

PHILIPPINES

Recent Economic Developments

Philippine economic performance strengthened in 2006 aided by a recovery of agriculture and exports and continued rapid growth of remittances. Following a major adjustment of the consolidated public sector deficit in 2005, the National Government deficit was cut by more than half through September 2006, as tax revenue increased sharply with implementation of the VAT reform and expenditure restraint. Progress with the Government's medium-term fiscal consolidation objectives has contributed to buoyancy in financial markets, which have bounced back following the worldwide correction in the second quarter that also significantly impacted the Philippines.

Robust growth continued through the first half of 2006. GDP growth increased to 5.6 percent in the first half of 2006, while GNP growth reached 6.5 percent, aided by double-digit expansion of remittances. Favorable weather helped increase farm output by over 5 percent. Strong growth in the petroleum products, metal and textile industries resulted in expansion of manufacturing activity by 6.4 percent growth. Overall industrial growth was slower at 5.1 percent, however, owing to weaker activity in the construction sector. The service sector, which contributes about half of total output, continued to lead overall growth. Back office activities such as business process outsourcing have become a dominant driver of service sector growth.

Figure 1

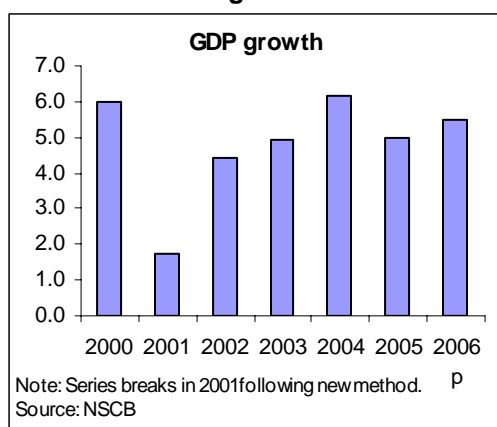
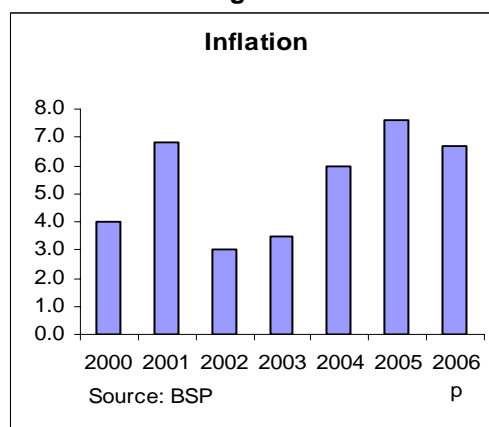


Figure 2



Private consumption grew by 5.4 percent, boosted by strong growth of remittances. Remittances appear to have reduced the volatility of consumption, while also functioning as perhaps the most important safety net in the country. Imports recovered from last year's negative growth, whereas investment continued to contract in the first half of 2006, by nearly 4 percent. Public consumption and public construction both increased by over 9 percent in the first quarter, but growth of both these variables declined sharply in the second quarter as government spending became more restrained by the non-enactment of the 2006 budget. Electronic products and business process outsourcing (BPO) led overall export growth. In particular, exports of non-factor services expanded

by 22 percent after the government revised its methodology to capture the growing contribution of the BPO sector.

Average inflation in the first ten months slowed to 6.6 percent from 7.8 percent, while the 12-month CPI decelerated to 5.4 percent in October, as farm prices stabilized and the stronger peso countered the impact on prices of the VAT adjustment. As a result, the BSP was able to keep its policy rates unchanged despite increases in US rates earlier in the year.

The pace of formal employment increased in parallel to the stronger economic activity in the year ending July. The number of wage and salary workers increased by about 1.2 million (7.5 percent) with the service sector accounting for the majority of the increase. Overall employment growth, however, was more modest, and unemployment increased from 7.7 percent to 8 percent, reflecting the growth of new entrants into the labor force and the fact that wage and salary workers account for less than half of the labor force. In particular, employment in agriculture decreased in the same period. About 8½ million Filipino workers, a quarter of the domestic labor force, work abroad.

Balance of payments surpluses increase reserves. Rapid growth of remittances and transfers from overseas workers, amounting to about 14 percent of GDP in 2005, has converted large trade deficits into modest current account surpluses. The strong performance of remittances and exports in 2006 has helped to insulate the current account from higher imported oil prices. This together with a surplus in the capital and financial account, aided by an increase in foreign direct investment by 60 percent through July 2006, has allowed the central bank (BSP) to increase gross reserves by \$3.1 billion in 2006 through September, notwithstanding the second quarter market correction.

