

PHILIPPINES

Recent Economic Developments

Robust growth in 2004. Economic growth has been on a rising path: GDP growth averaged 4.5 percent in 2002-03 and increased to 6.1 percent in 2004, the fastest in 15 years. GNP growth also reached 6.1% in 2004. Growth in 2004 was broad-based with the service sector, which accounted for 47% of output, growing by 7.3% followed by industry (5.3%) and agriculture (4.9%). Within services, the major drivers of growth were telecommunications, business process outsourcing and tourism. Within industry, manufacturing and construction were the major growth drivers.

On the demand side, personal consumption continued to grow at a robust 5.8% pace aided by double digit growth of remittances. Fixed capital spending expanded at a faster pace (5.1%) than 2003, driven by private construction. Investment in durable equipment, however, slowed relative to 2003 notwithstanding a rising capacity utilization rate that was approaching 80% by mid-2004. More encouraging was the acceleration in export volume growth in 2004 reflecting double digit expansion of both goods and non-factor services (as derived from national accounts data). The terms of trade, however, fell due to both higher oil prices and falling export prices.

The stronger growth performance was aided by several factors, including a favorable external environment characterized by a turnaround in semiconductor electronics demand, which comprises over two thirds of Philippine exports, very rapid export growth to China, ample liquidity in government debt markets in both foreign currency and peso financing, as well as agricultural growth above its historical norm despite a typhoon-related agricultural slowdown in the fourth quarter. In the first quarter of 2005, the pace of growth reportedly slowed reflecting slower consumer demand constrained by higher oil prices and more modest agricultural growth—though official data for the first quarter are not available.

Accompanied by Higher Inflation. Inflation rose to 7.9% on a year end basis, and 5.5% on a year average basis—the latter exceeding the central bank's (BSP) target range of 4-5% for 2004. Supply shocks—most notably the surge in world oil prices but including selected food items and power tariff adjustments late in the year—were the primary cause of higher inflation. But with core inflation increasing at a pace similar to headline inflation, and with inflation measured using the recently introduced 2000-based CPI indicating faster price increases than the traditional 1994-based index, the risk that higher generalized inflation could

take hold has been rising. Using the new index, 12 month inflation as of March reached 8.5%. The BSP responded in early April by raising its key policy rates by 25 basis points—to 7% for the overnight borrowing rate and 9.25% for the overnight lending rate, the first such increases in several years.

Fiscal Adjustment via Expenditure Restraint. Fiscal developments during much of the past year were dominated by increasing concern within the Philippines regarding the sustainability of public debt trends and financing of public sector deficits. In the event, the national government deficit continued to decline to 3.9% of GDP in 2004 from 4.6% in 2003. Both expenditure and revenue exceeded the nominal targets set for the year, expenditure by about P10 billion and total revenue by about P22 billion. However, tax revenue was up only P2 billion relative to program, as higher than programmed collections at BOC were offset by a nearly parallel shortfall at BIR. Moreover, since nominal GDP exceeded target in 2004 (given higher than targeted real growth and inflation), expenditure and tax revenue both fell as a proportion of GDP. Current expenditure/GDP fell by nearly 1% of GDP (and non-interest expenditure fell by over 1%) as personnel costs were reduced by again refraining from a general wage increase for the civil service, nominal transfers to local government units (LGUs) were stabilized, and maintenance and operations and subsidies were also reduced as a proportion of GDP. After falling by 4.5% of GDP during 1998-2002, tax revenue/GDP stabilized in 2003 at about 12.5% but again fell in 2004 to 12.3% of GDP.

In the first quarter of 2005, the national government deficit reached P63.5 billion, below the government's target of P77.8 billion for the period, but above the P56.8 billion deficit recorded in the same period of 2004. Total revenue was above target, though this was due to above-target revenue from the Bureau of Treasury, whereas tax revenue from the BIR and BOC was below target. Government spending in the first quarter was below target primarily due to lower than estimated interest payments (which now include interest on debt of the National Power Corporation (NPC) assumed by the government). The government's full year target aims to reduce the deficit below P180 billion from P187 billion in 2004. The nature of the VAT bill that emerges from Congress, which is in the process of reconciling the House and Senate versions of the bill, will impact revenue and deficit outcomes for the year.

