

PHILIPPINES QUARTERLY UPDATE
Towards an Inclusive Recovery
November 2009



The World Bank Group in the Philippines
Making Growth Work for the Poor

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Overview

The Philippines avoided a recession thanks to timely fiscal and monetary stimuli combined with larger than projected inflows of remittances. The quick recovery reflects fully the primarily domestic nature of the economy, the limited exposure to foreign demand, the conservative nature of banks, and prompt and forceful fiscal and monetary stimuli. The first two effects arose thanks to an unexpected surge in remittance inflows in real peso terms, the modest contribution of exports and export-oriented manufacturing to GDP, and the small share of employment in manufacturing and export-related companies. Banks' conservativeness prevented domestic financial disruptions from adding to the real economy's woes.

Signs of recovery have also sprung up for exports as well as for the corporate sectors. Exports have started to recover from their January trough, with the recovery firming up since May. Notably, exports to developed countries like the US and Germany have improved since August. In the domestic market, the corporate sector witnessed improved profitability, but SMEs, especially those which are export-related are still reeling from the crisis. With financial markets also on the rebound, banks were able to turn-around the losses experienced in the last quarter of 2008.

The adverse impacts of the crisis on the social sector show signs of easing, though the recent typhoons caused renewed duress. As the economy started to recover, "green shoots" emerged in the labor market. The share of wage and salaried workers increased in July compared to April 2009, with a large decline in the number workers in the informal sector. Hunger incidence also recently receded from its level during the height of the food and global financial crises. Despite these improvements and the strong fiscal stimulus undertaken by the Government, it is estimated that the global economic recession will throw 1.4 million Filipinos into poverty by 2010 compared to a no-crisis situation. Damages and losses inflicted by typhoons Ondoy and Pepeng are estimated to further worsen poverty incidence in the Philippines.

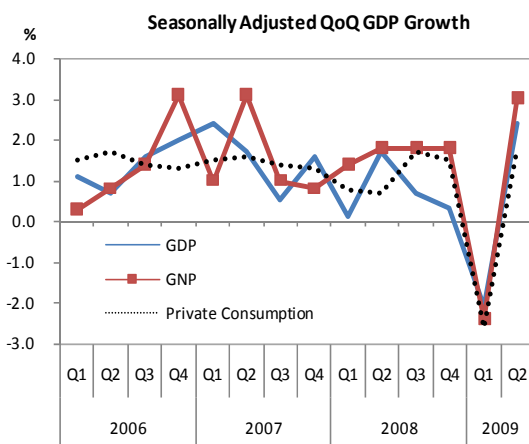
Real GDP growth is projected to rise from 1.4 percent in 2009 to 3.1 percent in 2010 though the pace of expansion will be lower than before the crisis, as bottlenecks to growth become more binding constraints in the post-global crisis environment. Continued large deployment of migrants and the authorities' commitment to keep the fiscal impulse largely unchanged next year should help growth pick up modestly. Growth is nonetheless projected to remain below potential due to pre-crisis structural bottlenecks. The Philippine economy achieved record growth rates in 2006-2007 despite these bottlenecks as excess global liquidity lifted global trade and growth, though this proved unsustainable. Achieving more rapid and inclusive growth in the less hospitable post-crisis environment—one that would allow the country to resume convergence with the more advanced countries in the region—will depend on determined implementation of reforms to improve the business environment, education and infrastructure, so as to enable companies to move closer to the technological frontier, as well as maintaining sound public finances.

Recent Economic Developments¹

Output and Demand

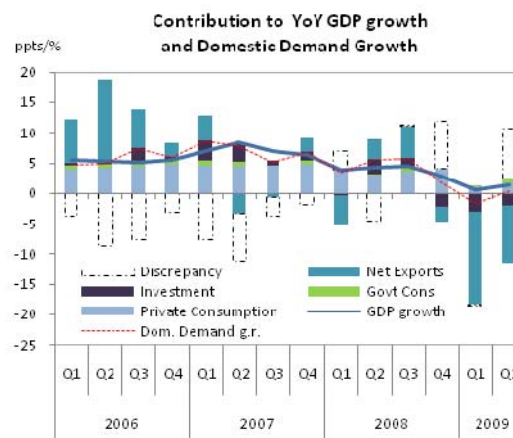
1. **The Philippine economy staged a moderate recovery in the second quarter of 2009 and avoided a recession thanks to renewed consumer and government spending.** While the economy contracted by 2.1 percent in the first quarter of 2009—the sharpest contraction since the mid-1980s—it grew by 2.4 percent in the second quarter (quarter-on-quarter, seasonally adjusted) (Figure 1). The level of output is now back to its fourth quarter 2008 (seasonally adjusted) level. The limited decline in GDP primarily reflects the limited reliance on foreign markets,² that is, the modest contribution of exports and export-oriented manufacturing to GDP and the small share of employment in manufacturing and export-related companies and the conservative behavior of domestic banks. The renewed growth in private consumption and the beneficial impact of the fiscal stimulus were the two contributors to GDP growth in the second quarter.³

