Philippines

Economic growth slowed to 5.1% in 2005 and inflation accelerated to 7.6%. Introduction of the expanded value-added tax helped lift confidence in the outlook at a time of political uncertainty, though the quality of fiscal consolidation will be watched closely. Investment continues to lag, while the dependence of growth on consumption and on remittance inflows limits prospects. In the near and medium term, growth of 5% is projected.

Economic performance

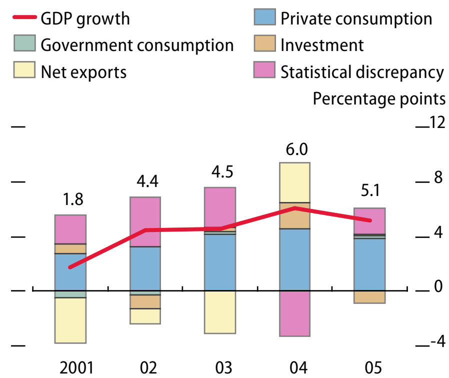
Gross domestic product (GDP) grew by 5.1% in 2005, below the 5.3–6.3% target range set for 2005 in the Medium-Term Philippine Development Plan 2004–2010. Gross national product rose by 5.7%. Such outcomes fall short of what is required to make significant inroads into persistent high levels of poverty and unemployment. Growth in 2005 slipped from a year earlier, attributed mainly to weaker agricultural performance and, to a lesser extent, slower growth in the services sector.

Buoyed by a strong flow of remittances from overseas workers, personal consumption expenditure remained the largest contributor to GDP growth in 2005. Private consumption contributed 3.9 percentage points (76% of the total), down from 4.6 percentage points in 2004 (also 76% of the total) (Figure 2.26.1). Government consumption stayed weak and contributed only 0.2 percentage points to overall growth, as the authorities reined in the fiscal deficit. Gross fixed capital formation fell by 3% (both private and public investment declined), and so it reduced growth by 0.6 percentage points. Shrinking investment not only blunts current output growth but constrains future potential.

External demand was lackluster. Exports of goods and nonfactor services grew by 2.3% in real terms. Growth of imports of goods and nonfactor services was even slower at 1.8%. As a result, the contribution of net exports to GDP growth was negligible, at 0.1 percentage points. Electronics, which account for about 66% of total exports, rose by just 2.2% (Figure 2.26.2). In particular, exports of semiconductors slowed significantly later in the year, increasing by only 3.8% in the fourth quarter. The weak performance of exports may signal an erosion of some of the cost and other advantages that the Philippines' electronics sector had in the past, rather than conditions in the global information technology market, because these improved in the second half of the year.

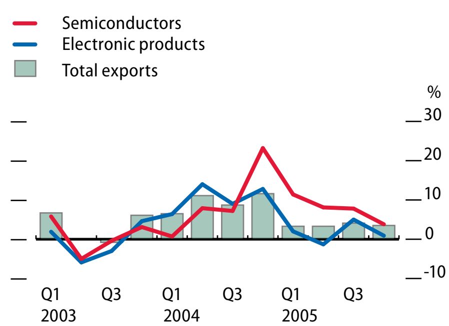
On the production side, the industry sector expanded by 5.3%, spurred by a good year for mining (Figure 2.26.3). Starting from a low base, there has been significant expansion in nickel, gold, and copper mining. Manufacturing grew by 5.6%, the highest rate since 2001. In services, rising by 6.3%, investment in back-office facilities remained strong, and telecommunications, trade, and financial institutions continued to perform well. However, the overall expansion in the services sector

2.26.1 Contributions to growth (demand)



Sources: Asian Development Outlook database; National Statistical Coordination Board, available: http://www.nscb.gov.ph/secstat/d_accounts.asp, downloaded 30 January 2006.

2.26.2 Growth of selected export commodities



Sources: National Statistics Office, available: http://www.census.gov.ph/data/sectordata/datafts.html; CEIC Data Company Ltd., downloaded 9 March 2006.

slowed from 2004 due to weak performance in the government and transport services subsectors. Robust wholesale and retail trading and mobile phone spending were consistent with strong private consumption expenditure; however, double-digit growth by banks was a surprise since it was inconsistent with sluggish loan growth data from the monetary authority. A likely source of the gains in the banking subsector was income from trading of government securities and fund flows from remittances. The agriculture and fisheries sector, still accounting for over a third of total employment, grew by only 2.0% in 2005, down from 4.9% in the previous year. This deceleration was largely due to drought in the first half of the year (Figure 2.26.4).