Table 1: Selected Economic Indicators, 1999 to 2004

	1999	2000	2001	2002	2003	2004
Growth, inflation and unemployment (percent)						
Real GNP	3.7	4.8	3.4	5.2	5.6	6.1
Real GDP	3.4	4.4	3.0	4.4	4.7	6.1
Inflation (period average)	6.7	4.4	6.1	3.0	3.0	5.5
Inflation (end period)	4.3	6.7	4.1	2.5	3.1	7.9
Unemployment	9.4	10.1	9.8	10.2	10.2	10.9
Saving and investment (percentage of GDP)						
National saving	28.3	29.5	22.5	24.9	22.3	22.2e
Gross domestic investment	18.8	21.2	20.6	19.2	18.1	18.4e
Public sector (percentage of GDP)						
National government balance	-3.8	-4.1	-4.0	-5.3	-4.6	-3.9
Total revenue	16.1	15.6	15.3	14.3	14.6	14.4
Tax revenue	14.5	13.9	13.3	12.5	12.5	12.3
Total spending	19.8	19.6	19.3	19.6	19.2	18.3
Consolidated public sector deficit	3.2	4.5	4.6	5.5	5.2	4.8e
Nonfinancial public sector debt	83.6	89.5	86.5	93.9	101.1	..
National government debt	57.1	63.1	62.2	66.7	71.7	..
Money and credit (end-year percentage change)						
M3	19.3	4.6	6.8	9.5	3.3	6.2
Credit to the private sector	-1.2	8.1	-3.0	1.2	1.8	4.3
Balance of payments						
Merchandise exports (percentage change)	16.0	9.0	-16.2	10.0	2.7	9.3
Merchandise imports (percentage change)	-0.8	14.3	-4.5	6.3	6.2	7.5
Current account balance (percentage of GDP)	9.5	8.3	1.9	5.7	4.2	3.8e
International reserves						
Gross official reserves (billions of dollars)	15.1	15.0	15.6	16.2	16.9	16.1
Gross official reserves (months of imports)	4.5	4.2	4.6	4.7	5.0	4.3
External debt						
Total (billions of dollars)	58.0	57.4	58.5	60.1	62.7	..
Total (percentage of GDP)	76.2	75.6	82.2	78.4	79.1	..
Debt service ratio (percent)	15.5	14.8	21.9	20.6	19.8	..
Exchange rate (peso/dollar, period average)						
Real effective exchange rate (Jan 2, 2003=100)	39.1	44.2	51.0	51.6	54.2	56.0
	120.2	112.2	106.7	107.0	95.6	91.8 (Nov)

Memorandum items

Nominal GDP (2004): USD 87.1 billion

Population (2003): 81.5 million

Source: GOP, IMF, WB estimates

Table 2: Consolidated Public Sector Financial Position (P. Billion)

	1999	2000	2001	2002	2003	2004
						Est.
Consolidated Deficit (% of GDP)	<u>96.2</u> 3.2%	<u>149.1</u> 4.4%	<u>169.3</u> 4.7%	<u>218.7</u> 5.5%	<u>221.7</u> 5.2%	<u>233.5</u> 4.8%
Total PSBR (% of GDP)	<u>138.0</u> 3.9%	<u>174.6</u> 5.0%	<u>189.8</u> 4.8%	<u>268.3</u> 6.3%	<u>275.0</u> 6.4%	<u>286.1</u> 5.9%
National Government	(111.7)	(134.2)	(147.0)	(210.7)	(199.9)	(187.1)
CB restructuring	(20.5)	(19.1)	(23.5)	(15.1)	(15.7)	(17.5)
Monitored GOCCs	(4.6)	(19.2)	(24.5)	(46.4)	(65.3)	(90.7)
OPSF	1.9	0.3	0.8	0.0	---	---
Adjustment of Net Lending and equity to GOCCs	3.0	4.2	4.4	3.9	5.8	9.2
Other adjustments	(6.1)	(6.6)	---	---	0.0	0.0
Other Public Sector	<u>41.8</u>	<u>25.5</u>	<u>20.5</u>	<u>49.6</u>	<u>53.4</u>	<u>52.6</u>
SSS/GSIS	36.4	15.4	15.6	25.6	17.6	25.1
BSP	(3.9)	(0.0)	(0.0)	1.2	6.9	3.3
GFI	3.3	2.8	3.9	5.4	4.9	5.2
LGUs	7.5	6.6	1.2	18.9	21.0	17.9
Timing adjustment of interest payments to BSP	(2.3)	0.5	(0.2)	(1.6)	0.7	3.9
Other adjustments	0.8	0.1	0.1	0.0	2.2	(2.8)

