

PHILIPPINES BRIEF

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Philippines: Highest Growth among Southeast Asian Middle Income Countries

Overview. Philippine GDP growth increased to 7.3 percent in the first half of 2007, while GNP growth reached 8 percent. This performance indicates that GDP growth for the year could reach or exceed the 6.7 percent upper end of the Government's target range for 2007. Economic performance and prospects have improved following the substantial fiscal adjustment, public debt reduction and balance of payments surpluses of recent years. Fiscal adjustment of some 5 percent of GDP in 2005-07 has been vital to such improvement by alleviating perennial investor concern about fiscal sustainability. By October, financial markets had largely recovered from the subprime crisis-induced volatility, notwithstanding a spate of corruption scandals featuring prominently on the political landscape. Further strengthening of the tax effort, which weakened in 2007 relative to target, will nonetheless be needed if official aspirations to eliminate the National Government deficit in 2008 are to be realized while ongoing efforts to strengthen infrastructure are pursued.

Growth, Employment and Poverty

Economic growth in the first half of 2007 was the highest in 20 years. On the production side, the services sector, which accounts for more than half of GDP, again led the expansion with growth of 8.6 percent (Table 1). Industrial growth also increased, driven by mining and construction, although expansion in manufacturing slowed as did agriculture (relative to the first half of 2006), limiting the impact of the higher growth on employment. On the demand side, personal consumption expanded by 6 percent, benefiting from growing remittances, and, in contrast to previous years, government consumption also increased as a share of GDP. Investment also rose at a slightly faster pace than GDP, albeit unevenly: both private and public investment in construction increased significantly, but investment in durable equipment remained lackluster. Judging by a 30 percent increase in investment approvals by the Board of Investment and the Philippine Economic Zone Authority for the first half of 2007, prospective investment may be set for a higher trajectory.

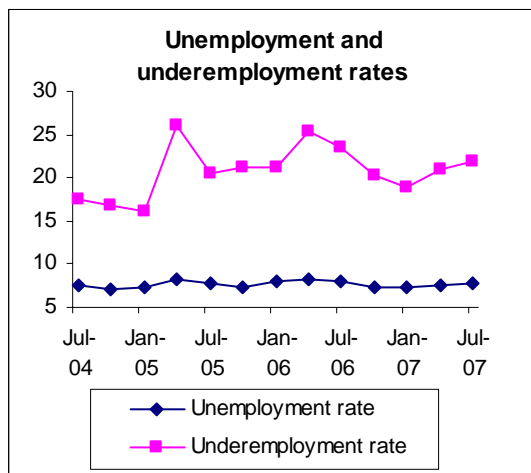
The unemployment rate declined in July and the quality of employment improved somewhat. Unemployment fell to 7.8 percent from 8.1 percent in 2006, and underemployment fell to 22 percent from 23.5 percent in 2006 according to the July round of the labor force survey (Figure 1). During this period, there was a marginal increase in the share of wage and salaried workers and a commensurate decline in share of unpaid family workers, suggesting some improvement in the quality of employment. Within wage and salaried workers, the largest increase was seen in the public sector indicating that election related hiring might have been a factor.

Table 1: Sector growth and contribution to growth

Component	Growth			Contribution		
	06H1	06H2	07H1	06H1	06H2	07H1
AGRI.FISHERY,FORESTRY	5.3	2.5	4.0	1.0	0.5	0.7
Agriculture & Fishery	5.4	2.5	3.9	1.0	0.5	0.7
Forestry	-11.8	2.5	26.2	0.0	0.0	0.0
INDUSTRY SECTOR	4.9	4.3	7.2	1.6	1.4	2.3
Mining & Quarrying	2.7	-16.6	24.3	0.0	-0.2	0.5
Manufacturing	4.6	4.6	3.8	1.1	1.1	0.9
Construction	6.7	7.9	20.6	0.3	0.3	0.9
Electricity ,Gas and Water	5.8	7.0	5.2	0.2	0.2	0.2
SERVICE SECTOR	6.2	7.2	8.6	3.0	3.5	4.2
Transport, Comm., Storage	6.1	6.6	10.1	0.5	0.6	0.9
Trade	5.1	6.9	8.6	0.8	1.2	1.4
Finance	12.2	10.6	13.2	0.7	0.6	0.8
O. Dwellings & R. Estate	4.3	7.1	5.9	0.2	0.3	0.3
Private Services	6.5	7.3	8.5	0.6	0.6	0.7
Government Services	4.3	5.1	2.6	0.2	0.2	0.1
GROSS DOMESTIC PRODUCT	5.6	5.3	7.3			