Figure 1. The economy avoided a recession (Quarter-on-quarter seasonally adjusted growth).



Source: National Statistical Coordination Board

Figure 2. Year-on-year GDP growth rebounded thanks to private consumption.



Source: National Statistical Coordination Board

2. **Private consumption recovered from the collapse it experienced earlier in the year, but net exports remain weak.** The quarter-on-quarter contraction in personal consumption expenditure in the first quarter of 2009—the first in over two decades—and

¹ The Philippines Quarterly provides an update on recent economic developments and policies, and presents findings from ongoing World Bank work on the Philippines. The update is produced by a PREM team from the Manila office consisting of Eric Le Borgne (task team leader) and Sheryll Namingit with support from the Philippines country team. Questions can be addressed to David Llorito (dllorito@worldbank.org).

² Excluding labor export and its associated remittances.

³ For the first half of 2009, growth reached 1 percent compared to the same period in 2008.

its rebound in second quarter are important drivers of the swing in GDP growth as private consumption accounts for more than 70 of GDP. On a year-on-year basis, private consumption contributed 1.7 percentage points to total growth, compared to only 1.0 percentage point in the first quarter (Figure 2). The recovery of consumption in the second quarter was mostly driven by remittance inflows, declining inflation, and an improving global outlook. Merchandise exports continued to contract on an annual basis in second quarter, mostly due to electronics. Export of services, however, expanded thanks to continued strong growth in the business process outsourcing industry. Imports contracted moderately as a surge in cereal imports offset a contraction in base metals, non-electrical machinery and transport equipments.

3. Implementation of the fiscal stimulus plan led to a sharp increase in government spending in the second quarter of 2009. Government consumption expanded briskly (by 9.1 percent), due to the front loading of the government’s fiscal stimulus package. As the government spent more (seen in the double digit increase in cash disbursement—Figure 3), government consumption and public construction altogether rose by 21.8 percent in nominal terms in the second quarter.

Figure 3. Public spending boosted growth in the second quarter.^{1/2/}

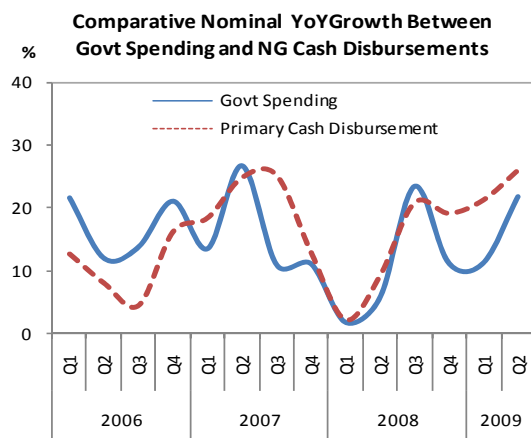
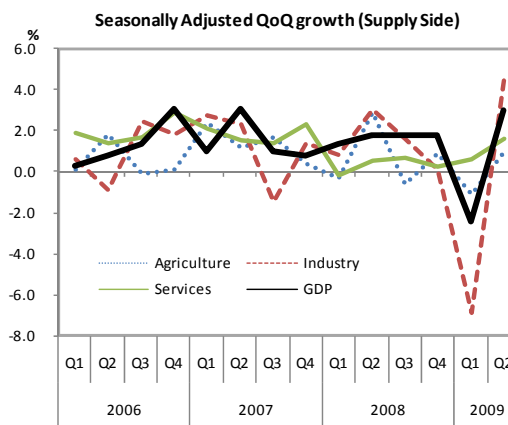


Figure 4. Productive sectors all posted moderate improvements.



Sources: National Statistical Coordination Board and Department of Budget and Management

1/ Government spending refers to government consumption and public construction.