Source: Department of Finance

The broader consolidated public sector deficit (CPSD) is estimated to have declined from 5.2% of GDP in 2003 to slightly below 5% in 2004 reflecting the adjustment in the national government deficit. Expanding losses of the NPC in 2003-04—the result of suppressed electricity tariffs and the repercussions from costly take-or-pay deals with independent power producers (IPPs) in the 1990s—resulted in upward pressure on the CPSD. Electricity tariffs were, however, adjusted in late 2004 by nearly one peso per kWh, and the NPC deficit was contained to below earlier projected levels. Non-financial public sector debt, which increased rapidly during 2002-03, is estimated to have stabilized at about 100% of GDP in 2004.

Balance of Payments: Resilient. Nominal export growth rebounded through the year in 2004 to over 9% but this was still well below the performance in neighboring economies, and was aided by approximately 45% export growth to China. Coupled with strong growth in remittances and tourism, the increase in higher priced oil imports was borne relatively smoothly, with the current account surplus easing only slightly to an estimated 4.5% of GDP. While gross reserves fell by about \$900 million, adjusted for pledged

assets, reserves increased slightly aided by central bank purchases of foreign exchange in the latter part of the year. External commercial borrowing requirements of the public sector in 2005 are estimated by the government at about \$4-4½ billion.

Financial Markets: Volatility followed by Buoyancy. In early 2004, equity markets and the peso were adversely impacted by pre-election uncertainties, and for several weeks regular Treasury securities markets were partially disrupted, but stabilized as election-related uncertainties dissipated. The peso came under intermittent pressure even after the May elections and depreciated gradually in real effective terms in 2004, but rebounded to 12-month highs against the U.S. dollar in early 2005. The stock market index increased by 26% in 2004 and reached a five-year high in early 2005, aided by a surge in portfolio inflows in the first two months of the year.

Spreads on bond issues were relatively stable in 2004, but increased vis-à-vis average EMBI spreads which declined through the year. Two recent global bond issues of \$1 billion in September 2004 and \$1.5 billion in January 2005 indicate continued market access even at long maturities—

despite downgrades of the Philippines credit rating by two international credit rating agencies to three notches below investment grade—though at a stiff price. The recent 25-year bond issue was priced at a spread of 505 basis point spread over the 30-year U.S. Treasury bond, indicating the considerable potential in savings from lowering investor concerns.

Labor Market: Increasing Employment and Unemployment. The pace of employment picked up in parallel to the stronger economic activity, with employment in the formal sector increasing by 1.1 million (3.7%) in 2004 driven by 5% growth in non-agricultural activities, primarily services. But with a heavy pool of underemployed labor and new entrants adding to the labor force, the growth in non-agricultural employment in 2004 was not sufficient to reduce the unemployment rate which crept up to 11.8% (year average) and 10.9% (October) from the comparable rates of 11.4% and 10.2% in 2003—highlighting the need for a sustained period of rapid growth to make a substantial dent in unemployment.

Poverty Reduction. Recently-issued official estimates indicate a decline in the incidence of poverty between 2000 and 2003, after a period of no reduction during 1997-2000. Based on annual per capita income thresholds of P12,267¹ in 2003, the number of poor declined from 25.4 million in 2000 to 23.5 million in 2003, or from 33% to 30.4% of the population. Both rural and urban poverty are reported to have declined over this period: rural from 18.6 million (47.7%) to 17 million (43.6%); urban from 6.8 million (17.8%) to 6.2 million (16.5%).² Inequality, as measured by the Gini coefficient, also declined from 0.4822 to 0.4678 in the same period.