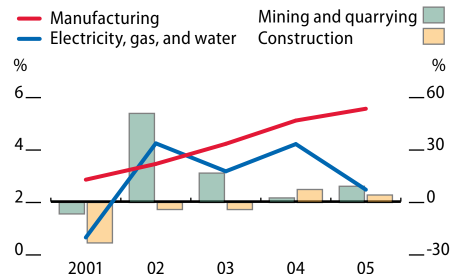
Despite a widening of the trade deficit to $7.5 billion (from $5.7 billion a year earlier), the current account posted a surplus of $2.3 billion, as a result of the strength of remittances (Figure 2.26.5). Recorded remittances in 2005 rose by 25% to $10.7 billion, though actual remittances could be substantially higher as a considerable amount is sent via informal channels. The capital account also showed improvement, with a surplus of net portfolio inflows of $2.8 billion, reversing net outflows of $1.7 billion the previous year (Figure 2.26.6). Portfolio inflows have been attracted by prospects of fiscal consolidation and prospective gains in equity and debt markets. Foreign direct investment inflows also strengthened, from a net $109 million in 2004 to $970 million, but they remain far below those of other major countries in the subregion, both in volume terms and as a share of GDP. Overall, the balance of payments in 2005 remained comfortably in surplus, by $2.4 billion. Gross international reserves rose by more than $2 billion to $18.5 billion in 2005 (Figure 2.26.7).

The unemployment rate fell a half percentage point over the year to 11.4%, though it remains stubbornly high (Figure 2.26.8). (In April 2005, the statistical agency approved a new unemployment definition, thus breaking the data series; to maintain historical consistency, the old definition is used here.) The underemployment rate rose to 21.0% of those employed, from 17.5% a year earlier, as economic growth is still not creating sufficient jobs for a fast-growing labor force. To some degree, pressure on domestic labor absorption is eased by an exodus of workers overseas. In 2005, for example, nearly 1 million workers left for jobs abroad. The total number working overseas was just over 8 million in 2004. Although generating subsequent remittance income, emigration on this scale comes at a high cost in terms of loss of knowledge and skills, and can have high social costs as well.

A sharp increase in petroleum-product prices and the impact of the drought on agricultural commodity prices lifted inflation to an average of 7.6% in 2005, breaching the Government's target of 5–6%. To keep inflationary expectations in check, the Monetary Board raised two key policy rates by 25 basis points in October. Inflationary pressures remained in early 2006, as the February figure (7.6%) resumed an upward trend (Figure 2.26.9).

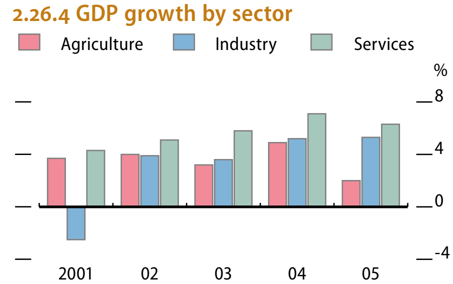
During 2004 and 2005, the Government pushed ahead with reforms on two fronts. First, power generation tariffs were raised with a view to cutting losses at state-owned National Power Corporation. Second, Congress approved changes to value-added tax (VAT) in May 2005, although implementation was delayed until November, resulting in lower

2.26.3 Industry sector growth



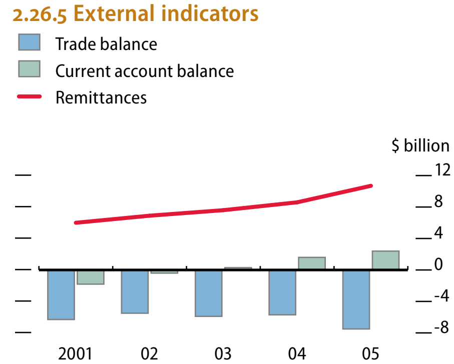
Sources: Asian Development Outlook database; National Statistical Coordination Board, available: http://www.nscb.gov.ph/secstat/d_accounts.asp, downloaded 30 January 2006.

2.26.4 GDP growth by sector



Sources: Asian Development Outlook database; National Statistical Coordination Board, available: http://www.nscb.gov.ph/secstat/d_accounts.asp, downloaded 30 January 2006.