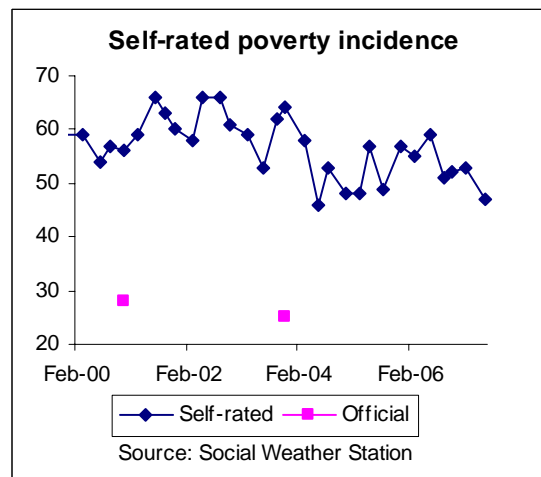
Source: National Statistical Coordination Board

Figure 1



Source: National Statistics Office

Figure 2



Source: Social Weather Station

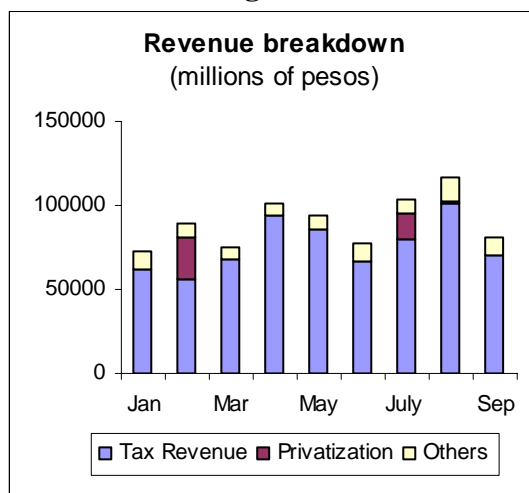
Poverty incidence appears likely to have fallen relative to the most recently available official estimate of 30 percent in 2003. In the three and a half years since the 2003 survey, average per capita growth of 3.9 percent was higher than any other similar period in the last 25 years. Preliminary results from the 2006 Family Income and Expenditure Survey however provide mixed evidence for the anticipated decline in

poverty: while they indicate a decline in inequality as measured by the Gini coefficient, they also indicate a slight decline in average family income in real terms, including for the bottom three deciles. Final results are due in early 2008. Meanwhile, the trend in self-rated poverty incidence appears to corroborate the expected decline in official poverty incidence data, although estimates of self-rated poverty remain well above official poverty figures (Figure 2).

Public Finance: Declining Deficits and Debt despite Tax Revenue Shortfalls

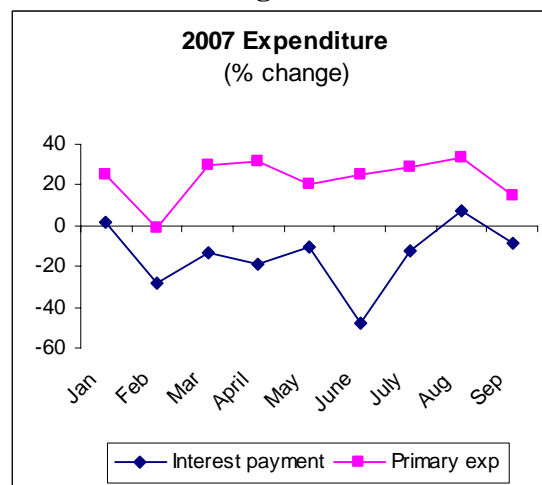
The consolidated public sector deficit was eliminated in 2006, and a P32 billion consolidated public sector surplus was recorded in the first half of 2007, aided by a lower National Government deficit, improved finances of major state-owned enterprises, and higher surpluses of the social security funds and local government units. The National Government deficit through September fell to P40 billion versus a targeted P54 billion, and thus appears on track to remain below the annual target of P63 billion (1 percent of GDP). Privatization receipts of P42 billion were instrumental in containing the deficit whereas tax revenue was below target (Figure 3). The government moreover intends to dispose of its remaining shares in Philippine National Oil Company-Energy Development Corporation and the Manila Electric Company, raising potential privatization revenue this year to some P80 billion or 1.2 percent of GDP.