2/ Budget disbursements refer to primary (i.e., non-interest) expenditure from the Department of Budget and Management.

4. The increase in government investment was more than offset by continued contraction in private investment in the second quarter. Capital formation continued to contract from a year earlier on a year-on-year basis (by 9.8 percent), with sharp falls posted in private construction (-6.5 percent), and, especially, in durable equipment (-18.9 percent), which has contracted since the fourth quarter of 2008. These were partly offset by strong growth (29.9 percent) in public construction.

5. On the production side, agriculture and services expanded slightly, while industry rebounded strongly from the sharp contraction in the first quarter of 2009 (Figure 4). While agriculture, fisheries and forestry expanded by 1 percent (quarter-on-

quarter seasonally adjusted), agriculture was held back by poor crops output which represent half of farm output. Bad weather, specifically stronger than usual typhoons, and difficulty in accessing credit as a result of the losses suffered by traders during the 2008 food crisis are the main reasons behind this disappointing performance. Industry posted a strong quarterly increase of 4.5 percent (seasonally adjusted) in second quarter, following a 6.9 contraction in the first quarter—the worst in over twenty years. The sharp rebound in industry was driven by construction, mining and quarrying. Despite the rebound, production remains at 2008 first quarter levels. Growth in the service sector accelerated to 1.6 percent (quarter-on-quarter, seasonally adjusted). Trade, private and government services, driven by private consumption, the government’s fiscal stimulus, and the strength of the BPO sector, were the main growth drivers of the large services sector.

Employment and Poverty

6. The labor market continues to be weak. Continuing the trend observed since the beginning of 2009, the labor force participation rate continued to rise (both on a year-on-year and quarter-and-quarter basis) and reached the highest level since January 2007. This phenomenon, which is usually observed in countries experiencing above trend growth, arises in the Philippines due to the necessity to supplement diminishing household income during economic downturns,⁴ and, as a result of population dynamics, a rapidly growing pool of new entrants into the labor force (especially new graduates); a likely slowdown (though still robust) in overseas deployment is also a contributing factor. The number of jobs created, however, was insufficient to absorb the new demand and the backlog so that the unemployment rate actually rose by 0.1 (0.2) percentage point compared to April 2009 (July 2008)—[Figure 5](#).

7. The Philippine labor market proved more resilient than in other countries that suffered from equally sharp drops in exports. Though the electronics and semiconductor sector accounts for about two-thirds of Philippine exports, it accounts for a much smaller share of industrial production (and of value-added) and an even smaller share of employment. Despite the sharp drop in this sector’s exports (about 40 percent decline in the dollar value in the first quarter of 2009, year on year), this resulted in relatively modest labor shedding compared to the size of the labor market—though the jobs lost were high quality ones (mostly formal and better paid). The labor contraction in these sectors led to a trickledown effect in the job quality ladder, so that the overall quality of the labor market decreased. Throughout the slowdown, the Business Process Outsourcing (BPO) sector continued to hire, on a net basis, as revenue grew by double digits. The sector so far accounts for only 1 percent of total employment but this share is expected to grow rapidly. Over the medium-term, structural reforms in education and related to the business climate are needed to ensure continued growth in the sector.

⁴ Box 1 illustrates some of the income shocks that companies have experienced, and for some, continue to experience during the economic slowdown. World Bank staff macro-micro simulations of the labor market adjustment to the Global crisis finds that with most of the slowdown occurring in the manufacturing and services sectors, workers in these sectors are projected to see cuts in their average monthly earning compared to the no-crisis situation (e.g., a 10 percent cut in the manufacturing sector).

8. As the economy started to recover, “green shoots” emerged in the labor market. The share of wage and salaried workers increased by 3.4 percentage points to 55.3 percent compared to its share in April 2009, thanks to a large decline in the number of own-account and unpaid family workers (190,000 and 769,000, respectively)—Figure 6. Net job creation continued to remain positive in July compared to last quarter thanks to the services sector. Employers put strong emphasis on keeping their permanent and high-value employees on payroll during the crisis by availing themselves of a flexible application of the labor code which helped to preserve jobs. As the economy picked up, companies were rapidly able to rehire, including in the hard-hit manufacturing sector (Figure 7). The Economic Resiliency Plan also helped buffer the labor market impact of the crisis, in particular its Comprehensive Livelihood and Emergency Employment Program (CLEEP) which aimed to generate jobs for displaced workers. With 59 percent of the total P13.7 billion allocation for CLEEP obligated, the program has reportedly generated 197,435 jobs and employed 328,262 individuals as of September 2009. This program contributed to the slowdown in the decline of unskilled jobs (Figure 8).

