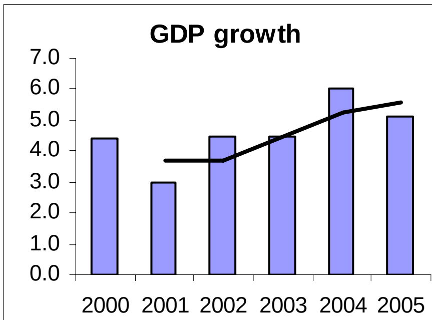
PHILIPPINES

Recent Economic Developments

Resilient economy sustained for a second year. The Philippine economy recorded another relatively strong performance in 2005. Public sector deficits and debt were reduced in real terms and the VAT reform law, passed in May 2005, was fully implemented by February 2006 following a number of challenges and delays. Progress on implementation of the fiscal reform program, coupled with the economy's resilience to various shocks—ongoing political tensions, higher oil prices, agricultural slowdown—boosted financial markets as reflected in a stronger peso, higher private capital inflows, and falling borrowing costs and spreads for the public sector. Improved tax administration and governance are now needed to ensure that recent policy reforms translate into sustained deficit and debt reduction as well as effectively implemented public programs for infrastructure and social programs.

Reasonable growth despite political tensions: Notwithstanding the difficult political circumstances, the economy in 2005 remained strong. GDP grew by 5.1 percent in 2005[1], making this the first time the economy has had two successive years of growth higher than 5 percent. GDP growth in 2004 was 6 percent. GNP grew by 5.7 percent due to record high remittances valued at 13 percent of GNP. Overall, per capita income grew by 2.9 percent down from 3.8 percent last year[2]. High population growth relative to the region continues to limit per capita income growth.

Figure 1.1

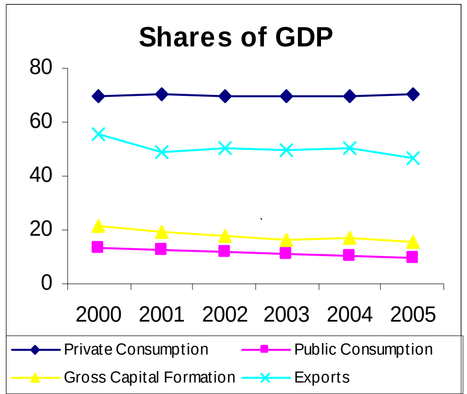


Note: Series breaks in 2001 following new method.
Source: NSCB

[1] The national account figures released a month earlier than usual contain an unusually high statistical discrepancy of almost P43 billion for the whole year with half coming from the last quarter. Revised growth figures may follow.

[2] The average population growth rate for the period 2000 to 2005 is estimated to be 2.2 percent by the National Statistics Office (NSO).

Figure 1.2



Source: NSCB

Private consumption drove economic growth, expanding by 4.9 percent despite rising oil prices, increases in power tariffs and excise taxes. Investment and export performance were sluggish and disappointing. Public consumption grew by 2.7 percent for the year but contracted in the second half as government reigned in expenditures to contain the overall fiscal balance. Gross capital formation fell in 2005 by 4.3 percent versus growth of 9.5 percent in 2004 as a response to the poor political environment, late passage of the budget, and subsequent public capital outlay tightening. Low import growth in 2005 reflected the general decline in the purchase of durable equipment, with the exception of telecommunications and electrical machineries. Weak global demand for Philippine electronic products and the relocation of Toshiba, a major laptop exporter, to China, led to a general slowdown in exports.

Sluggish growth in the agriculture sector. Droughts brought about by El Niño in the first half depressed growth in the agriculture sector which grew by a meager 2 percent compared to 4.9 percent in 2004. Industry propelled by strong manufacturing activity and the recent passage of the mining law grew by 5.3 percent. The service sector continued to lead with a 6.3 percent growth, contributing over 47 percent to overall GDP. Services contributed 3.0 percentage points to growth followed by industry (1.8) and agriculture (0.4). Within the service sector, financial services grew by15.4 percent, faster than telecommunications (7.1 percent) as remittances and ample liquidity fuelled increases in banks' non-interest revenues such as transactions of government securities. The rest of the service sub sectors grew at a slower pace compared to last year. Within industry, the 2004 Supreme Court ruling declaring the 1995 mining law constitutional contributed to the 9.3 percent growth in the mining and quarrying sub-sector compared to only 2.6 percent a year ago. Manufacturing growth modestly improved to 5.6 percent although the base was narrow and limited to a few sectors. Growth in the utilities sub sector slowed to 2.5 percent from 4.2 percent last year as a result of high energy prices.