Figure 3



Source: Bureau of Treasury

Figure 4



Source: Bureau of Treasury

National government expenditure increased in real terms in a reversal of prior trends. Public spending grew by 11 percent through September but net of interest payments, the increase was 23 percent (Figure 4), driven by construction. The halving of borrowing spreads over the last two years has significantly lowered interest payments to below 5 percent of GDP. Primary spending was driven by both investment and consumption. While government expenditure as a share of GDP is not programmed to increase next year, a larger share of the 2008 budget is to be used to fund the government's infrastructure program as itemized in the President's State-of-the-Nation Address in July.

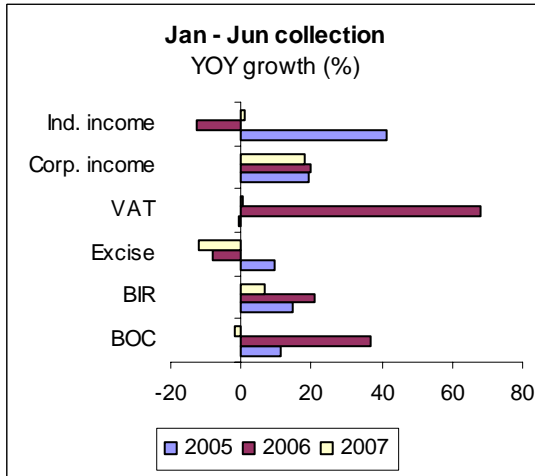
Tax collection was off sharply in the first half but recovered to increase by over 15 percent in the third quarter. Overall, collection through September rose by 7.8 percent, i.e., still below nominal GDP growth, and thus well below target. The Bureau of Internal Revenue collected 8.6 percent more than the comparative period last year (Figure 5) while the Bureau of Customs collected only 4.9 percent more. A stronger peso and lower interest rates relative to target contributed to the decline, but weak administration in both bureaus was the main factor according to the Department of Finance. To turn around the tax effort, a new commissioner for BIR was appointed and administrative measures were adopted, including audits of large taxpayers, review of withholding tax remittances of the top 10,000 corporations and anti-smuggling operations using third party information. The President herself has presided over several command conferences at both BIR and BOC. The government had originally targeted a tax effort of 14.7 percent of GDP for 2007 although in light of the shortfall in the first half, it will be difficult to significantly surpass last year's 14.2 percent ratio.

Tax administration reforms are underway. As of October, the integrated tax system of BIR was rolled-out to 23 revenue district offices. In July, the BIR, using third party information from the Securities and Exchange Commission (SEC), identified 11,572 corporations and partnerships which were registered with SEC but not with BIR. To catch unregistered single proprietorships and professionals, the President promulgated Executive Order No. 646 mandating local government units and the BIR to share business registration and real estate data. The formal sharing of data with other government offices is expected to commence next year. Aside from registration, BIR is currently looking at improving its accounts receivable management and finishing its encoding backlogs. Un-encoded registration and transaction forms have piled up in many district offices and have become hindrances to conducting audits and determining the true size of the tax base. At the BOC, anti-smuggling operations have caught several oil and motor vehicle smugglers. A number of high ranking collectors have been charged with connivance and neglect of duty. To further protect against technical smuggling (i.e. mis-declaration of goods), Executive Order No. 660, signed in September, instructs the customs bureau to collect duties and taxes on goods imported into the Subic Special Economic Zone if these will not be consumed within the zone. The executive order intends to stop the illegal practice of importing duty and tax free goods into the zone but shipping them out later on for regular domestic consumption.

