Philippines

Achievements in 2006 included moderate economic growth, a downtrend in inflation, and stronger fiscal and external positions. This year, still-high levels of remittances and low real interest rates, as well as greater fiscal expenditures, should keep expansion at around the same level. However, it has not been strong enough to lift employment sufficiently, mainly because of a declining investment-to-GDP ratio. Improvements in the investment climate are needed, to spur economic expansion, increase employment generation, and provide public resources for social programs.

Economic performance

GDP rose by 5.4% in 2006, maintaining its slight upward trend of the past 5 years (Figure 2.26.1). With a strong rise in remittances from overseas workers to $12.8 billion (11.0% of GDP), gross national product growth accelerated to 6.2%, from 5.6% in 2005. Personal consumption expenditures and net exports were the main contributors in 2006. The substantial remittances and low interest rates supported private consumption. However, gross fixed capital formation continued to decline as a share of GDP to the lowest level in 20 years (Figure 2.26.2), reflecting a deficient investment environment and restraints on the public capital spending required to buttress the Government's fiscal position.

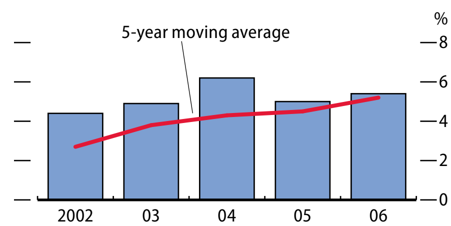
On the supply side, the pace of growth in agriculture more than doubled from 2005 to 4.1% in 2006 with more favorable weather conditions early in the year and a larger harvested area. Production of rice and corn in particular rebounded from a slump the previous year, and fisheries maintained a solid advance.

Industry's growth rate remained just below 5%. Transport and communications, finance, and private services, including business process outsourcing and other information technology-enabled services, led the way in the services sector, which grew by 6.3% and accounted for 3 percentage points of total GDP growth (Figure 2.26.3).

However, growth has not been strong enough to raise the employment level to significantly dent the unemployment rate. In the 3 years 2004 to 2006, employment edged up by 2.5% on average each year, or about half the level envisaged in the Medium-Term Philippine Development Plan 2004–2010. Services, primarily wholesale and retail trade, accounted for two thirds of the employment gain, and agriculture a quarter.

Unemployment remained close to 8% in 2006. Slightly more than half of the unemployed were high-school graduates (32.3%) and college graduates (18.4%), indicating that, in addition to raising the overall level of employment, there may be a mismatch in skills (see *Education and structural change in four Asian countries* in Part 3). In a worrisome trend, the number of underemployed rose to 23% of total employment in 2006 from 18% in 2004.

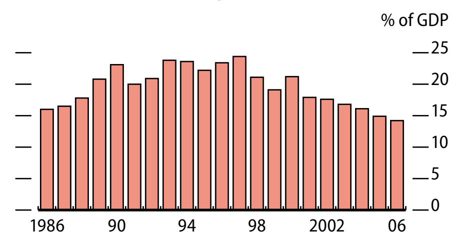
2.26.1 GDP growth



Sources: Asian Development Outlook database; National Statistical Coordination Board, available: http://www.nscb.gov.ph, downloaded 31 January 2007.

Click here for figure data

2.26.2 Gross fixed capital formation



Source: CEIC Data Company Ltd., downloaded 12 February 2007.

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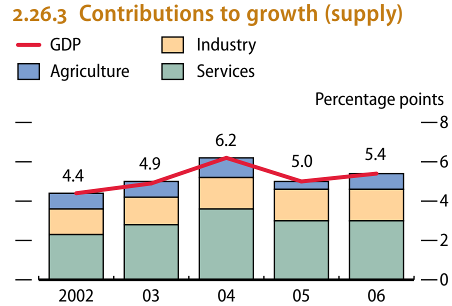
2.26.3 Contributions to growth (supply)



Sources: Asian Development Outlook database; National Statistical Coordination Board, available: http://www.nscb.gov.ph, downloaded 31 January 2007.

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The Government's efforts to buttress its fiscal position by raising revenues and restraining growth of current expenditures have contributed to a gradual rise in the gross domestic savings rate to 19.8% of GDP in 2006 from 17.1% in 2001. With both public and private investment weak, the savings-investment gap widened. As a result, the current account balance went from a deficit of 2.4% of GDP to an estimated surplus of 4.0% of GDP over the same period.