Falling rice production contributed to slow agricultural growth and increased rice imports in 2005, adding to the deficit of the National Food Authority. Recent surveys[3] indicate that the more Filipinos are suffering from hunger: over 49 percent of the population rated themselves as impoverished while close to 17 percent reported hunger, compared to 48 percent and 12 percent, respectively, a year ago, suggesting that the positive growth performance in the last two years is not perceived to have been widely shared.

[3] Social Weather Station (SWS) survey on self-rated poverty and hunger (December 2005).

Table 1.1 Contribution to growth

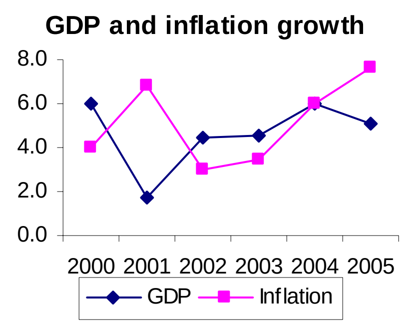
	2000	2001	2002	2003	2004	2005
GDP	6.0	1.8	4.4	4.5	6.0	5.1
Agriculture	0.9	0.7	0.8	0.6	1.0	0.4
Industry	3.2	-0.8	1.3	1.2	1.7	1.8
Service	2.0	2.0	2.4	2.7	3.3	3.0

Source: NSCB

Prospects for higher growth in 2006 hinge upon the rebound of agriculture and exports. The La Niña phenomenon, which began early in 2006, is expected to revive food production. Stronger export growth in recent months may portend a more favorable performance in 2006. Business process outsourcing (BPO) is expected to further strengthen; in line with its rapid growth, the government has announced adding a separate sub-sector in the national income accounts solely to report value-added in BPO. However, the cascading effect of the reformed value-added tax (RVAT) may dampen domestic demand in the first half.

Average inflation in 2005 increased to 7.6 percent. High oil prices and power tariff adjustments added to the pressure on prices, although the strengthening peso worked in the opposite direction. BSP raised its overnight borrowing and lending rates to 7.5 percent and 9.75 percent, respectively, via adjustments in September and October. As a result, money supply growth in depository institutions fell from 14.8 percent in September to 9.6 percent in December. With the fall in liquidity, BSP has not announced any plans for further rate increases.

Figure 1.3



Source: NSCB

For 2006, inflation is projected by the central bank at between 7.5 percent and 8.2 percent reflecting full implementation of the RVAT and subsequent cascading price increases. To mitigate VAT-induced price increases beginning February, the government has exempted minimum wage earners in both public and private sectors from the personal income tax.

Public Finance

Fiscal consolidation efforts advanced considerably in 2005. The national government (NG) deficit declined to 2.7 percent of GDP in 2005 from 3.9 percent in 2004 (and a peak of 5.3 percent in 2002) mainly as a result of expenditure tightening. The centerpiece of the Arroyo Administration's fiscal reform program, the RVAT, was passed in mid-2005. Its implementation, however, was delayed from July to November (for the widening of the base) and February 2006 for the rate increase from 10 to 12 percent. Despite the passage of a number of revenue bills in 2004 and 2005 such as excise taxes on cigarettes, alcohol and tobacco, performance-linked pay for revenue collecting agencies, the temporary increase in corporate income tax rates from 32 percent to 35 percent, and the RVAT, the bulk of the adjustment to the deficit in 2005 continued to derive from expenditure cuts, which contributed thee-fourths to the NG deficit reduction. Revenue improvements contributed only 0.3 percent while expenditure contributed 0.9 percent to overall deficit reduction.