However, there remain some concerns about these measurements. First, the preliminary results of the Family Income and Expenditure Survey (FIES), on which the poverty estimates are based, indicate a decline in real per capita income by about 10% (using the CPI as the deflator) during 2000-03, whereas the National Accounts indicate an increase by about 7% over the same period.

Second, the implicit rate of inflation implied by the poverty thresholds for 2000 and 2003 is significantly lower than that implied by the CPI: 7% as against 14% over the three years. The difference is not explained by the fall in the relative price of food which has a higher weight in the poverty thresholds than in the CPI. Even “adjusting” the CPI with the food weights in the poverty thresholds, the resulting inflation over the 3-year period is about 12%. Underlying reasons for these discrepancies remain unclear, and both issues—the reconciliation of surveys with National

Accounts and the methodology of setting poverty thresholds—merit further exploration.

Corporate Sector

Corporate profitability continues to be on an upward growth path. Earnings per share of listed companies rose by about 28% in 2004. The average Return on Equity of companies included in the MSCI Index was 11.2% in 2004; significantly higher than 7.8 percent achieved in 2003. Firms in the services sector and in particular in the transport and communications sector recorded the best improvements in sales and profitability. The upward trend in corporate profitability is expected to continue in 2005 supported by robust consumption growth fueled by OFW remittances; OFW remittances in 2004 were around US\$8.5bn recording an 11 percent increase over 2003.

Prospects for mobilizing resources from the equity market have improved. The PSE composite is up 15 per cent this year, making it the best performer in Asia. The index rose by 26 per cent last year and 42 per cent in 2003. More important, average daily volume has also increased, rising to 2.3 billion pesos in February 2005 compared to an average turnover of 481 million in 2004. This performance has been largely on account of substantial increase in net foreign portfolio investment flows that have shown steady increases in the past six months. Net foreign portfolio investments in the first two months of this year have been more than US\$800 million, a sharp increase from the \$63 million registered in the same period last year. These positive trends will get additional support from a spate of IPOs, the highest in more than a decade, that are likely to hit the market. In the next two months or so, two large companies are planning to raise about \$865 million from their IPOs. If these perform well, a number of firms in sectors ranging from media to energy are waiting in the wings to enter the market. These issues would add depth and liquidity and attract foreign investors who have hesitated because of lack of volume in the markets.

The Information Technology Sector in the Philippines is receiving attention and investments from investors and IT firms. Information technology (IT) investments in economic zones registered with the Philippine Economic Zone Authority (PEZA) rose by 60% in 2004 to P6.67 billion from 2003's P4.170 billion. The number of call center seats has increased rapidly in the last two years and could double by the end of 2005. The IT investments include business process outsourcing, call center, medical transcription, software development, digital animation and manufacturing. It is estimated that investments in information technology-enabled services could reach annual levels of P20 billion in four to five years.

A Supreme Court ruling in the mining sector has brightened the investment environment. In December

¹ Income thresholds are calibrated by region.

² Urban and rural estimates for 2003 exclude certain provinces.

2004 the Supreme Court issued a ruling upholding legal and regulatory changes liberalizing foreign investment in the mining sector. Following this ruling, investor response and interest has been very positive leading to hopes of significant FDI inflows. Already a number of Chinese and Australian companies have expressed interest in undertaking significant investments in the mining sector. If all the projects under discussion come to fruition, they will bring in investments of more than US\$3bn. The Board of Investments expects that total investments could be as high as US\$6bn generating annual additional exports of around US\$3bn. However, given the lead times associated with exploration and validation of the financial viability of mining operations, translation of planned investments into actual investments may take time. A systematic strategy to address concerns stemming from environmental degradation, displacement of communities and revenue sharing arrangements with local governments could contribute in reducing lead times.

