

PHILIPPINES

Despite domestic political tensions and increased market volatility, the Philippine economy performed unusually well in 2007—ending the year with its highest growth in three decades, benign inflation, a strong balance of payment position and an improving public sector fiscal situation. Notwithstanding this performance, the economy continued to show persistent structural weaknesses—a low tax effort, high unemployment and underemployment, and rising poverty. These weaknesses, together with mounting global uncertainties and domestic political instability, raise concerns whether the economy's high growth can be sustained over the medium-term.

GDP expanded by 7.3 percent in 2007 largely on account of strong domestic demand. Private consumption was again the main driver, supported in part by rising remittances (the appreciation of the peso notwithstanding). Stimulated by higher public investment, private investment picked up too but the growth came mostly from construction; durable equipment growth remained lackluster. Export growth declined sharply over the four quarters of 2007 reflecting slower demand from key trading partners (except China). The peso's sharp appreciation was also a factor although high infrastructure cost remains a key bottleneck to improving competitiveness. Negative real import growth was a surprise given the strength of domestic demand and the appreciation of the peso. On the production side, the services sector was the star performer, growing by an impressive 8.7 percent. The banking sector recorded double-digit growth despite the sub-prime induced volatility in the second half. Agriculture remained robust but manufacturing growth slowed further for the fourth straight year.

The economy's strong performance in the last four years has not translated into poverty reduction. Between 2003 and 2006, poverty incidence increased from 30.0 percent to 32.9 percent despite average GDP growth of 5.4 percent. The Gini coefficient remains high at 0.45. Both urban and rural poverty increased on average and only 4 of 17 regions recorded an improvement in the poverty headcount. Falling real incomes of families and compression of public spending contributed to the rise in poverty.

Inflation was benign in 2007, averaging 2.8 percent. Higher food and oil prices were muted by the strong peso which appreciated by nearly 20 percent in the last two years—the most among the currencies in the region. In early 2008, inflation breached the central bank's 4-5 percent target as international food and oil prices surged. Alarming, rice prices grew by 7.7 percent in February. The government has begun to secure its rice requirements by asking Vietnam to guarantee the country 1.5 million tons of rice and by tapping the emergency regional rice reserve.

Tight monetary policy slowed money growth last year. In the last six months, the central bank reduced the overnight borrowing rate by 1 percentage point compared to 2.75 percentage points in the US. M3 growth fell from 22.3 percent in end-2006 to 10.4 percent in end-2007.

The domestic financial system exhibited resilience in the face of international market turbulence. With the exception of a handful of banks, the banking system as a whole was mildly affected given their small holdings of sub-prime-linked securities (0.2% of total assets according to the BSP). There was more, albeit still quite small, collateral damage resulting from falling sovereign bond prices.

[High remittance inflow \(\\$14.4 billion\) in 2007](#) far outweighed the slowdown in exports, turning a large trade deficit into a healthy current account surplus of 4.4 percent of GDP. At the same time, net capital inflow was positive, aided by stronger portfolio investment (\$3.1 billion) and other investment (\$1.6 billion) inflows. As a result, reserves climbed by 50 percent, and reached \$36 billion by February 2008 (6.1 months of imports). The strong reserve position enabled the country to pre-pay close to \$3 billion in foreign debts last year of which \$1.1 billion came from the public sector. Total external debt in 2007 is estimated to fall to about 40 percent of GDP.

[The consolidated public sector deficit improved to a surplus through September 2007.](#) Proceeds from privatization of 1.4 percent of GDP helped compensate for lower tax revenues. Administrative inefficiencies such as the under-registration of taxpayers, the lack of risk-based audits, and weak anti-smuggling enforcement, and built-in policy weaknesses such as the non-indexation of excise tax rates, have continued to undermine revenue collection. Decade-low interest rates and spreads provided the government more flexibility in increasing capital and social spending. The primary surplus (almost 4 percent of GDP) helped trim government debt (55.8 percent of GDP in end-2007 from 63.8 percent in end-2006).