Table 1.2 Selected Economic Indicators 2000 to 2005

	2000	2001	2002	2003	2004	2005
Growth, inflation and unemployment (percent)						
Gross national product/1	7.1	2.3	4.2	5.1	6.2	5.7
Gross domestic product/1	6.0	1.8	4.4	4.5	6.0	5.1
Inflation (period average); 2000 base year	4.0	6.8	3.0	3.5	6.0	7.6
Inflation (end period); 2000 base year	6.5	4.5	2.5	3.9	8.6	6.6
Unemployment/2	10.1	9.8	10.2	10.2	10.9	10.3
Savings and investment (percent of GDP)						
Gross national savings/3	29.4	20.8	23.4	18.4	19.5	18.2
Gross domestic investment/1	21.2	19.0	17.7	16.7	17.1	15.7
Public sector (percent of GDP)						
National government balance	-4.0	-4.0	-5.3	-4.7	-3.9	-2.7
Total revenue	15.3	15.5	14.3	14.6	14.5	14.8
Tax revenue	13.7	13.5	12.5	12.5	12.4	12.7
Total spending	19.3	19.6	19.6	19.3	18.4	17.5
Consolidated public sector balance/3	-4.5	-4.6	-5.5	-5.7	-4.8	-2.8
Nonfinancial public sector debt/3	88.1	87.4	93.7	101.3	96.1	83.6
National government debt	64.6	65.7	71.0	78.2	79.0	72.3
Money and credit (year-end percent change)						
M3	4.6	6.8	9.5	3.3	9.2	9.0
Credit to the private sector	8.1	-3.0	1.2	1.8	4.6	-1.5
Balance of payments						
Merchandise exports (percent change)/3	9.0	-16.2	10.0	2.8	9.6	4.3
Merchandise imports (percent change)/3	14.5	-4.5	6.2	20.1	10.6	6.6
Current account balance (percent of GDP)/3	8.2	1.9	5.7	1.8	2.4	2.4
International reserves						
Gross official reserves (billions of dollars)	15.1	15.7	16.4	17.1	16.2	18.4
Change in reserves (billions of dollars)	-0.5	-0.2	0.7	0.1	-0.3	2.4
Gross official reserves (months of imports)	4.2	4.6	4.7	4.2	3.7	3.8
External debt						
Total (billions of dollars)/4	51.2	51.9	53.6	57.4	54.8	55.5
Total (percent of GDP)/4	67.5	72.9	69.8	72.5	63.7	56.8
Debt service ratio (G&S and receipts)/4	12.4	15.8	16.4	16.9	13.8	14.1
Exchange rate (peso/dollar, period average)	44.2	51.0	51.6	54.2	56.0	55.1
Real effective exchange rate (1990 = 100)	107.0	101.8	102.2	89.0	85.2	..

Memorandum items

Nominal 2005 GDP: USD 97.7 billion

2005 population: 84.4 million

Source: GOP, World Bank, IMF

1/ Revised

2/ Using old definition of unemployment

3/ 2005 figures are estimates

4/ Reported by BSP, as of September 2005

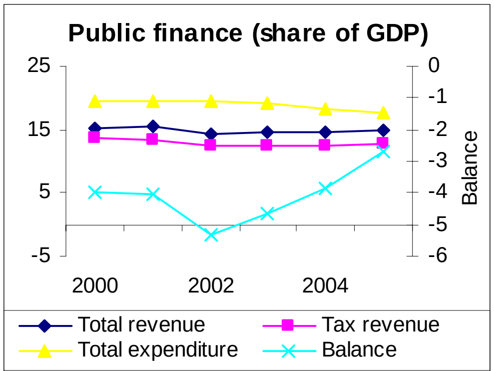
Table 1.3. National Government Operations (Percent of GDP)

