Philippines

GDP grew much faster than expected in the first half of 2007, led by net exports, private consumption, and government spending. For the full year, the aggregate growth forecast is revised to 6.6% from 5.4% in *Asian Development Outlook 2007* (*ADO 2007*), and the prediction for 2008 is edged up to 6.0%. Inflation forecasts are revised down for both years. Fiscal revenue collection fell behind target in the first half of this year, raising concerns about efforts to rein in the deficit and increase spending on development.

Updated assessment

GDP growth accelerated to 7.3% in the first half of 2007 from 5.6% in the first half of 2006 (Figure 3.7.1). The sharp rise was due to robust growth of net exports and private consumption, and higher government expenditure. Private consumption, accounting for more than three quarters of GDP, grew by 6.0% in the period, underpinned by an 18.1% rise (to $7.0 billion) in remittances from overseas workers. Government consumption rose by a sharp 11.8% and public sector construction investment surged by 33.8%. Both were boosted by some nonrecurring factors: recovery expenditures for typhoon-damaged areas and accelerated spending ahead of legislative and local government elections in May 2007.

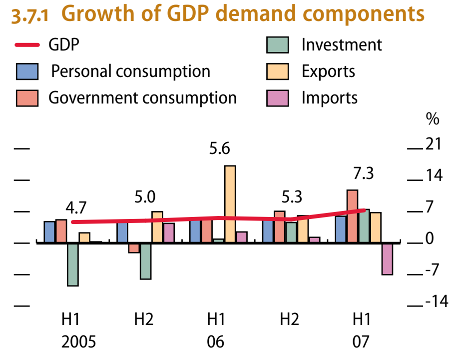
In a positive sign for future productive capacity, investment in durable equipment grew by 2.0%, after 2 years of contraction. Total investment contributed positively to aggregate growth in the first half.

On the supply side, services recorded particularly strong growth of 8.6%. Retail trade, a major subsector, expanded by 10.5% on the robust private consumption. Industry grew by 7.2%: construction and mining performed well, manufacturing less so (Figure 3.7.2). Construction was strongly supported by the jump in public sector investment. Private sector construction also grew, by 8.5%, a turnaround from a decline in the year-earlier period. Mining output (up by 24.3% in the first half) benefited from high global prices for minerals and startups of new projects. Production of coal, natural gas, and nickel increased, although from low bases. Quarrying surged with the higher levels of construction activity.

Manufacturing grew by just 3.9% in the first half, the lowest rate of expansion in several years, in part because of weakness in global demand for electronic products, a major export category. Agriculture, which was hit by typhoon damage late in 2006, recovered to grow by 4.0% in the first half of 2007.

The outlook for the full year has improved with the stronger than expected first-half performance and lower than projected inflation. Private consumption spending will continue to be boosted by remittances. On the other hand, with elections out of the way, government spending is unlikely to be as strong in the second half. The contribution of net exports is projected to decline, too, because imports were unusually weak in the first half. Moreover, a prolonged dry spell, mainly in the largest

3.7.1 Growth of GDP demand components



Sources: Asian Development Outlook database; National Statistical Coordination Board, available: http://www.nscb.gov.ph, downloaded 30 August 2007.

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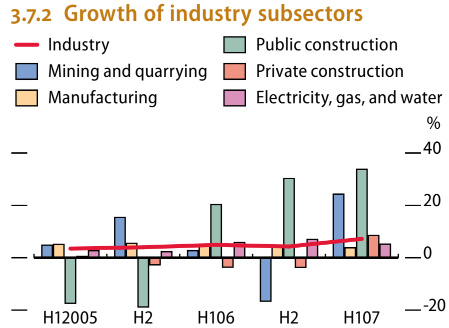
3.7.2 Growth of industry subsectors



Sources: Asian Development Outlook database; National Statistical Coordination Board, available: http://www.nscb.gov.ph, downloaded 30 August 2007.

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island of Luzon, could hurt agricultural output. Consequently, GDP growth in the second half is not projected to match the first-half result. Still, taking into account the higher than expected private consumption and government-led investment, the GDP forecast for this year is revised up to 6.6% from 5.4% in *ADO 2007*.

Merchandise exports (on a customs basis and in US dollars) rose by 6.6% in the first half, well below the 18.2% pace in the year-earlier period. One reason for the slowdown was relatively torpid growth in exports of electronic products (6.3% against 14.7% a year ago) because of weaker global demand. Electronic products account for 60% of total merchandise exports. Garment exports fell by 11.3%, hurt by an appreciating peso. In contrast, shipments of minerals shot up by 53% owing to strong demand from markets including the People's Republic of China.