2.26.5 External indicators



Sources: Asian Development Outlook database; Bangko Sentral ng Pilipinas, available: http://www.bsp.gov.ph/statistics/statistics.asp, downloaded 24 March 2006.

than expected incremental revenues (Box 2.26.1). In addition, incentives provided by the Special Purpose Vehicle Law enabled banks to strengthen their balance sheets by selling nonperforming assets. The nonperforming loan ratio declined to 8.7% by end-November 2005, from 13.6% a year earlier. This is a substantial reduction from the post-Asian financial crisis peak of 17.3% in 2001. The capital-adequacy ratio for banks averaged 18%, comfortably above the statutory minimum of 10%. Other significant developments in the financial market include the establishment of an electronic exchange for fixed-income securities and derivatives—the Philippine Dealing and Exchange Corporation—which started trading in March 2005. Before this exchange was set up, secondary debt securities were traded through banks.

An improved fiscal performance helped ease pressure on lending rates and reduce spreads on government debt instruments. The national government deficit narrowed to 2.7% of GDP (P146.5 billion) in 2005, 1.2 percentage points less than a year earlier and an impressive reduction from its peak of 5.3% in 2002. With a lower financing requirement, the benchmark 91-day treasury bill rate fell to 5.4% by end-November, a 227 basis point decline from its start-of-year level. (Treasury bill rates continued to decline through January 2006, to 4.9%.) In fact, with inflation high, real rates for treasury bills were negative in 2005. Meanwhile, spreads narrowed on government bonds because of the reduction in the fiscal deficit, an improved credit outlook from

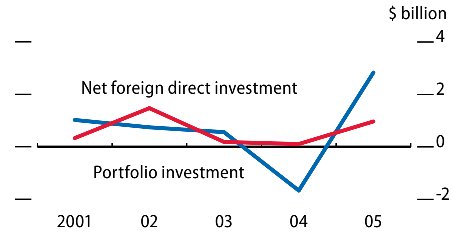
2.26.1 Continuing reforms in revenue mobilization

Implementation of the new value-added tax (VAT) law—which increased the VAT rate from 10% to 12% from February 2006—and the imposition of increased excise duty ("sin" tax) on alcoholic products and tobacco were significant achievements. The VAT law amendments covered not only VAT but measures covering tax policy and tax administration, including lifting of exemptions from VAT in key sectors, such as power, medical services, and petroleum products; increasing the corporate income tax rate from 32% to 35%; and increasing the coverage and rate of the gross receipts tax of bank and nonbank financial intermediaries.

However, the anticipated contribution to overall revenue is yet to be realized. Both laws suffered setbacks as legal challenges delayed their implementation. Although signed into law in May 2005, the new VAT law became effective only in November 2005. The sin tax law was amended in December 2004 and scheduled to come into effect in January 2005. However, the courts issued various restraining orders in the first half of 2005, delaying implementation, such that realized incremental revenue from sin taxes in 2005 was only P3 billion, or 20% of the programmed level. The new VAT law yielded only P2.6 billion incrementally in November 2005, its first month of implementation, or about half its programmed level.

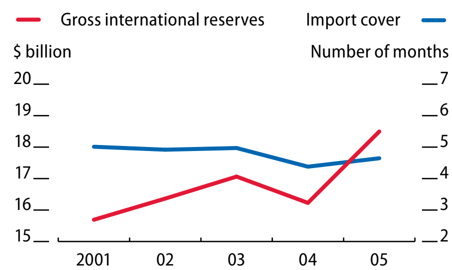
Other sources of revenue performed better than in previous years. Income and profit tax collection in 2005 grew by 16.2%, up 2 percentage points from 2004. The reason may be strengthened tax administration through intensified efforts to pursue tax evaders and lifestyle checks on tax officials. However, business groups reported that smuggling remains high, leading to large losses in customs receipts.

2.26.6 Foreign investment



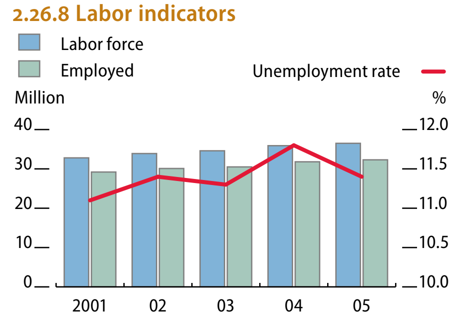
Sources: Asian Development Outlook database; Bangko Sentral ng Pilipinas, available: http://www.bsp.gov.ph/statistics/spei/tab1.htm, downloaded 28 March 2006.