Aided by stronger capital inflow. Until the tightening of global liquidity conditions led to the May-June 2006 correction, financial markets in the Philippines displayed an extended period of improvement, reflected in reduced spreads for global bond issues, falling interest rates for local currency government borrowing, a strengthening currency, and a buoyant stock market which reached a seven-year high in mid-May. Bond spreads have fallen significantly in the past two years, reflecting both the liquidity in emerging market spreads and improving Philippine spreads vis-à-vis the EMBI. In common with other emerging markets, these positive trends were reversed during mid-May to early July, but financial markets have since stabilized and in fact have been relatively quick to regain lost ground in comparison to other emerging markets. For example, the Philippine peso was trading at a four-year high against the US dollar in October, gaining some 14 percent from a year ago. Ample domestic liquidity pushed down short-term treasury rates well below inflation, but rates have risen relative to mid-May. FDI and portfolio flows grew rapidly in 2005 and early 2006 but these flows remain small in relation to the economy and its neighbors.

Public Finance: an Improved Fiscal Position through September 2006. A sharp increase in tax revenue collection thus far in 2006 has strengthened the credibility of the Government's fiscal consolidation objectives for the medium term. In the first nine

months, the national government deficit fell to P50.4 billion from P108.5 billion through September 2005. Strong revenue collection and spending restraint generated budget surpluses in four out of the nine months. In particular, VAT revenue was 6 percent above target in the first eight months (after netting out revenue losses prompted by mitigating measures to protect lower income tax payers). Over all, revenue grew by nearly 20 percent through September, while tax revenue including non-cash collection grew by 24 percent. The non-passage of the 2006 budget restrained spending through September although the recent passage of a P47 billion supplemental budget mainly to finance obligatory expenses such as salaries and internal revenue allotment (to local governments), is expected to raise spending in the last quarter of 2006. Nevertheless, the National Government deficit for 2006 is expected to fall below its target of P125 billion (2.1 percent of GDP).

The consolidated public sector posted a small surplus in the first half of 2006, reflecting a deficit of only P32 billion in the National Government, a smaller deficit in the monitored GOCCs (state-owned enterprises), and a larger surplus of other public sector agencies (in particular publicly managed pension funds and local governments). The consolidated public sector is, however, expected to revert to deficit in the second half of the year.

The government collected P48.4 billion in additional value-added taxes in the first eight months, six percent above target. The Bureau of Customs (BOC) accounted for about three quarters of the eight-month take at P36.6 billion or P2 billion above its goal. The Bureau of Internal Revenue (BIR), meanwhile, collected P11.8 billion, nine percent higher than target. On a gross basis, incremental VAT revenues from January to August reached P66.6 billion. Mitigating measures however soften the RVAT's impact on consumer prices. As a result, a total of P9.4 billion in revenues was forgone. Raising the VAT rate to 12 percent early this year yielded P18.0 billion. The balance was collected from the lifting of VAT exemptions, net of mitigating measures. In particular, petroleum products and raw materials delivered nearly half of gross VAT revenues at P34 billion, aided by higher oil prices.

In the BIR, higher corporate tax rate of 35 percent helped BIR collect P5.7 billion more in taxes. Value-added and corporate income taxes, which grew by 71 percent and 22 percent respectively in the first seven months, led overall tax collection in BIR. High oil prices through August contributed significantly to higher VAT collection. Retail oil prices have increased by 20 percent since the implementation of the RVAT in November before falling in September. Huge VAT collections from oil provided some space for the government to reduce oil tariffs to soften the impact of higher oil prices on the poor. However, reliance on oil to rake in added tax receipts would not be sustainable. Continuous improvement in tax administration is necessary to ensure that the reform momentum will not lose steam. There is, however, scope for improvement in the area of personal income and excise taxes where collections have not been as encouraging as for the VAT. The BOC exceeded its monthly target in eight out of nine months of the year through September. The large collection in the BOC was aided by a surge in

imports of electronic parts after a slump in 2005 and the high prices of petroleum products, and occurred notwithstanding appreciation of the peso in 2006.

