heavily concentrated in the capital, Manila. Encouraging more service providers to set up in other cities, where wages and rents are lower, would help it to keep costs down and to spread its employment benefits.

3.27.11 Balance-of-payment components and reserves



Sources: Asian Development Outlook database; Bangko Sentral ng Pilipinas, available: http://www.bsp.gov.ph, downloaded 18 February 2008.

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are vulnerable to swings in market sentiment. Further improvements in the ratio of tax revenues to GDP depend largely on strengthening the administrative capabilities of the main revenue-collecting agencies. Another risk is that higher than expected inflation could drive the central bank to raise interest rates, damping business and consumer demand and raising the public debt service burden. The uncertain incidence of typhoons and dry spells as usual poses risks to the weather-vulnerable agriculture sector.

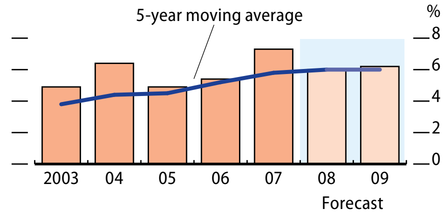
Development challenges

Last year's quickened pace of economic growth generated a net 924,000 jobs. This still falls well short of the medium-term development plan's target of about 1.5 million new jobs a year between 2004 and 2010. One reason is the stagnation of manufacturing. More robust manufacturing would not only generate more jobs, but the links with other sectors would spur employment there, too. Manufacturing also generally provides longer-term employment than other sectors. However, no substantial expansion in manufacturing is likely without a significant and sustained improvement in the investment climate. Business process outsourcing, which has grown rapidly to employ about 320,000 people, holds out hope for further employment generation, if it can find suitably trained staff.

Poverty has been a persistent problem even with the pickup in economic growth over recent years. The incidence of families living in poverty increased by 2.5 percentage points to 26.9% between 2003 and 2006 (Figure 3.27.14), which means that about 4.7 million families, or 27.6 million people, lived in poverty in 2006.

One factor in this deterioration is increasing prices for basic items. The annual per capita poverty threshold was raised from P12,309 in 2003 to P15,057 in 2006 to take price increases into account. In addition to external factors such as higher oil prices, prices of food and beverages increased by 19.3% in 2003–2006. This was partly due to typhoon damage to crops in 2005 and 2006. Insufficient increases in incomes and a high population growth rate were other factors that affected poverty incidence. Further improvement in the fiscal position would enable an increase in social spending to address this issue and to build infrastructure that would help to attract employment-creating industries.

3.27.12 GDP growth



Sources: Asian Development Outlook database; National Statistical Coordination Board, available: http://www.nscb.gov.ph, downloaded 31 January 2008; staff estimates.

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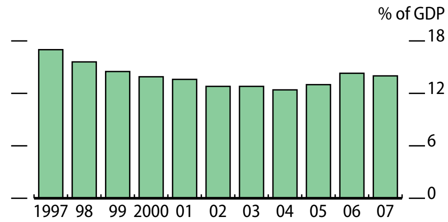
3.27.13 Tax revenues



Sources: CEIC Data Company Ltd.; Bureau of the Treasury, available: http://www.treasury.gov.ph; both downloaded 14 February 2008.

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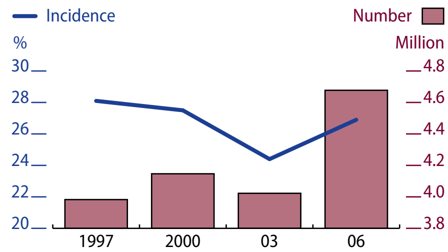
3.27.14 Poverty indicators among families



Source: National Statistical Coordination Board, available: http://www.nscb.gov.ph, downloaded 6 March 2008.

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