2.26.7 Reserves



Source: Bangko Sentral ng Pilipinas, available: http://www.bsp.gov.ph/statistics/spei/tab5.htm, downloaded 24 January 2006.

2.26.8 Labor indicators

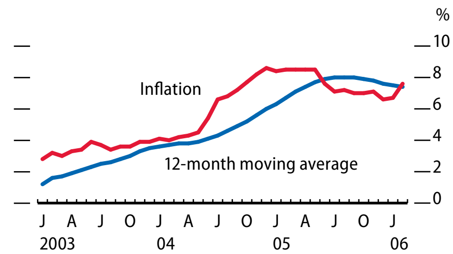


Sources: National Statistics Office, available: http://www.census.gov.ph/data/sectordata/datalfs.html, downloaded 16 February 2006; Bureau of Labor and Employment Statistics, available: http://www.bles.dole.gov.ph/, downloaded 16 February 2006.

international rating agencies, and narrower spreads on emerging market debt (Figure 2.26.10). In line with this, in January 2006 the Government issued $2.1 billion of global bonds, enabling it to fund more than 60% of the $3.1 billion in expected commercial foreign borrowing requirements for the year. Yields on these bonds were significantly lower than the most recent international borrowings by the Government.

Despite progress, concerns over fiscal consolidation remain. For a start, the national Government's total debt stock remained high at about 72% of GDP as of end-2005, with interest payments accounting for one third of total government expenditure (Figure 2.26.11). This leaves the Government vulnerable to financial shocks. In addition, though revenues grew faster than spending, the narrowing of the fiscal deficit (Figure 2.26.12) was also helped by windfall revenue gains from treasury operations and by significant—probably unsustainable—reductions in expenditure. For example, the capital budget declined in real terms. Government spending fell from 19.6% of GDP in 2001 to 17.5% in 2005, but in a country where 44% of the population survives on less than $2 a day, there is a pressing need for strengthened delivery of social services and for infrastructure that targets the poor and the vulnerable. Moreover, compressed spending on public overhead capital limits the economy's prospects for higher long-term growth.

2.26.9 Monthly inflation



Sources: National Statistics Office, available: http://www.census.gov.ph/data/sectordata/2005/cp051201r.htm; CEIC Data Company Ltd., downloaded 15 March 2006.

Economic outlook

There is no immediate prospect of a significant improvement in the growth outlook. Consumption will remain the main driver from the demand side, with support from remittances. From the supply side, the contributions of the three sectors are expected to change little, and thus services will remain the largest contributor to growth. Further gains in fiscal consolidation, especially demonstration of sustained results in tax administration, will help build credibility and provide the basis for strengthening macroeconomic stability.

The forecasts assume that further progress is made in power sector reforms, especially privatization. This will help strengthen the investment climate and support a more positive outlook for the medium term. However, gains in investor confidence from progress in reforms could be partially offset by sporadic political turbulence.

2.26.1 Selected economic indicators

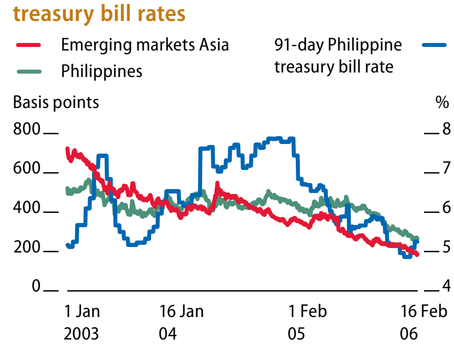
	2006	2007
GDP growth	5.0	5.3
Inflation	6.8	6.5
Current account balance (% of GDP)	1.9	1.8

Source: Staff estimates.

Prospects for 2006 and 2007

As there is marginal scope for fiscal or monetary maneuver to support demand and growth, there is little prospect of growth accelerating significantly in 2006 and 2007. GDP is therefore expected to grow by about 5% during these 2 years (Figure 2.26.13). The immediate prospect for agriculture, which accounts for 19% of GDP, is uncertain because a La Niña weather phenomenon, which brings torrential rains, may reduce crop production this year. A modest rebound in agriculture is assumed for 2007 (Figure 2.26.14). The food and beverage subsector of manufactures would also be affected, as prices of raw materials rise in 2006 and subside in 2007. Export-oriented manufacturers should be bolstered by expected modest gains this year in global trade volumes. The services sector, with the largest share of GDP at 48%, is expected

2.26.10 Sovereign risk spreads and treasury bill rates



Note: Sovereign risk spreads are yield spreads of sovereign bonds over US treasury bonds. Emerging markets follow the definition of J.P. Morgan, available: http://www.utdt.edu/~ely/intro_embig.pdf.
Source: Datastream, downloaded 10 March 2006.

to maintain its high growth of 6.0–6.3%, with the transport and telecommunications subsector leading growth on the back of market expansion in medium-sized cities and areas of economic expansion outside Metro Manila.