Figure 5. The labor force participation rate continued to increase...

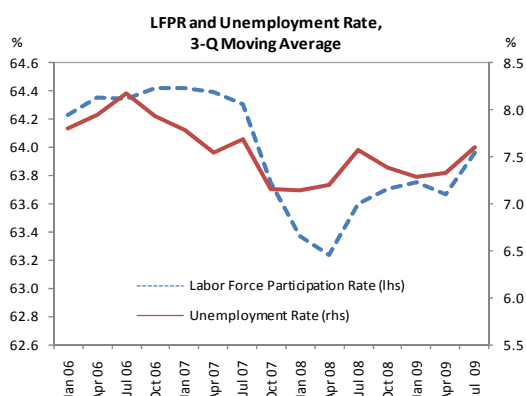


Figure 6. Workers in the informal sector declined but underemployment is still on the rise

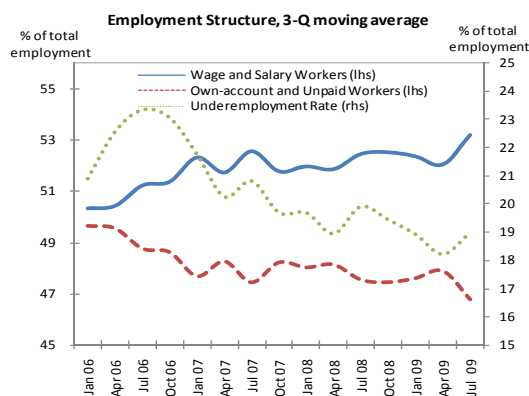


Figure 7. Job creation in manufacturing and services sectors buffered the rise of unemployment

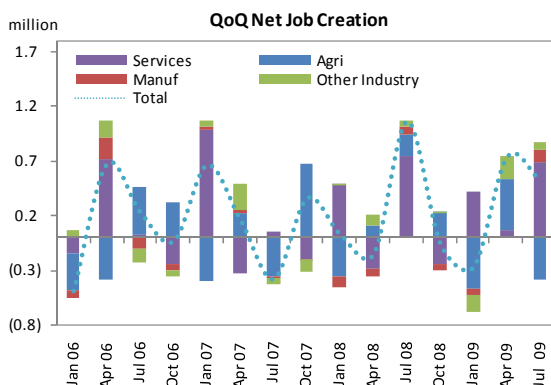
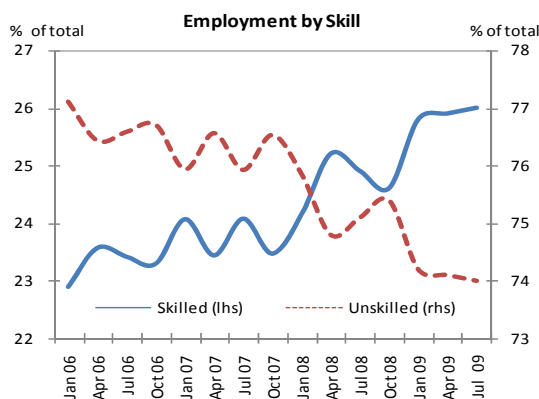


Figure 8. The decline in the employment of unskilled workers moderated 1/ 2/



Source: National Statistics Office

1/ Skilled covers government, professionals and technical workers

2/ Unskilled covers clerical, service and sales, agriculture, trade, plant and machinery, laborers.

9. **Hunger incidence receded through September though the series of typhoons likely led to renewed duress.** As a result of the global food price shock and the ensuing global recession, hunger incidence peaked at 23.7 percent in December 2008 (Social Weather Station survey). As the domestic economy recovered and food prices stabilized, hunger incidence receded to 17.5 percent in September 2009 (both moderate and severe hunger eased). However, massive flooding and landslides caused by Typhoons Ondoy and Pepeng shattered many families. Aside from the lost lives, livelihoods have been profoundly affected. Poverty and hunger incidence are both expected to increase as a result. Box 1 provides tentative estimates of the economic, social and poverty impact of typhoons Ondoy and Pepeng. As detailed in the box, typhoon Ondoy itself is estimated to have pushed an estimated 150,000 to 250,000 near-poor into poverty, causing national poverty incidence to rise by 0.1 to 0.3 percentage points, and to have dragged a significant share of the National Capital Region's poor further into poverty.