Changes in tax policy are under consideration. Bills lined up for 2008 are the fiscal incentives rationalization and the simplified net income taxation scheme (SNITS). The former has been filed in both houses of Congress but opposing versions of the bill may complicate passage into law. The SNITS, which primarily limits allowable deductions, was implemented in the mid-nineties but was repealed by the 1997 comprehensive tax reform law. It is being reintroduced in its original form. Revision to the sin tax law is not expected until 2010 despite poor performance of excise collection. The 2004 sin tax law had adjusted the rates of alcohol and tobacco products effective January 1, 2005 and provided for further rate adjustments every two years until 2011. The adjustments, however, have not sufficed to reverse the falling trend in excise collection

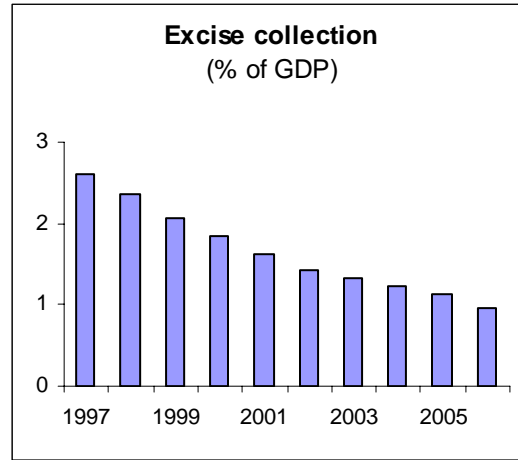
(Figure 6). The government does not anticipate filing a new sin tax bill until after the 2010 general elections.

Figure 5



Source: Bureau of Internal Revenue

Figure 6



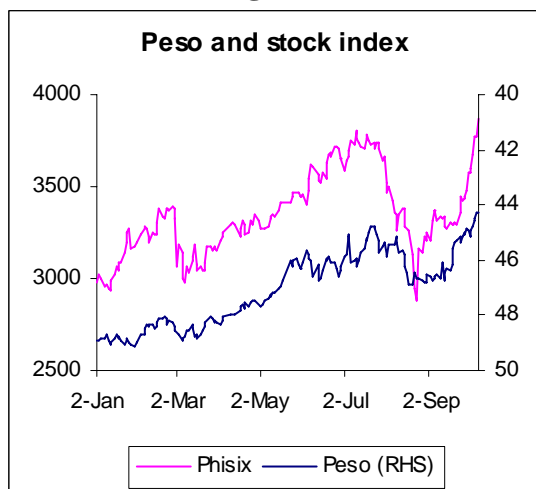
Source: Bureau of Internal Revenue

Among the government owned and controlled corporations (GOCCs), the consolidated power sector, which includes PSALM, NAPOCOR and TRANSCO, achieved a small surplus through the first half of 2007, while the National Food Authority remained the biggest contributor to the deficit. In August, PSALM successfully sold Masinloc Power Plant, thereby accelerating its privatization pace relative to 2006. Existing legislation mandates the sale of at least 70 percent of NAPOCOR’s generating plants. In June, national government debt fell below 60 percent of GDP and non-financial public sector debt fell to 74 percent in end-2006 from 86 percent a year ago. Further declines in public debt are anticipated in light of the primary fiscal surplus, robust economic growth and currency appreciation.

Financial Markets and Banking

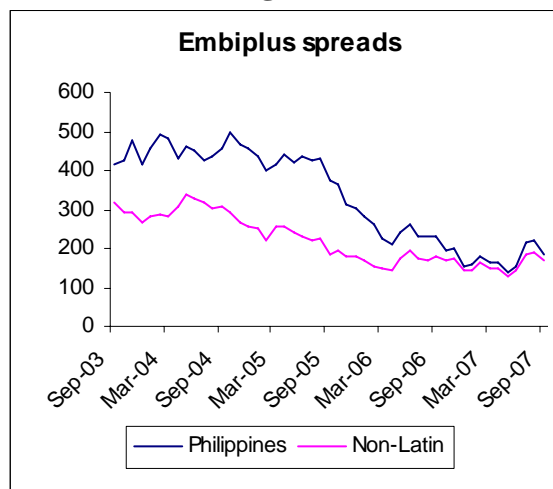
Financial markets had largely recovered by October from the global volatility generated by the subprime crisis in the U.S. (Figure 7). The stock market index, which lost 24 percent of its value in July-August—amongst the highest drops in East Asia—had recovered all its losses by early October and reached a new high soon thereafter. The peso was back at the P44 level in October after depreciating by 4.5 percent in July-August. ROP spreads (of foreign currency-denominated government bonds) have been on a downtrend since 2005, even relative to the overall tightening of emerging market spreads, attributable to progress on the fiscal front. From almost 500 basis points in February 2004, spreads fell to 138 basis points in May 2007, rose slightly in June-July following slippages in tax collection, and further to 220 basis points during the subprime induced volatility, before dropping to 180 in early October. Philippine spreads are now comparable to average spreads in non-Latin American countries (Figure 8).