	2000	2001	2002	2003	2004	2005	Change 03-04	Change 04-05
Total revenue	15.3	15.5	14.3	14.6	14.5	14.8	-0.1	0.3
Tax revenue	13.7	13.5	12.5	12.5	12.4	12.7	-0.1	0.3
Bureau of Internal Revenue	10.8	10.7	10.0	9.9	9.7	9.9	-0.2	0.2
Net income & profits	6.0	6.2	5.7	5.7	5.8	6.0	0.1	0.2
Excise tax	1.8	1.6	1.4	1.3	1.2	1.1	-0.1	-0.1
Sales taxes & licenses	2.3	2.4	2.3	2.3	2.2	2.3	-0.1	0.0
Other domestic taxes	0.5	0.5	0.5	0.5	0.5	0.5	-0.1	0.1
International trade taxes	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Bureau of Customs	2.8	2.6	2.4	2.5	2.5	2.6	0.1	0.1
Other offices	0.1	0.1	0.1	0.1	0.2	0.2	0.0	0.0
Nontax revenue	1.6	2.0	1.8	2.1	2.1	2.1	0.1	0.0
Bureau of Treasury	0.9	1.3	1.2	1.3	1.3	1.3	0.0	0.0
Fees & charges	0.5	0.7	0.6	0.4	0.4	0.4	0.0	0.0
Privatization	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
CARP	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Others	0.0	0.0	0.0	0.3	0.2	0.4	-0.1	0.2
Marcos wealth	0.0	0.0	0.0	0.0	0.2	0.0	0.2	-0.2
Grants	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Total expenditure	19.3	19.6	19.6	19.3	18.4	17.5	-0.9	-0.9
Allotment to LGUs	3.0	3.3	3.5	3.4	3.1	3.0	-0.3	-0.1
Interest payment	4.2	4.8	4.7	5.3	5.4	5.6	0.1	0.2
Tax expenditures	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Subsidy	0.3	0.3	0.2	0.3	0.3	0.2	-0.1	-0.1
Equity	0.0	0.0	0.0	0.1	0.0	0.0	-0.1	0.0
Net lending	0.1	0.1	0.1	0.1	0.1	0.0	0.0	-0.1
Others	11.7	11.1	11.1	10.0	9.5	8.7	-0.5	-0.8
Total capital outlay	3.3	2.9	3.1	1.9	2.1	1.9	0.2	-0.3
Balance	-4.0	-4.0	-5.3	-4.7	-3.9	-2.7	0.8	1.2
Primary balance	0.2	0.8	-0.6	0.6	1.5	2.8	0.9	1.3
Financing	6.1	4.8	6.7	6.7	5.0	4.4	-1.7	-0.6
Net domestic	3.6	4.2	3.9	3.3	3.3	2.7	0.0	-0.7
Net foreign	2.5	0.6	2.8	3.4	1.7	1.7	-1.7	0.0

Source: Bureau of Treasury

Highest tax effort since 2001. Revenue collections of the BIR in 2005 grew for the first time in five years, by 0.2 percent of GDP, while contributions from the BOC grew by 0.1 percent of GDP. These translate into a 14.2 percent growth for BIR compared to only 7 percent average growth in the last five years. BOC revenues grew slightly above 15 percent as in the previous year. As a result, the tax effort improved from 12.4 to 12.7 percent of GDP, the highest level since 2001. This is notwithstanding the poor collection from excises on alcohol and tobacco, which declined in excise tax collection by 0.1 percent of GDP. Improvements in tax administration on income taxes, however, were enough to counter the foregone excise revenue. The contribution of non-tax revenue to total revenue remained stable at 2.1 percent of GDP despite higher than programmed revenue from the Bureau of Treasury. Over two-thirds of Treasury income was derived from the bond sinking fund; this is, however, expected to decline as government reduces its borrowing requirements in the next few years. The overall revenue effort increased by 0.3 percent of GDP to 14.8 percent, not counting "non-cash revenue", equivalent to another 0.4 percent of GDP.

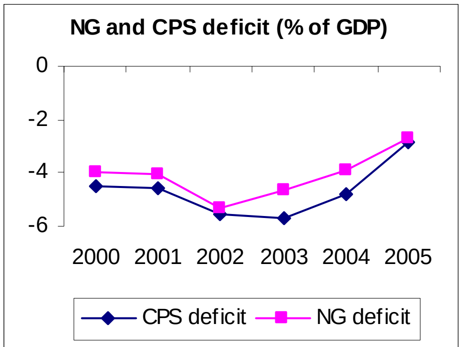
Figure 1.4



Source: BTR

Falling shares of expenditure amounting to 1.8 percent of GDP over the last two years have been the main driver of deficit reduction, but with adverse effects for the social program and infrastructure delivery. Total expenditures dropped to 17.5 percent of GDP in 2005 from 18.4 percent in 2004. Interest was the only category which increased, by 0.2 percent of GDP (reflecting the transfer of P200 billion of NPC debt to the NG). Transfers to local governments were reduced by 0.1 percent of GDP, capital expenditures by 0.3 percent of GDP, while maintenance and personnel services contracted by over 0.5 percent of GDP.