Merchandise imports on the same basis rose by only 2.3% in the first half, in part reflecting weakness in the electronic and garment industries. Furthermore, imports of fuel and of industrial equipment were flat, and imports of cereals fell sharply as domestic harvests improved early in the year. Thus, the trade deficit for the first half narrowed to $776.1 million from $1.7 billion a year earlier. This narrower gap and the rise in remittances helped bolster the current account surplus, which rose to $1.8 billion, equivalent to 5.8% of GDP, in the first quarter of this year. For the full year, the current account surplus is now expected to come in at 5.4% of GDP, revised up from 3.2% in *ADO 2007*.

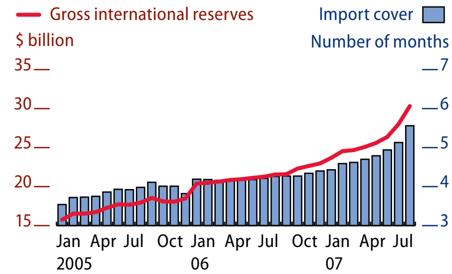
Gross international reserves increased to $30.3 billion as at end-August 2007, equivalent to 5.6 months of imports (Figure 3.7.3). Strong demand for pesos for current and capital account transactions led to a 5.2% appreciation against the US dollar in the 8 months to August (Figure 3.7.4). The real effective exchange rate appreciated by 5.1% in that period.

Despite the lift in domestic demand, inflation decelerated faster than anticipated, to average 2.6% in the January–August period. (Figure 3.7.5). The impact of a 2 percentage point rise in value-added tax early in 2006 subsided, and the peso's appreciation helped offset higher import prices. Prices of food staples were stable in the first half (although the dry weather could put upward pressure on food in the second). Lower than expected inflation in the first 8 months has prompted a downward revision in the full-year forecast to 2.9% from 4.8% in *ADO 2007*.

Broad money (M3) rose by about 20% on average in the first 6 months of 2007, double the rate of a year earlier, driven mainly by foreign exchange inflows and, to a lesser extent, by the growth of credit to the public and private sectors. Reflecting ample liquidity in the banking system, interest rates on domestic treasury bills eased: the nominal yield on 91-day bills declined below comparable US treasuries in November 2006, for the first time in 25 years, and this relationship has been maintained this year (Figure 3.7.6).

Bangko Sentral ng Pilipinas, the central bank, concerned that the strong growth in money supply posed inflation risks, in May moved to drain surplus liquidity. It encouraged government-controlled corporations to deposit funds with the central bank and made available a special deposit account facility to a wider range of financial institutions. In July, the monetary authorities ended a tiering system on rates paid to banks

3.7.3 Reserves



Source: Bangko Sentral ng Pilipinas, available: http://www.bsp.gov.ph, downloaded 7 September 2007.

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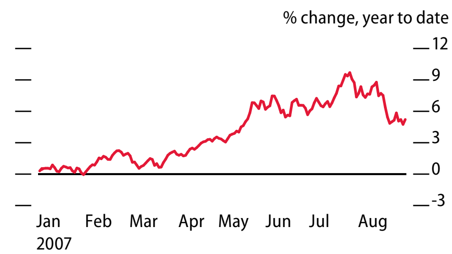
3.7.4 Peso against US dollar



Note: A point above zero indicates an appreciation of the peso.

Source: CEIC Data Company Ltd., downloaded 3 September 2007.

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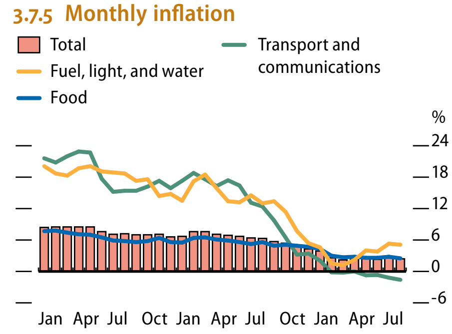
3.7.5 Monthly inflation



Sources: National Statistics Office, available: http://www.census.gov.ph; CEIC Data Company Ltd.; both downloaded 5 September 2007.

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on overnight deposits, an arrangement that had been introduced late in 2006 to encourage banks to lend. Simultaneously, the central bank cut key policy rates. It has described the overall impact on monetary policy of these July changes as neutral.