Figure 3

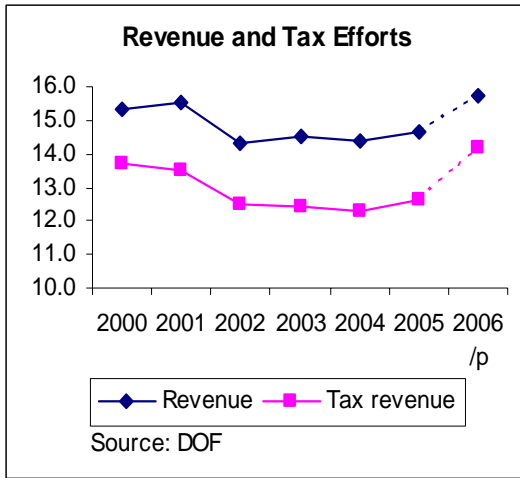


Figure 4

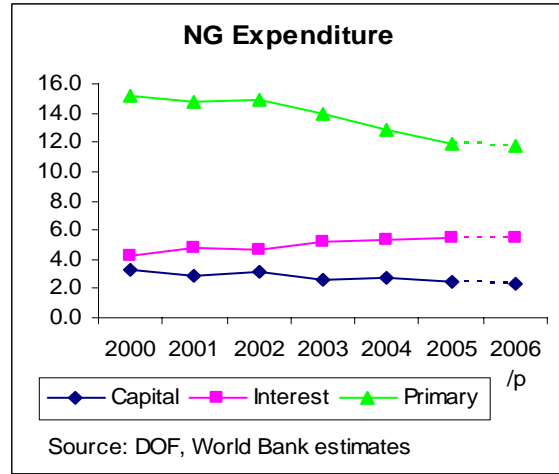


Figure 5

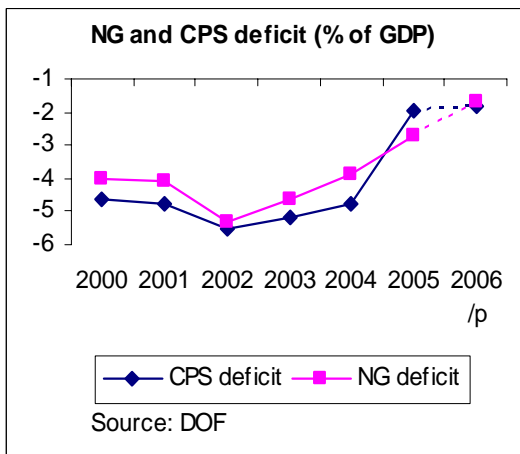


Figure 6

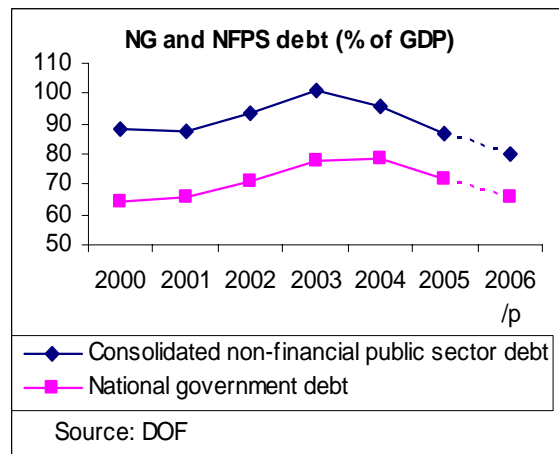


Figure 7

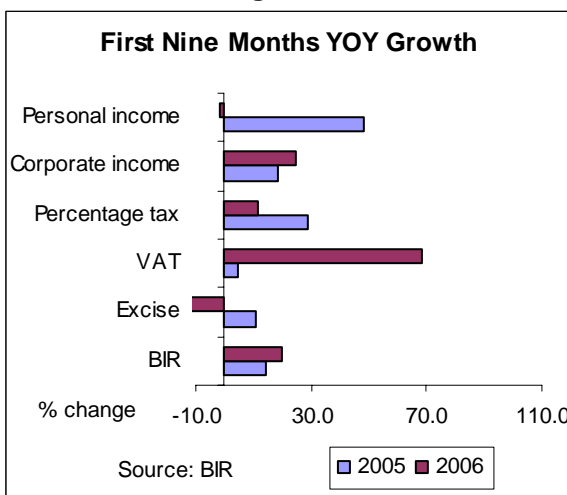
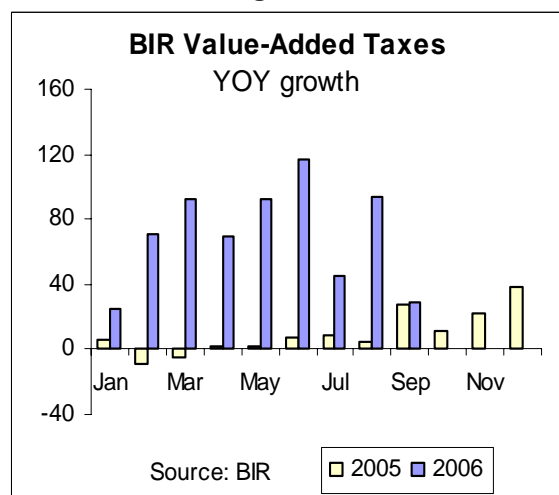