Merchandise exports rebounded in 2006 across all major product categories, a result of robust demand in external markets. Exports performed well in spite of a 22% appreciation between 2004 and 2006 of the real effective peso exchange rate. Almost half the export expansion was attributable to semiconductors, which account for 47% of total merchandise exports (Figure 2.26.4). Resource-based exports, especially gold and copper, also surged on high international commodity prices, and contributed close to a third of total export growth.

The import intensity of key exports, such as electronics and garments, led to strong growth of imports as well. The rate of increase was slower than that of exports however, reflecting a more moderate rise in world oil prices and higher domestic production in agriculture, which tempered the growth of food imports. The deficit in the services account narrowed, too, because of higher receipts from communications and business services, as well as tourism. Remittances (Figure 2.26.5) continued to provide important support to the current account.

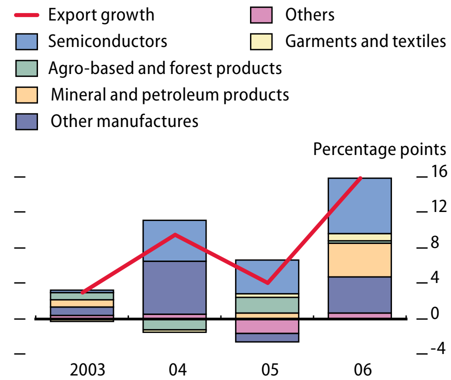
The overall balance of payments posted a hefty surplus of $2.6 billion in the first 3 quarters of 2006, similar to a year earlier. Although inflows of net portfolio investment slowed from 2005, net foreign direct investment (FDI) during the 3 quarters rose to $1.6 billion (1.4% of 2006 GDP). However, 43% of the FDI was in the form of intercompany loans rather than new equity; and FDI (in both US dollars and as a share of GDP) remains below the norm for Southeast Asia.

The surplus in the balance of payments put substantial upward pressure on the currency; the central bank tried to mitigate the effect by accumulating foreign exchange reserves. Gross reserves rose by $4.5 billion in 2006 to $23.0 billion, or more than 4 months of import cover, enabling the Government in December to pay back early about $220 million of loans from the International Monetary Fund and about $83 million from the Asian Development Bank.

The banking system's accumulation of net foreign assets fueled liquidity. Broad money (M3) growth has accelerated in the last few years, driven primarily by this accumulation (Figure 2.26.6). In 2006, net domestic credit also reversed from a decline in 2005 to contribute 7.8 percentage points to M3 growth, in large measure reflecting a recovery in credits to the private sector. A decline in the risk premium (based on improved fiscal performance), expectation of peso appreciation, accommodative monetary policy, and buoyant liquidity exerted downward pressure on interest rates. The nominal yield on 91-day treasury bills declined below comparable US treasuries in November (Figure 2.26.7) for the first time in 25 years.

Inflation slowed markedly in the second half of 2006 (Figure 2.26.8) as the impact of a 2 percentage point rise in the value-added tax (VAT) rate early in the year receded. Lower inflation was also helped by a stronger

2.26.4 Contributions to export growth



Sources: National Statistics Office, available: http://www.census.gov.ph; CEIC Data Company Ltd., downloaded 8 February 2007.

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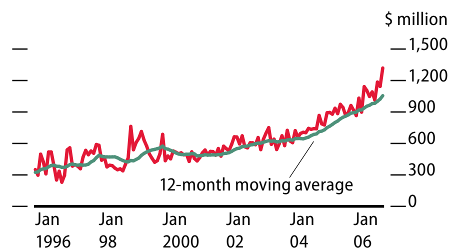
2.26.5 Monthly remittances



Sources: Datastream, downloaded 6 January 2006; Bangko Sentral ng Pilipinas, available: http://www.bsp.gov.ph, downloaded 20 February 2007.

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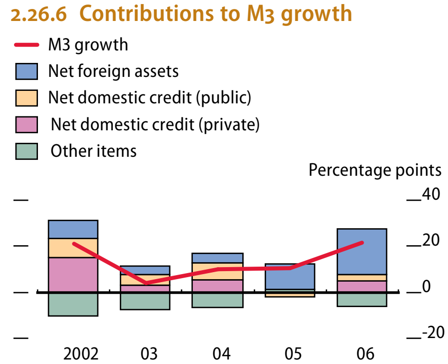
2.26.6 Contributions to M3 growth



Source: Bangko Sentral ng Pilipinas, available: http://www.bsp.gov.ph, downloaded 15 January 2007.