On the demand side, weakness in investment and exports is expected to be the theme in 2006, but they should pick up in 2007. Gross fixed capital formation is forecast to rise by 3.5% in 2006 and 7.0% in 2007. Most of this will stem from increases in private investment, though public investment will also contribute as a result of higher investments in infrastructure. Consumption expenditure will continue to provide the main support for growth in both years.

The fiscal deficit is seen narrowing further in 2006 and 2007. This supports continued easing of interest rates as the Government's domestic financing requirement declines. Inflation, however, is expected to average nearly 7% as cost-push pressures build from still-high fuel prices, a one-time effect of the VAT rate increase, and the effects of La Niña weather on agricultural production (Figure 2.26.15). Aided by remittance inflows, the current account surplus will stay at around 2% of GDP in 2006 and 2007 (Figure 2.26.16).

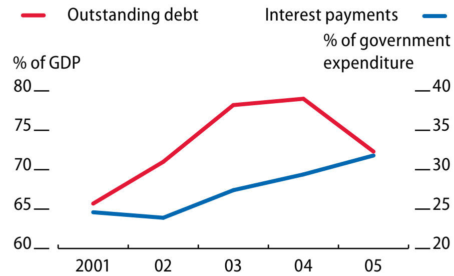
The key risks to the immediate outlook include the intensity of La Niña rainfall, which could reduce agricultural production and have spillover effects on the food and beverage subsector. Slippages in the implementation of core reforms, in particular tax administration and power sector reforms, could erode the credibility of the Government. Finally, political uncertainty has yet to completely subside, and this has the potential to undermine growth prospects over any time scale.

Medium-term outlook

Growth of GDP to 2010 is expected to average 5–6% a year, while that of gross national product will be slightly stronger than this due to an acceleration of net remittance inflows. On a year-to-year basis, agriculture will be the main swing factor to growth, depending on weather conditions. Industry will continue to expand at around 5%, while services will maintain its rate of around 6%. On the expenditure side, private consumption will remain the main driver, growing at 5.0–5.5%, and given that it accounts for about 80% of overall demand, it will continue contributing about 4 percentage points to overall growth. Government consumption, on the other hand, will edge higher to around 3%, with more headroom provided by a narrower fiscal deficit.

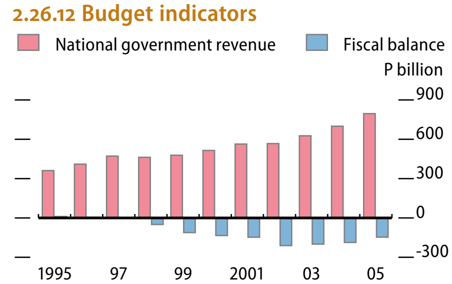
Exports will grow slowly at about 7%, similar to imports. The *Asian Development Outlook 2006* baseline forecast for growth over the medium term is well below the official Medium-Term Philippine Development Plan target rates of 6.3–7.3% for 2006, increasing to 7.0–8.0% in 2009 and 2010. While these higher levels of growth are indeed needed to raise per capita income to levels consistent with fast reduction of poverty levels, in order to achieve them the capital stock needs to expand by at least 10% a year in net terms, much higher than an estimated 3% in recent years. Lifting the capital stock would require an extended investment push that creates a virtuous cycle of higher rates of productivity, wages, and labor absorption. To invigorate investment, momentum must build behind reforms. Although the reform agenda is long and potentially complex,

2.26.11 National government debt



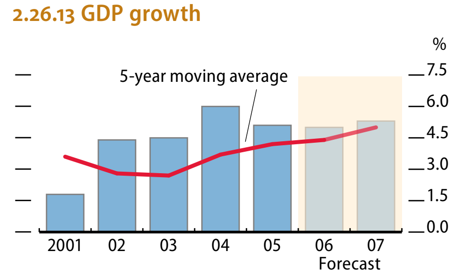
Sources: Asian Development Outlook database; Bureau of the Treasury, available: http://www.treasury.gov.ph/statdata/statdata.html, downloaded 13 March 2006.