Figure 8



Institutionalization of reforms in BIR underway. On tax administration, BIR has recently created a Tax Reform Administration Group (TRAG) headed by a deputy commissioner to manage the reform program of the bureau. Task forces were created for each of the seven critical reform areas that were identified, including registration cleanup, enhanced audit, and performance-based management. The long delayed Implementing Rules and Regulation of the Lateral Attrition Law has finally been approved prompting the tax bureaus to step up collection effort. Efforts to further improve tax administration would preserve the momentum already in place.

Expenditures continue to fall amidst congressional impasse. In the expenditure side, the non-passage of the 2006 budget has restrained spending in the first three quarters which managed to grow by only 8.3 percent. In July, the failure of both houses of Congress to reconcile the two versions of the budget before going into mid-year recess resulted in a reenacted budget for the whole year. The budget impasse is the latest in a series of stand-offs between the House of Representatives and the Senate. Lower House support for charter change which provides for the Senate's abolition has fueled mutual misgivings resulting in delays and non-passage of much needed legislations. To mitigate the impact of dampened spending, a P47 billion supplemental budget was signed into law in October and will finance obligatory expenses such as salaries and internal revenue allotment. The government still aims to narrow the budget deficit to no more than P125 billion or 2.1 percent of GDP.

Private and Financial Sector Update

Sustained progress on the macro fiscal front, increasing reserves, robust inward worker remittances when combined with planned increases in public spending on infrastructure could set the stage for resumption of private investment. Progress continues in reducing vulnerabilities in the financial sector. The sustained application of existing regulations and adoption of risk based capital adequacy standards and related guidelines coupled with significant income from investments in Government securities is reducing vulnerabilities while encouraging mergers in the banking sector, setting the stage for a possible resumption of credit growth to the private sector which at present remains weak.

Progress in addressing banking sector vulnerabilities has been made. The banking sector, which accounts for more than 80 percent of total resources of the financial system, witnessed a pick-up in reform implementation during the past eighteen months. BSP has implemented reforms that address core aspects of banking sector operations and the regulatory framework for the effective conduct of banking supervision. The reforms have focused on strengthening corporate governance, risk management, and capital adequacy in commercial banks. Regulations are in closer alignment with international standards and regulatory policies are more responsive to the growing sophistication and globalization of the banking industry. These efforts are manifested in key banking sector measures; with most impact on asset quality and capital adequacy (Table 1). First-half financial statements of the top five banks suggest that the positive trend would be sustained over 2006.

Table 1: Banking Sector Indicators 2002 - March 2006

	2002	2003	2004	2005	2006 ^a
Liquidity					
Liquid Assets to Deposits	47.7	47.9	53.2	53.0	51.0
Asset Quality					
NPL Ratio (excl inter-bank loans)	16.6	16.1	14.4	10.3	10.0
NPA Ratio	26.5	26.1	24.7	20.0	18.3
NPL Coverage Ratio	50.2	51.5	58.0	73.8	74.5
NPA Coverage Ratio	30.1	30.9	33.2	39.2	38.7
Profitability (%)					
Net Interest Margin	3.8	3.7	4.2	4.6	4.1
Cost to Income Ratio	71.4	68.9	69.8	67.3	66.7
Return on Assets	0.8	1.1	0.9	1.1	1.1
Return on Equity	5.8	8.5	7.1	8.7	9.2
Capital Adequacy					
Total Capital Accounts to Total Assets	13.4	13.1	12.6	12.0	12.5
Capital Adequacy Ratio (solo basis)	15.5	16.0	17.4	16.7	16.7
Capital Adequacy Ratio (consolidated basis)	16.9	17.4	18.4	17.6	17.7

Source: BSP and Bank Annual Reports. ^a Data as of March 2006.