The Government has made significant progress in narrowing the wide fiscal gap over recent years, reining in the fiscal deficit to 1.1% of GDP in 2006, the narrowest in 9 years, through, among other measures, broadening the tax base and raising the value-added tax. This year's deficit target was set at P63.0 billion, or 0.9% of GDP. However, revenues collected in the first half of 2007 fell short of programmed levels, so that the deficit was P9.7 billion wider than target (Figure 3.7.7).

Proceeds from privatization are expected to be used to cover shortfalls in revenues. The Government raised P43 billion from the sales of stakes in various corporations, as well as some property, in the first 7 months of 2007. More asset sales are planned.

Outstanding government debt declined by 5.4% in the first half from a year earlier, to P3.78 trillion ($81.6 billion). However, the still-high debt (about 60% of GDP, excluding contingent liabilities of debt guarantees to state-controlled companies; Figure 3.7.8) and the large share of interest payments in the budget (they consumed 25.4% of total revenues in the first half) expose the economy to swings in sentiment in financial markets.

The labor market strengthened somewhat with faster economic growth. In April, the unemployment rate was 7.4% on a preliminary basis, down from 8.2% a year earlier, and the underemployment rate declined to 18.9% from 25.4%. Business process outsourcing has been an encouraging field for job creation. It boosted employment from 2,400 to 237,400 between 2000 and 2006 and has potential to grow more. That would require diversification into higher value-added segments, such as medical transcription, back-office processing, and digital content, which in turn needs skills training. Job creation is a major challenge for the country, given that 43 million people live on less than $2 a day and the labor force is increasing by 2% a year.

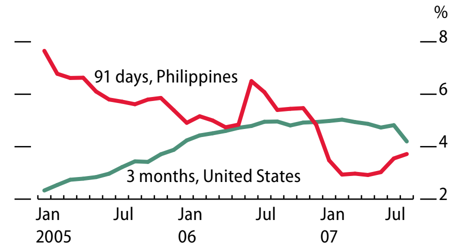
Prospects

Robust growth is expected to be sustained in 2008, though not at the pace of this year. Services will continue to be the main driver, supported by growth in remittances and therefore in consumption. Retail trade and transport, residential real estate, and communications services are expected to expand strongly. Services as a whole is projected to grow by 7.4% next year (Figure 3.7.9).

In industry, export-oriented manufacturing will do better if global demand for electronic products picks up as projected, but mining and quarrying are likely to decelerate from the rapid expansion seen in 2007. Government expenditures on infrastructure will support growth of construction. Industry as a whole is expected to grow at around 5.0%, and agriculture, assuming normal weather conditions, at 3.9%.

Improvements in the business climate brought about by lower inflation and reductions in the fiscal gap will likely mean slightly higher growth in total investment next year. There are signs that foreign direct investment is starting to pick up: major commitments have been made

3.7.6 Treasury bill rates



Sources: Bangko Sentral ng Pilipinas, available: http://www.bsp.gov.ph; Board of Governors of the Federal Reserve System, available: http://www.federalreserve.gov; both downloaded 7 September 2007.

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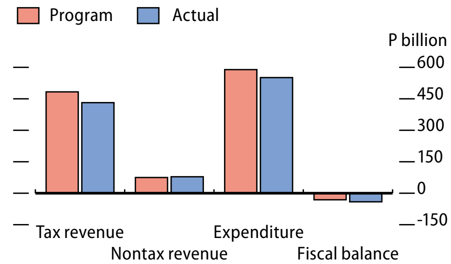
3.7.7 Fiscal performance, first half 2007



Source: Department of Finance, available: http://www.dof.gov.ph, downloaded 31 August 2007.

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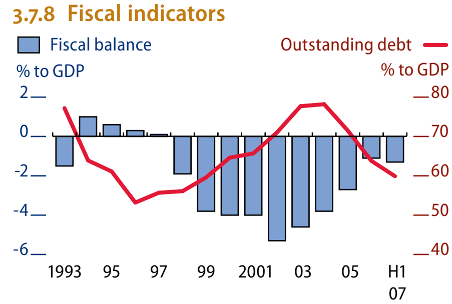
3.7.8 Fiscal indicators



Sources: National Statistical Coordination Board, available: http://www.nscb.gov.ph; CEIC Data Company, Ltd.; Bureau of the Treasury, available: http://www.treasury.gov.ph, all downloaded 30 August 2007.