Figure 7



Source: Philippine Stock Market and BSP

Figure 8



Source: Bloomberg

Interest rates have fallen significantly in the last two years. Overnight borrowing and lending rates were reduced by 150 and 175 basis points respectively in July, offset by removing the prior tiering of central bank deposit rates, whereby excess deposits earned lower rates. The removal of the tiering scheme was largely to rationalize monetary policy although lower policy rates could have a hand in tempering the rise in bank lending rates during the sub-prime turmoil. Policy rates were again reduced by 25 basis points in October to 5.75 percent for borrowing and 7.75 percent for lending, but special deposits rates were not adjusted. Since the subprime-induced volatility, bank lending rates have risen moderately to 8.725 percent at end-September, but remain well below last year's rates. The 91-day T-bill rate averaged 3.3 percent in October, 2 percentage points lower than last year. Treasury bills were often oversubscribed, allowing government to keep rates low.

Domestic credit growth to the private sector has risen but continues to lag nominal economic growth. Outstanding credit to the private sector as of August grew by 7.5 percent, the highest monthly growth this year, and the central bank forecasted a possible increase to 10 percent growth by year end. Lending (net of reverse repurchase¹) expanded to all sectors through August, except manufacturing, mining, and utilities (Table 2). A number of factors may explain the still relatively modest growth in lending. Firms may have opted to use their retained earnings instead of debt to fund new investments given higher corporate profits in 2007. Favorable market conditions have induced several initial public offerings, and equity also has come from the higher inflow of foreign direct investment. At the same time, relatively slower growth in manufacturing has had a dampening impact on overall credit growth, particularly given its size relative to the economy. Diminishing domestic credit and the special deposit instruments of the central bank have tempered money growth despite a large build-up of foreign assets. M3 growth decelerated to 14.9 percent as of August from above 20 percent last year. In

¹ Reverse repurchase are bank's placement in BSP.

September, the year-to-date consumer price index increased by only 2.6 percent down sharply from 6.8 percent for the same period in 2006.

Table 2: Loans outstanding of private depository corporations (percent growth)

Sector	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug
Agriculture, Fisheries & Forestry	9.1	7.2	5.1	3.8	6.0	7.4	6.1	5.7
Mining and Quarrying	-17.3	-20.3	-22.0	-17.0	-11.3	-10.6	-10.8	-3.7
Manufacturing	1.2	-0.9	-2.8	-7.2	-5.6	-6.0	-3.4	-5.6
Electricity, Gas & Water	7.5	-4.4	4.0	4.3	-3.4	-3.7	-2.4	-7.0
Construction	5.0	5.0	2.2	5.7	4.5	9.3	9.9	11.9
Wholesale & Retail Trade	9.7	5.8	11.8	15.3	7.4	4.0	2.0	4.1
Transportation, Storage & Communication	-1.4	0.7	12.1	14.5	10.8	11.5	11.0	15.4
Fin. Inst., Real Estate & Bus. Services	19.2	16.6	20.0	26.9	2.9	7.5	4.6	6.4
Community, Social & Personal Services	12.2	14.2	18.7	20.7	17.0	13.8	8.0	11.5
TOTAL (Gross of RRP's)	10.2	8.4	11.1	13.0	4.4	4.9	3.4	4.3
TOTAL (Net of RRP's)	5.8	5.4	4.7	6.2	7.0	4.7	6.9	6.9

Source: Bangko Sentral ng Pilipinas

The non-performing loan ratio of universal and commercial banks declined to a post-Asian crisis low of 5.2 percent as of July 2007.² Capital adequacy as estimated by BSP reached 17.8 percent as of March 2007, also the highest level since the Asian crisis. Effective July 2007, banks are required to shift to the Revised Risk-Based Capital Adequacy Framework, which is the local adoption of the Basel II international capital standards (per BSP Circular 538 of August 2006). Even though local banks have minimal direct exposure to US subprime-linked assets, bank balance sheets were impacted by the falling ROP prices, in which the banks are significant investors. While ROP prices have largely recovered in recent months, under Basel II the profitability of investing in prospective ROPs will be impacted for banks.