The take-out of Non-Performing Loans from commercial bank balance sheets has picked up. The Special Purpose Vehicle (SPV) Act was enacted in 2002 to enable take-out of NPLs and NPAs. After a slow start, by end 2005, about P97 billion worth of non-performing assets were sold through transactions under the SPV Act, reducing by about 19 percent the stock of non-performing assets in the banking system. In early 2006 the life of the SPV Act was extended by a period of another two years. BSP estimates that this would facilitate resolution of additional NPL/NPA with face value of about P100 billion during the next six months or so.

Capital Adequacy Requirements are being brought in line with international norms. In 2001, BSP adopted the risk-based capital adequacy requirements prescribed by the Bank for International Settlements (BIS)—the Basel II Framework. Pillar 1 of the framework—minimum capital requirement, comes into full force beginning 2007. Banks would be required to follow the Standardized Approach with regard to Credit Risk and the Basic Indicator and Standardized Approaches with regard to Operational Risk. Further, Filipino banks are required to maintain a minimum capital ratio for credit risks at 10 percent, higher than the 8 percent recommended under Basel II. The application of IFRS became mandatory for commercial banks starting with 2005 financial accounts. The greater rigor of IFRS is causing banks to raise additional capital. Commercial banks including state-owned banks raised more than \$200 million in the first half of 2006 by way of bonds that qualify as Tier-2 capital. At least another \$100 million worth of hybrid capital debt instruments are planned to be issued during the remainder of this year. These changes are also leading to revival of merger activity in the banking system with two commercial banks being put into play in the first half of 2006.

Positive news on the macroeconomic front is leading to revival of private investor confidence and government willingness to tackle investment climate constraints:

- **The rating agencies have reacted with positive ratings watch announcement.** Most investment banks have also been issuing favorable reports regarding growth prospects in the Philippines.
- **The government has announced an ambitious infrastructure investment program.** Budget allocations for public fixed investments are planned to be increased funded in part by the extra tax revenues generated from tax increases of 2005 and because of better tax collections. By 2008 the government aims to sustain annual infrastructure investment at about 5 percent of GDP. A list of ten high priority infrastructure projects, mainly in the transport sector, is expected to be announced shortly. At the same time, in 2006, the government embarked on an exercise to further reform the BOT law so as to enable faster bidding out of infrastructure concessions on a competitive basis. The government also plans to step up privatization of power sector assets with a significant privatization valued at \$500 million to be completed soon. If managed well, these measures should significantly increase private investments in the infrastructure sector while addressing a key concern of investors in other sectors.
- **Surveys suggest increased optimism among private companies and investors.** A recent survey by the Philippines Chamber of Commerce indicated that more than half of the membership plans to expand their business in 2006. These views are also echoed in the latest quarterly survey of business and consumer confidence conducted by BSP. The business confidence survey indicated that firms expect sales, production, and export orders to pick up due to increased remittances, planned infrastructure projects, a boom in the mining sector and better government performance. A review of half-yearly earnings announcement of the main listed Filipino companies indicates an overall positive trend in sales and earnings and no deterioration in debt or debt service coverage levels. These remain at levels reported in previous updates.
- **The IT Enabled Services (ITES) Sector continues to generate positive headline announcements.** About three years ago, the ITES sector, especially the BPO sector, was identified as a possible significant source of growth. This assessment is turning out to be correct. Employment in this sector has increased from about 70,000 in 2003 to about 240,000 by mid 2006. The growth of this sector is also causing tightening in the commercial real estate market in Manila with favorable implications for the banking system because loans are collateralized by real estate. BPO export revenues have increased from less than \$0.5 billion in 2003 to more than \$2.5 billion in 2006. Consensus exists within the industry that by end of the decade the ITES sector could generate more than \$10 billion of export revenues with a workforce of around one million. The main impediment remains capacity constraints in training sufficient number of skilled workers.

Structural impediments to investment remain a major factor, however. Poor infrastructure investment and the high cost of doing business are major constraints in enhancing the country's competitiveness. Public and private investments at 2.3 and 12.8 percent of GDP respectively in 2005 are very low compared to neighboring countries. On doing business, the Philippines ranks number 126 out of 175 countries and economies surveyed in 2006. It takes 48 days to start a business and as much as 600 days to enforce a contract. In response to the lagging competitiveness rankings, the President in her State-of-the-Nation address announced a P1 trillion medium-term public investment plan spread over four years in the public sector's budget aimed at enhancing infrastructure and the competitiveness of the country. Moreover, in reaction to the results of the Doing Business Survey, the government launched a national competitiveness summit with the aim of addressing the country's ease of doing business.