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by a Korean ship-building company, a PRC glass manufacturer, and a US semiconductor company. Net foreign direct investment rose by 16% in the first half of 2007, to a still-modest total of $1.2 billion. Certainly a lift in investment would be welcome: the ratio of gross domestic investment to GDP declined from 21.2% to 14.3% between 2000 and 2006, curtailing economic growth and employment generation. Increased government investment in infrastructure should further enhance the business climate. (The budget proposed for 2008 includes a 20% increase in development expenditures.) Taking into account the various influences, the forecast for GDP growth in 2008 is revised up to 6.0% from 5.7% in *ADO 2007*. Given the moderation in inflationary pressures, the inflation forecast for 2008 is revised down to 3.5%.

Merchandise export growth is projected to be supported by some strengthening of global demand for electronic products next year. If the rest of Asia grows as projected, this will benefit the Philippines: its share of total exports going to East Asia (excluding Japan) and ASEAN has increased from 25.5% in 1997 to 41.9% in 2006 (Figure 3.7.10). However, some of these exports are used in the other Asian countries to make products ultimately shipped to the US, so that an unexpected weakening in that market would also have an impact on Philippine exports to the rest of Asia. Merchandise imports are projected to pick up from this year's weak level because of the growth in consumption and investment, and to provide inputs for the electronics industry. The current account surplus is projected at 5.2% of GDP, close to this year, but revised up from *ADO 2007*.

Planned reforms of the power sector, if achieved, would bring several benefits. The Government aims to privatize power generation and transmission as a way to stimulate investment in the sector and reduce its costs. One goal is to sell 70% of the power generation assets in Luzon and Visayas by end-2008. Having started with sales of relatively small hydropower plants, the Government expects to sell major facilities, including two 600 megawatt coal-fired thermal plants, and to award the concession for transmission assets in 2007 and 2008. Progress would improve the investment climate and the fiscal position (long-term debt of the power sector is a major portion of government contingent liabilities).

The main domestic risk to this outlook is related to fiscal reform. Improvement in the fiscal performance in 2006 raised optimism about the country's economic prospects, as illustrated by an increase in net portfolio investment in the first 7 months of 2007 to $3.6 billion, four times as large as a year earlier. However, the shortfall in (mainly tax) revenues in the first half of 2007 has raised concerns about the fiscal consolidation program. If the Government's efforts stall, sovereign borrowing costs could rise. Privatization proceeds are not recurrent, so cannot always be relied on to fill the budget gap. A balanced budget is targeted for 2008, but that still requires privatization proceeds to cover planned expenditure.

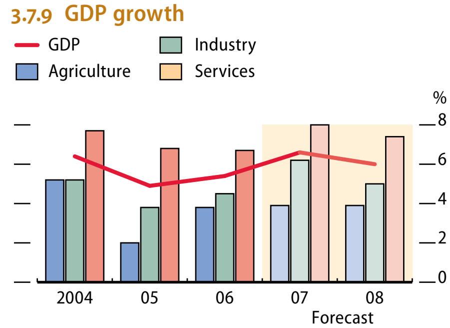
Higher tax revenues are all the more important as the Government's stance on fiscal expenditures has shifted from austerity (seen in a decline of government expenditures from 19.9% of GDP in 2002 to 17.3% in 2006) to an expansion of development spending. If revenues do not rise commensurately, the public investment program may need to be trimmed, or the fiscal deficit allowed to widen.

3.7.1 Selected economic indicators (%)

	2007		2008	
	ADO 2007	*Update*	*ADO 2007*	*Update*
GDP growth	5.4	6.6	5.7	6.0
Inflation	4.8	2.9	5.0	3.5
Current acct. bal. (share of GDP)	3.2	5.4	2.9	5.2

Source: Staff estimates.

3.7.9 GDP growth



Sources: Asian Development Outlook database; staff estimates.

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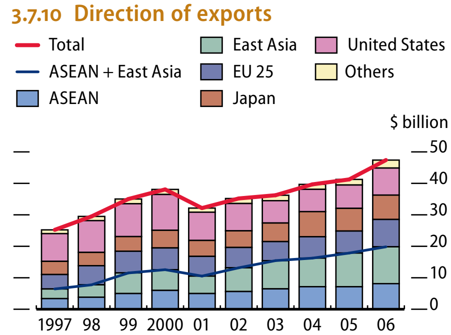
3.7.10 Direction of exports



Source: CEIC Data Company Ltd., downloaded 2 August 2007.

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