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exchange rate, declining world oil prices, and a moderating increase in domestic food prices. The deceleration in inflation and the peso's strength enabled the central bank to pursue an accommodative monetary policy. While policy interest rates were kept steady, the central bank adopted a tiering scheme in November 2006 to dissuade banks from depositing funds with it and to encourage them instead to lend to the public. Under the tiering scheme, banks' deposits with the central bank earn a lower rate of interest, the higher the amount of their deposits.

A narrowing in the fiscal deficit to 1.0% of GDP (from 5.3% in 2002; Figure 2.26.9) was attributable to a 20% jump in revenues, reflecting the increase in the VAT rate and an expansion of the tax base, set against a rise in expenditures of just 8%. Compared with the Government's target, the deficit was narrower by about half. Revenues slightly exceeded the target, while expenditures were about 5% down as the Congress' disapproval of the 2006 appropriations bill led to the reenactment of the prior year's budget. A stronger currency and lower domestic interest rates also resulted in lower than expected interest payments, accounting for about half the shrinkage in the deficit relative to the target.

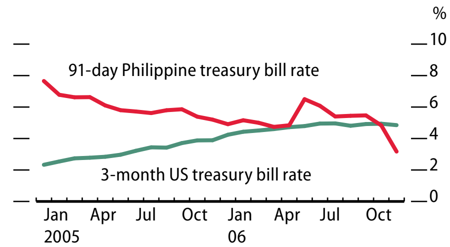
Excluding interest payments, the primary fiscal balance switched to a surplus of 4.1% of GDP in 2006, from a deficit of 0.6% of GDP in 2002. Coupled with lower interest rates, a stronger currency, and an improvement in economic growth, this contributed to a reduction in the Government's outstanding debt from a recent peak of 78.5% of GDP in 2004 to 64.2% in 2006 (Figure 2.26.10). This figure excludes about 9.5% of GDP in contingent liabilities, comprising the national Government's guarantees on debt of government-controlled corporations and financial institutions. Debt levels are still high in spite of the favorable trend, and interest payments consume close to a third of revenues, compressing the fiscal space for development expenditures.

The privatization program gained some traction last year, with the realization of P5.8 billion (more than twice receipts in 2005). The Government sold its stake in the Philippine National Oil Corporation–Energy Development Corporation through an initial public offering for P4.6 billion. In early 2007, the sale of the stake in the Philippines Long Distance Telephone Company yielded P25 billion (0.4% of 2007 GDP).

The Government made encouraging progress in privatizing its assets in the power sector as well. Its aims are to reduce the sector's drain on public finances and to provide an adequate and efficient supply of energy through the private sector. In September 2006, the Power Sector Assets and Liabilities Management Corporation, the agency set up to manage and privatize the generation and transmission assets of the National Power Corporation, sold a 112 megawatt plant for $129 million. In January 2007, it finalized the sale of another 360 megawatt plant for $530 million.

Prior to these sales, only five small plants with a total generating capacity of 8.5 megawatts had been sold for $5.2 million. These sales, however, represent only about 12% of total generation capacity to be sold. In February 2007, an attempt to sell a 25-year concession of the transmission grid failed for the fourth time, as only one of three potential bidders submitted a bid.

2.26.7 Treasury bill rates



Sources: CEIC Data Company Ltd., downloaded 8 February 2007; Board of Governors of the Federal Reserve System, available: http://www.federalreserve.gov, downloaded 17 January 2007.

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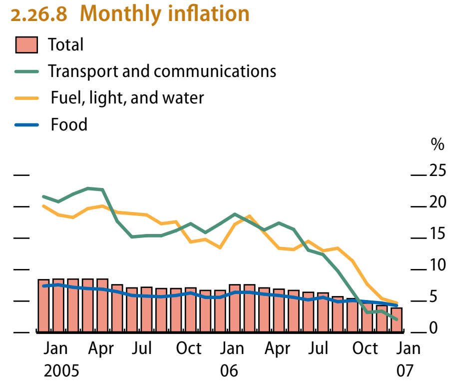
2.26.8 Monthly inflation



Sources: National Statistics Office, available: http://www.census.gov.ph; CEIC Data Company Ltd., downloaded 8 February 2007.