Figure 1.5



Source: DOF

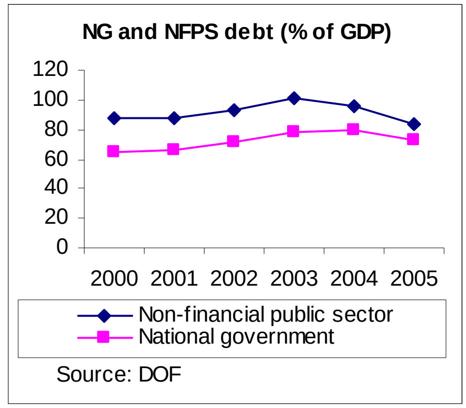
Better performance of government corporations (GOCCs). The consolidated public sector deficit (CPSD) dropped from 4.8 percent of GDP in 2004 to an estimated 2.8 percent in 2005.[4] Improvements in the CPSD were mainly due to improvements in the balance sheets of major GOCCs, primarily the performance of the National Power Corporation (NPC) following three successive tariff adjustments. NPC managed to reduce its deficit from 1.5 percent of GDP in 2004 to 0.1 percent in 2005. A fourth

[4] DOF estimates.

adjustment is planned for this year. However, NPC is still due to dispose more than 80 percent of its generating assets. The deficit of the National Food Authority (NFA) widened from 0.2 percent of GDP in 2004 to 0.4 percent in 2005 mainly as a result of increased rice imports due to a drought in the first half of 2005.

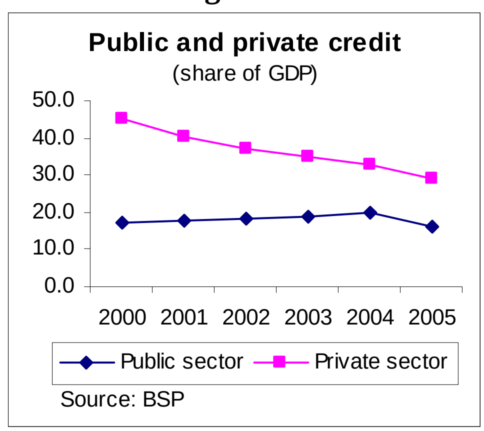
Public debt remains high but has declined as a share of GDP. The national government debt dropped to 72 percent of GDP while non-financial public sector debt dropped to 84 percent at year-end from over 100 percent in 2003[5]. In addition to the lower deficits, the appreciation of the peso since the height of the political crisis, falling rates on government securities and improving spreads have helped to contain public debt. Heavier dependence on domestic borrowing in the last few years has reduced the share of external debt to 44 percent in 2005. Total private and public external debt as reported by the central bank stood at $55.5 billion as of September (58 percent of GDP).

Figure 1.6



The fiscal outlook for 2006 looks promising assuming sound implementation of the RVAT. At 70 percent collection efficiency, the government aims to collect an additional P68 billion for the 10 months of 2006.[6] If VAT collection efficiency drops below this figure, however, government must depend on improved tax administration elsewhere to achieve its targets. Tax administration efforts, which include the revival of the "RATE", "RIPS" and "RATS" programs, a gradual shift to automated audit from manual audit that will bring down audit time from six to one month, scaling-up of web-based tax transactions, and tax benchmarking in selected industries, can potentially increase tax effort by another 0.4 percent of GDP. Improvements in governance in the tax agencies could yield considerably more. Divestiture of government shares in San Miguel and the Philippine Postal Corporation are also in prospect. The government had initially programmed a deficit of 2.7 percent of GDP for 2006 but in light of the lower-than-target 2005 deficit, this is now projected at 2.1 percent with expenditure targeted to stabilize as a share of GDP. The favorable results for 2005 have also prompted the government to bring forward its target for achieving a balanced NG budget from 2010 to 2008. The delayed

Figure 1.7



[5] DOF estimates.