Power sector restructuring, renewed interest in PPI and planned sale of government assets should contribute in improving the investment climate. The investment environment is likely to get a boost from government efforts to restructure the power sector through planned privatizations of the assets of NAPOCOR. The government has entered into an agreement with a private firm for sale of one of the generating facilities owned by NAPOCOR. The transaction is valued at more than US\$600 million. Besides reviving private investment in the power sector, success in completing this transaction and similar transactions in the future would enable the government to reduce the added debt burden incurred by it when it took over the foreign debt of NAPOCOR. This could contribute in reducing concerns among investors about the high level of external sovereign debt and the burden it imposed on the fiscal position of the government and its ability to invest in essential public infrastructure. The government is also exploring private investment in transport sectors without having to provide guarantees. Some of the proposed investments are in advanced stages of negotiation and if successfully completed could lay the basis for fresh private investments in other sectors. Finally, the government is also planning to sell about Peso 18 billion of assets in the property and media sectors. These planned sales would contribute in increasing public sector revenues as well as lead to additional investments from prospective buyers.

In order to translate recent positive developments into sustained increases in fixed investment, continued progress in fiscal reforms and financial sector reforms remains the key. After registering growth in the third quarter of 2004, fixed asset investment in the past five months has slowed down. Going forward, firms remain cautious about committing to new investments. The 2005 Business Expectations Survey by BSP shows that while

firms are more optimistic about the business environment, only 20% of them plan to go ahead with expansion. In addition to the macroeconomic risks, stiff competition, unclear economic laws, high interest rates and poor access to credit were cited as key concerns. In the immediate short-term firms are looking for indications that the uncertainty caused by perceptions of fiscal problems would be tackled by the government. Thereafter, firms would look for signs of revival in infrastructure investments accompanied by financial sector reforms that increase the willingness and ability of financial institutions to take on risk assets.

Financial Sector

There has been some movement during the last few months on **workouts of distressed assets**. As of end-December 2004, the industry's non-performing loans (NPL) ratio improved to 12.72 percent from the previous month's ratio of 13.57 percent. This was a result of the simultaneous 6.1 percent decline in NPLs and the 0.1 percent growth in total loan portfolio. The substantial NPL reduction in December 2004 was primarily the result of sale of P16.38 billion of NPLs to special purpose vehicles (SPVs) under the SPV Act of 2002. However, the SPV Act facilitated deals are not likely to take place easily as these will cost the banks much more than has been anticipated as the discounts being demanded by prospective buyers are expected to be high. The BSP anticipates that about P80 billion of the P500 billion non-performing assets (NPAs) in the system will be transferred under the SPV Law by the current April 8, 2005 deadline for completing deals through the SPV facility.

Even though loss recognition from such workouts can be done over a period of time as provided under the SPV facility, the **intermediation capacity of the banking sector may continue to be weak**, constrained in the short term by the system's profitability. Investment in Government securities has been the more profitable alternative for banks with investment in these growing to over one-fourth of the asset base of key commercial banks.

The proposal of the central bank to establish a **credit information bureau** moved ahead another step having been approved by the Senate Committee in its first reading. As per media reports, initially 49% of the bureau will be owned by the central bank and the remaining 51% will be offered to industry associations and interested multilateral agencies. The credit information system is expected to increase access to credit especially to small borrowers, lower credit transaction and borrowing costs, and improves management of credit risk.

Amendments to the BSP Charter, which would strengthen bank supervision and help the Philippines comply with international best practice, have yet to be passed.

Strengthening legal protection of bank supervisors in performing their duties and improvement in the framework for resolving problem banks are two key elements of the proposed charter amendment.

In February 2005, the Philippines was removed from the list of Non-Cooperative Countries and Territories (NCCT) by the Financial Action Task Force (FATF), which confirmed that the Philippines was effectively implementing **anti-money laundering** (AML) measures to remedy previously identified deficiencies. The FATF will continue to monitor the implementation of these measures to ensure that progress on AML is sustained.

The largest **contractual savings** institution (SSS) faces sizeable deficits and its last actuarial valuation indicated possible depletion of assets by 2015 without remedial measures. On the collection side, improved compliance is urgently needed with SSS reporting consistent collection from only 7 million of its 24 million members. The Government Service Insurance System (GSIS), though in a better position to meet its obligations, also has difficulty collecting premiums owed to it by various Government agencies. The GSIS will need to improve pension administration, investment performance and fund management in order to strengthen its long-term sustainability.