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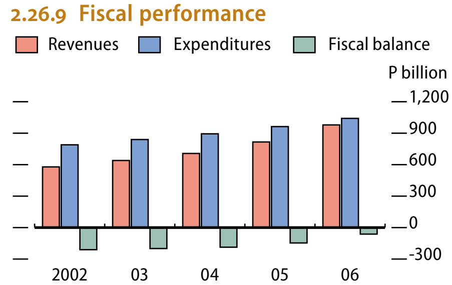
2.26.9 Fiscal performance



Source: Bureau of the Treasury, available: http://www.treasury.gov.ph, downloaded 7 February 2007.

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Economic prospects

The modest growth trajectory is projected to be maintained this year and next. The baseline international assumptions are for the global economy and trade to slow from last year's pace. With its share of exports (on a national accounts basis) close to 50% of GDP in 2006, and its dependence on capital inflows, the Philippines is closely tied to the global economy and to sentiments in international financial markets. This is offset somewhat by the seeming independence of remittances to global disturbances, likely reflecting their diversified origins. Low real interest rates and higher fiscal spending on priority projects should also support growth.

Against this backdrop, GDP is projected to grow by 5.4% this year before picking up to 5.7% in 2008 on the expectation of a more favorable external environment (Figure 2.26.11). The key domestic assumption underlying these projections is that fiscal reforms remain broadly on track. Another assumption is that the current El Niño weather phenomenon remains mild.

The services sector will remain the main contributor to growth on the supply side, expanding by a forecast 6.3% in 2007 and continuing its secular increase as a share of GDP. Agricultural production is likely to grow slightly below its trend rate of 4.0% (Figure 2.26.12). The enactment of the Biofuels Act in January 2007, which mandates a gradual phase-in of ethanol blends in fuel, is likely to boost cultivation of sugarcane and cassava for ethanol production.

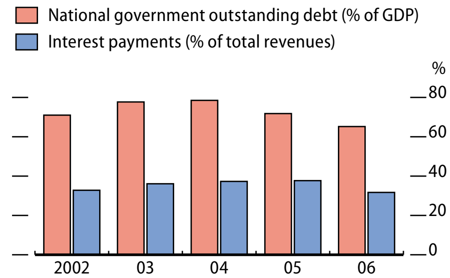
Construction will benefit from the planned upturn in public spending on infrastructure. However, the expected softening of the global electronics market and the slowdown in overall external demand will crimp manufacturing output. Industry as a whole is expected to grow by 4.8%, again underperforming aggregate GDP growth. The shares of the economy that agriculture and industry accounted for will thus continue to decline.

Private consumption and, to a lesser extent, net exports will support demand. Consumption should continue to benefit from buoyant remittances and low real interest rates, which for some maturities of deposits remained negative in 2006 (Figure 2.26.13). The contribution of net exports to growth will likely fall to less than 1 percentage point (from about 4 percentage points in 2006), against a backdrop of softer demand in external markets, a strong currency, and higher import requirements consistent with a modest recovery in investment.

Investment will likely recover to 4–6% growth, compared with 2.0% in 2006 and an average annual increase of just 0.4% in 2002–2006. It will be supported by higher government expenditures and low real interest rates. Bank balance sheets have strengthened (Figure 2.26.14), and so banks' willingness to lend may rise, especially as the lending–deposit spread is at the top of the range seen over recent years. However, businesses are unlikely to sharply lift spending on new plant and equipment without deeper reform of the investment environment.

The trade deficit is expected to widen slightly to about 6.6% of GDP in 2007, reflecting the trends in external demand, exchange rates, and investment, although the value of imported petroleum products (15.8% of total imports) should fall from the levels of 2006 (Figure 2.26.15).

2.26.10 Debt and interest payments



Source: Bureau of the Treasury, available: http://www.treasury.gov.ph, downloaded 13 March 2007.

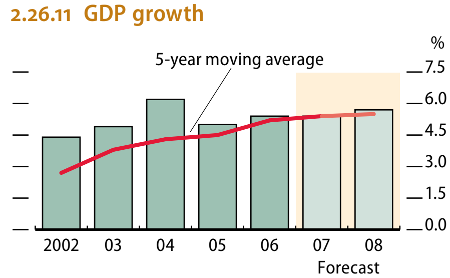
Click here for figure data

2.26.1 Selected economic indicators

	2007	2008
GDP growth	5.4	5.7
Inflation	4.8	5.0
Current account balance (% of GDP)	3.2	2.9

Source: Staff estimates.

2.26.11 GDP growth



Sources: Asian Development Outlook database; National Statistical Coordination Board, available: http://www.nscb.gov.ph, downloaded 31 January 2007; staff estimates.