Balance of Payments: Rising Surplus amidst Slowing Trade

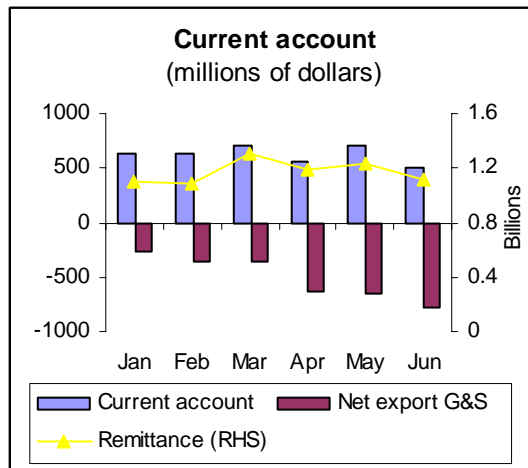
Gross international reserves reached \$32.4 billion in October, up from \$23 billion at end-2006, reflecting rising surpluses on both current and capital accounts. The current account surplus rose sharply on account of growing remittance inflows and a smaller trade deficit. Trade in both directions however slowed, to below 5 percent for exports through August and below 4 percent for imports. The appreciation of the peso (by about 20 percent against the US dollar over two years) and the prospect of slower OECD growth, have raised some concern about prospective export growth. Export groups claim that about a thousand small and medium export oriented enterprises have shut down or have been forced to layoff workers. While the central bank has intervened to slow the peso's rise, sterilized intervention has proved fiscally costly. The BSP has enacted several additional measures to limit appreciation including by easing foreign

² Based on BSP definition (Circular 351) which allows banks to deduct bad loans with 100 percent provisioning from NPL computations.

currency regulations for accessing investment abroad, and accelerating prepayment of foreign debt.

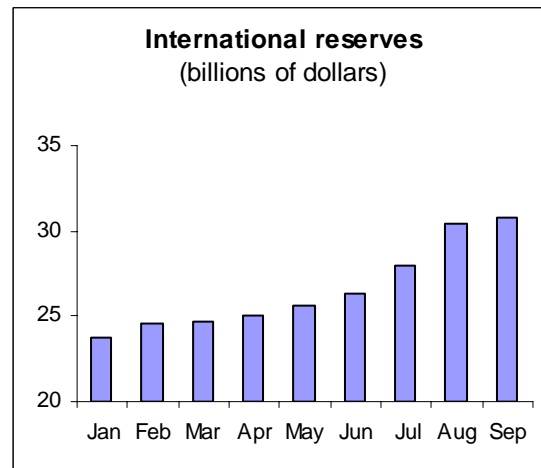
Remittances in the last 16 months continued to flow in at the rate of at least \$1 billion a month, turning trade and income deficits into a growing current account surplus (Figure 9). Remittance net inflows grew by 15 percent to \$9.3 billion through August. To cater to the growing number of Filipino overseas workers, several large domestic banks with remittance offices in Europe and North America are expanding coverage.

Figure 9



Source: *Bangko Sentral ng Pilipinas*

Figure 10



Source: *Bangko Sentral ng Pilipinas*

Stronger inflows were also recorded in the capital account. Net foreign direct investment reached \$1.6 billion in the first seven months of the year, an increase of 70 percent. Net portfolio inflows jumped 143 percent to \$3.4 billion as of September despite a spike in outflows in August to a quarter of a billion. Almost 90 percent of portfolio flows went to the stock market with the balance invested in government securities. The strong reserve position (Figure 10) has permitted prepayment of \$1.1 billion and \$600 million in public and private debt respectively. Outstanding Philippine external debt as recorded by the central bank stood at \$53 billion as of end-June 2007, down by \$900 million from the same period last year. External debt fell to 41.3 percent of GDP as of June from 50.5 percent in June last year.