2.26.12 Budget indicators



Source: Bureau of the Treasury, available: http://www.treasury.gov.ph/statdata/yearly/yr_corsum.pdf, downloaded 2 February 2006.

2.26.13 GDP growth



Sources: Asian Development Outlook database; National Statistical Coordination Board, available: http://www.nscb.gov.ph/secstat/d_accounts.asp, downloaded 30 January 2006.

demonstrated successes in a few key areas could help shift perceptions and build a consensus behind the need for a determined reform effort over the medium term.

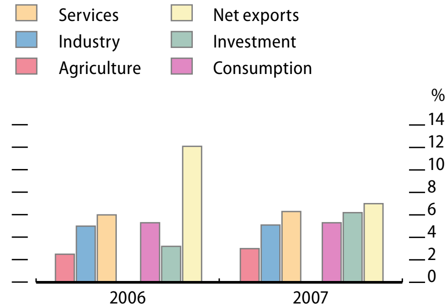
Key reform challenges

A near-term challenge for the Government is to demonstrate success of the VAT and sin tax laws in meeting fiscal revenue targets. Not only will this provide a measure of the Government's resolve and capacity to implement reforms but will also provide the additional fiscal headroom that is needed so that infrastructure problems can be tackled and shortfalls in other critical areas of public expenditure provision filled. But improving tax administration faces many technical, administrative, and institutional hurdles. Measures that have already been implemented have not yet had a substantial impact on revenue collection. Improved revenue mobilization will require an effective performance-based system for tax-collection agents, strengthened and widened tax audits, and an improved taxpayer registration system. Customs processes and procedures, which are nontransparent and a source of considerable revenue leakage, also need overhauling.

Power sector reform is another major test. In recent years, the public power sector has been one of the most important single causes of fiscal hemorrhage and a major contributor to perceptions of a weak investment climate. The Electric Power Industry Reform Act passed in June 2001 provides the framework for addressing these issues, including restructuring, recapitalizing, and privatizing the assets of National Power Corporation (NPC). Although the asset sales have been delayed, generation tariff adjustments in 2005 helped move NPC close to breakeven. The challenge is to sustain the gains in the financial performance of NPC, facilitate the transfer and disposal of transmission and generation assets, and improve the business environment in the sector.

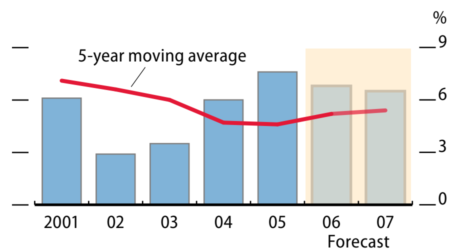
Local government units (LGUs) have an important role to play in fiscal consolidation and in unlocking the medium-term growth potential of the economy. The Local Government Code initiated in 1991 allowed the devolution of government spending responsibilities to LGUs and substantially increased transfers of national government revenues to LGUs. However, after 14 years the Local Government Code's goal has not been fully realized, and LGUs, in general, are not yet playing their anticipated role. A key issue relates to flaws in the fund-transfer formula, leading to a mismatch between expenditure responsibilities assigned to LGUs and the transfers that they receive to finance them. In this context, poor creditworthiness hampers LGU access to other sources of financing, such as bank loans and bonds. Legal restrictions that encumber LGUs' tax- and revenue-raising capacities, and a narrow tax base that reflects out-of-date property valuations, are two areas that need attention.

2.26.14 Growth of supply and demand components of GDP



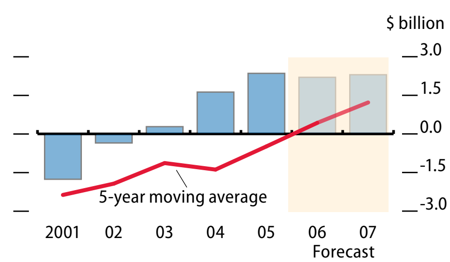
Source: Staff estimates.

2.26.15 Annual inflation



Sources: Asian Development Outlook database; National Statistics Office, available: http://www.census.gov.ph/data/sectordata/2005/cp051201r.htm, downloaded 2 February 2006; staff estimates.

2.26.16 Current account balance



Sources: Asian Development Outlook database; Bangko Sentral ng Pilipinas, available: http://www.bsp.gov.ph/statistics/spei/tab1.htm, downloaded 24 March 2006; staff estimates.