Click here for figure data

Remittances are projected to remain at about 11% of GDP. Consequently, the current account surplus is likely to post a healthy, but smaller, surplus of about 3.2% of GDP in 2007. The privatization of several significant assets in late 2006 and early 2007 and the increase in FDI approvals (Figure 2.26.16) in 2006 suggest that FDI inflows may retain the gains made last year and contribute to a surplus in the overall balance of payments.

The peso is likely to maintain its strength, supported by foreign exchange inflows from the balance-of-payments surplus. However, to preserve the price competitiveness of exports against the backdrop of slowing external demand and the appreciation of the peso (in real trade-weighted terms), the central bank may again accumulate foreign exchange reserves to stem the pace of currency appreciation. Measures to liberalize foreign exchange outflows to be effective from April 2007 may also relieve some upward pressure on the peso. They include doubling the amounts of foreign exchange that residents can buy to pay for overseas services and investment abroad.

Some of the increase in reserves may be used to further prepay official external debt, in line with the Government's strategy to reduce the proportion of external debt to domestic debt (Figure 2.26.17). Inflation is likely to remain within the target of 4–5%, affording scope for monetary policy to remain accommodative.

Congress approved a budget for 2007 that envisages a continuation of fiscal consolidation with a rise in development spending. The deficit is programmed at about 1% of GDP, similar to the actual gap in 2006. Revenues are likely to be 14.3% stronger than the outturn in 2006, equivalent to 16.9% of projected 2007 GDP. This rate of increase is higher than the average annual 10% improvement in the 2001–2005 period, before VAT reforms led to a jump in revenues in 2006.

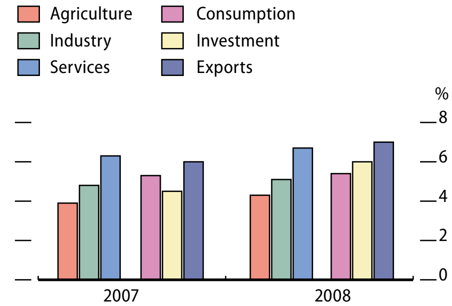
This suggests that, in the absence of new tax measures, efforts to enforce tax collection need to continue over the medium term both to finance higher expenditures on infrastructure and to reduce the deficit. For 2007, given privatization receipts from asset sales (counted as revenues, not a financing item) in late-2006 and early this year, the projected strengthening in receipts should be achievable.

Spending is programmed to go up by 13.5%, to 17.9% of projected 2007 GDP from 17.3% in 2006, the first pickup in its share of GDP in 5 years. Outlays on infrastructure are planned to increase by 16.4%, including a notable rise in spending for public works, transport and communications, and, to a lesser extent, education.

The main risk to the projections, apart from the extent of the slowdown in external markets, is the potential impact of the Congressional elections in May 2007. The elections need to be transparent and peaceful, and the fiscal and structural reforms kept on track. Steady progress on privatization will be an important signal to investors on the Government's commitment.

If reforms related to better tax collection and privatization stall, the country risk premium is likely to rise, with an adverse impact on capital inflows, the exchange rate, and interest rates, reversing some of the gains made in recent years and dimming the outlook for future growth. El Niño and the uncertain incidence of typhoons pose an additional risk.

2.26.12 Growth of supply and demand components of GDP



Source: Staff estimates.

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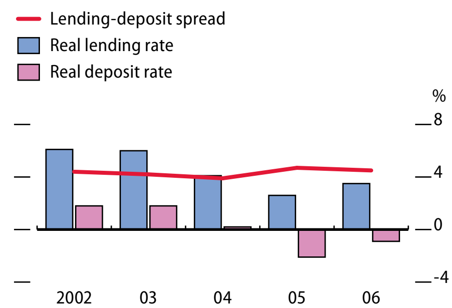
2.26.13 Lending and deposit rates



Note: Deposit rate refers to 61–90 day peso time deposit.

Source: CEIC Data Company Ltd., downloaded 8 February 2007.

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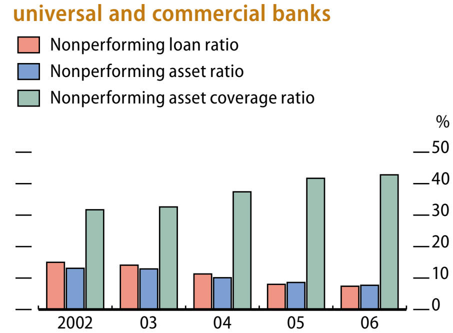
2.26.14 Banking performance indicators: universal and commercial banks



Note: Data for 2006 are as of end-September.