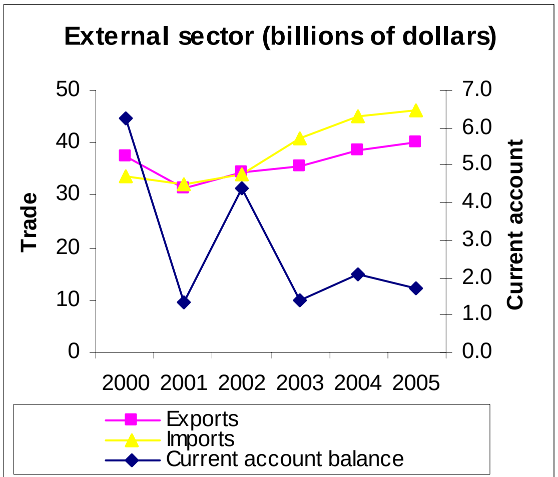
[6] VAT collections are reported one month after collection. For 2006, collections from February to November will be reported as VAT revenue.

passage of the 2006 budget, if prolonged, could however create bottlenecks with adverse impacts on efficiency and transparency.

External sector

Stronger fourth quarter trade performance amidst overall weak growth: The external sector saw a current account surplus of $2.4 billion in 2005, aided by record high remittance inflows[7]. Exports, which grew sluggishly in the first eleven months at 2.7 percent, rebounded in December with growth of 16.8 percent, lifting growth to 4.3 percent for the year. Electronics products, which comprise over two-thirds of exports and suffered from a lack of global demand throughout the year, were the driver of growth in December by growing 15.7 percent owing to a surge in demand for digital integrated circuits and finished electrical parts and machineries. Last minute bulk orders for garments also boosted the December figure.

Figure 1.8

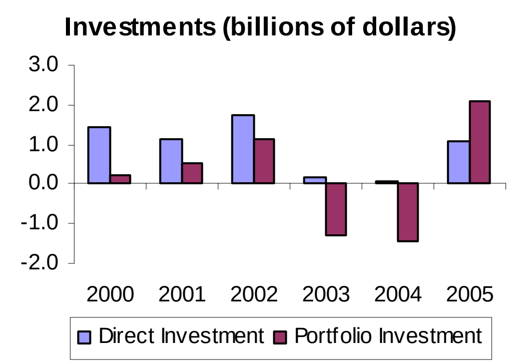


Source: BSP

Similarly, imports, which were almost flat through the first eleven months, jumped by 21.7 percent in December, resulting in full year growth of 6.6 percent. The slow growth for the year is traced to lower import demand for electronic parts and the decline in investment. Remittances from overseas Filipino workers jumped 25 percent in 2005 to $10.7 billion, excluding remittances from residents and those transmitted via informal channels.

Foreign investment up despite mid-year credit downgrades. Portfolio investment, which grew rapidly in the first half of 2005, slowed in the second half but overall remained about four-fold stronger than in 2004, with $2.1 billion in net receipts. Similarly, foreign direct investment increased to $1.1 billion and was derived mainly from equity capital to the real estates and the manufacturing sectors. Over $6 billion in new mining investments are in the pipeline of which $347 million is expected this year. However, the much smaller inflows of FDI compared to elsewhere in

Figure 1.9



Source: BSP

[7] Monthly trade figures are expected to be revised in the near future following revision of the 2005 figure.

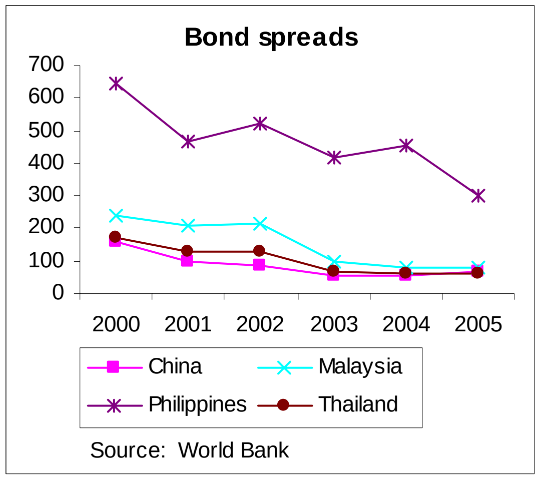
East Asia suggests that substantial gains can be achieved with further gains in macro stability and an improved investment climate[8].