Source: CEIC Data Company Ltd.; downloaded 9 February 2007

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Development challenges

The key challenge is to move to a higher growth trajectory and create more and higher-quality jobs for the unemployed, underemployed, as well as new entrants into the labor force. Growth and employment have lagged behind the Government's medium-term targets of 6.8–7.8% in 2008 and 7–8% by 2010. Expanding at close to these targets, with the associated increase in employment by an average of 1.4 million–1.6 million annually, will require sustained efforts to improve the investment climate. Inadequate investment is the main factor that has curtailed growth and employment. The medium-term targets, for example, were based on investment picking up at double-digit annual rates in 2006–2010 to reach 28% of GDP by 2010, almost twice the current level.

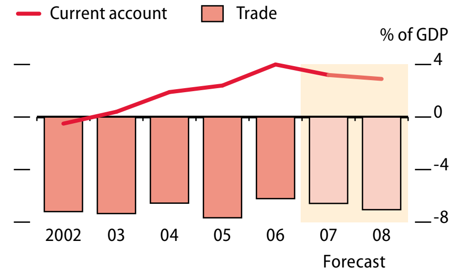
In agriculture, which accounts for 36% of employment, investment has been weak because of factors that include farmers' poor access to credit and support services, expensive inputs, high costs of transport, and the incomplete land reform program. In manufacturing, sampled firms in a 2003 survey of the investment climate cited as the major constraints: macroeconomic instability (at that time) and uncertainty in economic policies; inadequate infrastructure services, especially of power and transport; and corruption and the costs of complying with regulations, especially related to customs, trade, and labor markets.

Improvements in the fiscal position have since fostered greater macroeconomic stability. Nevertheless, the still-high debt and the large share of interest payments in the budget expose the economy to swings in sentiment in financial markets and underscore the importance of containing the risk premium with steady progress on reforms. Further increases in revenues as a share of GDP, reduction of debt and interest payments, and restraint in other current expenditures are required to deploy necessary resources toward development spending on infrastructure and social programs.

Certainly the requirements for investment in infrastructure, education, and health are huge. According to the Medium-Term Public Investment Program 2006–2010, such investment needs total P2,915 billion over the 5 years, including P1,711 billion for infrastructure. Of the infrastructure investment, P775 billion is set to be financed by the national Government, P460 billion by the private sector, and the remainder mainly by government-controlled corporations and state financial institutions. Given that around P100 billion is allocated to infrastructure in the 2007 budget, the targeted average of P155 billion a year in investment by the national Government seems ambitious, and underscores the importance of policy reforms to encourage greater private sector participation in infrastructure.

A 2006 study of progress toward the 2015 Millennium Development Goals by countries in Asia and the Pacific indicated that, although the Philippines is on track to achieve (or has already achieved) several targets, including reducing the proportion of the poor (based on $1-a-day criterion), it is behind targets in some health, education, and environment indicators. An important contributor to this regression is the declining share of resources devoted to social spending. Improvement of the investment climate to boost growth and employment, and further efforts to expand the tax base and enforce collection, are required.

2.26.15 Current account and trade balances



Sources: Asian Development Outlook database; staff estimates.

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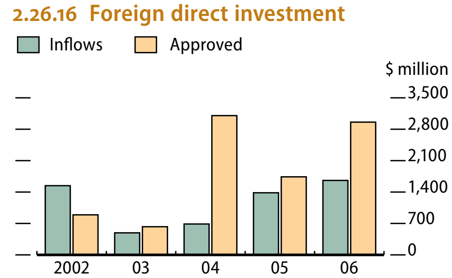
2.26.16 Foreign direct investment



Note: Data for 2006 are for January to September.

Source: CEIC Data Company Ltd., downloaded 8 February 2007.

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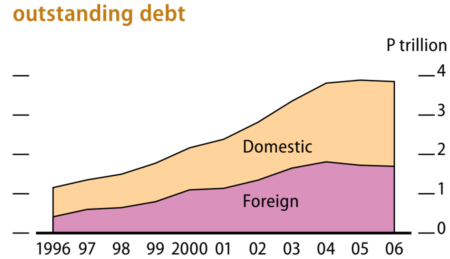
2.26.17 National government outstanding debt



Source: Bureau of the Treasury, available: http://www.treasury.gov.ph, downloaded 13 March 2007.

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