BOP surplus highest in five years. The combined performance of the current and financial accounts resulted in a balance of payment surplus of $2.4 billion at the end of year, higher than the balance in the last five years combined. As a result, gross international reserves reached a high of $18.4 billion (3.9 months of imports) by year-end. In January 2006, the government borrowed $2.2 billion in foreign borrowings (at maturities extending to 25 years and a spread of 334 basis points over comparable US bonds), which further boosted reserves to an all time high of $20.5 billion.

Financial markets

Credit outlook improved. Financial markets, which at first reacted negatively to the fiscal and political setbacks in the middle of the year, have recovered beyond pre-crisis levels. Direct and portfolio investment inflows in 2005 were more than double their 2004 levels while corporate earnings were high fuelling stock market gains. The centerpiece of the fiscal reform, the RVAT, was primarily credited for improved market conditions and investors' outlook. As a result, two of the three major credit rating agencies revised their credit outlooks from negative to stable, citing improved fiscal and political conditions. A number of global investment banks also upgraded their assessments of Philippine debt.

Figure 1.10



Credit access is improving as well. In November, Philippine bond price improved to 360 basis points above the benchmark US treasury note from 410 basis points before the implementation of the RVAT. In the first week of January, the government issued $2.2 billion in dollar and euro bonds at maturities extending to 25 years at 333.4 basis points above comparable US treasury paper, down from over 500 basis points in a similar issuance in January 2005. This amount represents about 70 percent of total foreign borrowing requirements from the bond market this year. Treasury is expected to earn a significant amount from investing the borrowed stock.

Markets outperform pre-crisis highs. Record high remittances, portfolio investments and the full implementation of the RVAT have been credited for improving market conditions. The peso closed at 53.07/USD at the end of the year (a two-and-a-half year high) and appreciated towards 51/USDas of late March 2006 despite political tensions and the declaration of a week long state of national emergency in end-February.

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[8] In 2004, net FDI to the Philippines was half that of Cambodia and less than a tenth that of Thailand or Indonesia.

The stock market index increased by 13.4 percent in 2005 and continued to rally in early over 2006. Interest rates on government paper have also declined notwithstanding higher inflation. The rate of the three-month debt paper declined from 7.79 percent to 5.15 percent in the year ending December. On January 9, the 91-day T-bill rate declined further to 4.96 percent, its lowest level in more than three years, but it has increased marginally since then. The low rates reflect the confluence of high market liquidity and lower government borrowing requirements.

Financial markets however remain vulnerable to tightening in global or domestic liquidity conditions in light of still high public debt and financing requirements—and political instability and a poor governance environment cannot help in this regard. Philippines ranking in the 2005 Transparency International fell to 117 in 2005 from 102 in 2004. National corruption surveys also indicate worsening perceptions of governance. Politics and governance shortfalls thus remain formidable obstacles to development.

Banking Sector

Asset Quality and Profitability in the Banking System continues to improve. The September 2005 NPL ratio for the entire banking system was about 9.5%; by December 2005, the universal and commercial banks' had reduced their NPL ratio to 8.51%, well below a ratio of 12.7% at end-2004. The ratio of restructured loans to total loans stood at 5.25% in December 2005, down from the 5.5% at end-September 2005. Year-on-year comparison show a nearly 20% reduction in problem assets: at end 2005, total NPAs stood at P345 billion down from P430 billion at end-2004. Banks also increased provisioning levels. NPL and NPA coverage ratios at end 2005 were 78.35 % and 42.12%, respectively, significantly better than the 60.40 % NPL coverage ratio and 35.56% NPA coverage ratio at end 2004.

Contributing to the decline in the NPL ratio were the asset sales conducted under the Special Purpose Vehicle (SPV) Act. Banks had been given until early in 2005 to set up SPVs and avail of incentives under the SPV Act. Congress has now extended the Act by another 18 months. The central bank estimates, the extension should enable the banking system to dispose of another P20-25 billion, reducing the NPL ratio to below 7%.

Net intermediation margins improved from 4.26% at end March 2005 to 4.52% at end September, capital adequacy ratio improved to about 18% and return on average assets to about 1.11%. The banking system continued to deploy the bulk of the incremental deposits into government securities, while credit growth to the private sector has been slow.