Balance of Payments and External Debt

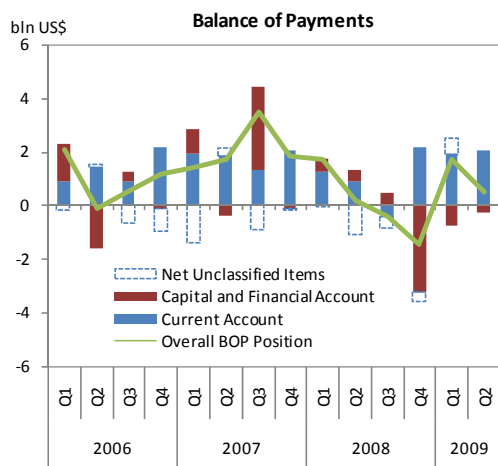
10. **Investors are reassessing Philippines' country risk, in part due to the improved balance of payments during the crisis.** The balance of payments (BoP) surplus rose by 14.6 percent year-on-year during the first six months of 2009 (to 2.9 percent of GDP from 2.3 percent in the same period last year). Larger than projected remittances, continued strong performance of the BPO sector, along with foreign direct investments (up by almost 50 percent year-on-year through June) were key drivers of the BoP's rising surplus. Gross international reserves steadily increased (partially boosted by national government deposits of funds raised from global bond market and the Asian Development Bank, and the additional SDR allocation from the IMF) throughout much of the crisis and reached a record high \$42.5 billion at end-September (covering more than seven months of imports and more than thrice the country's short-term external debt by residual maturity). That the Philippines' balance of payment and current account remain firmly positive following a series of diverse and adverse shocks over the past two years (food and fuel shocks, financial crises, global recession) testify to the country's much improved resiliency compared to pre-crisis expectations.⁵ This has led Moody's to upgrade the country's foreign and local currency government ratings by one notch (to "Ba3" from "B1") in July.

11. **External trade is slowly recovering and prospects are improving.** Exports and imports continued to rise, in dollar terms, from their January trough (when they contracted by 40.6 percent and 34.5 percent year-on-year, respectively). The recovery in trade firmed up since May. In August, exports to the US declined by only 3.9 percent on a year-on-year basis while exports to Germany (mostly semiconductors) surged by 70 percent. As the US book-to-bill ratio finally crossing the 1.0 threshold in July (a ratio

⁵ Lessons drawn from the Asian financial crisis, in particular regarding foreign exchange exposure of corporations and banks, partly explain this newfound resiliency. However, overseas remittances and improved public finances are the two most prominent factors behind the balance of payments strength. It should be noted, however, that while the global recession proved that the Philippines was not as volatile as initially expected thanks, in part to resilient remittances, the reliance on exporting labor as a model for long term development remains an open question.

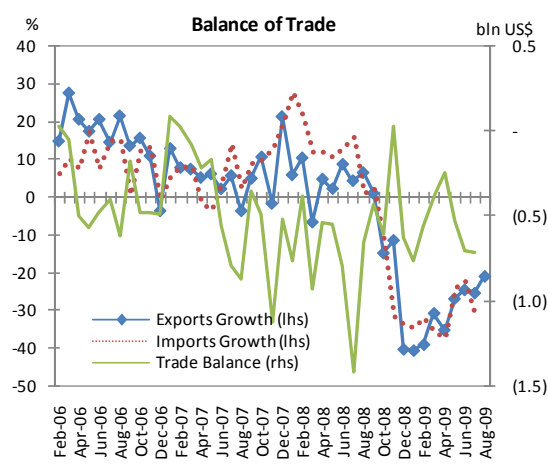
greater than 1.0 indicates an expansion), the rebound in exports seems on firmer ground (driven by a recovery in developed countries rather than seasonal restocking of inventories in preparation for the fourth quarter when demand cyclically surges). Through July, the trade deficit, on account of the rapid drop in imports, was significantly lower at US\$3.9 billion compared to the US\$5.4 billion in the same period last year. The drop in imports reflects both the impact of a slowing domestic economy, a global recession—leading to less import for re-export (especially in the electronics and semi-conductor sectors)—and lower commodity prices (especially oil).

Figure 9. Philippines: A resilient current account surplus



Source: Bangko Sentral ng Pilipinas

Figure 10. Philippines: External trade is slowly recovering



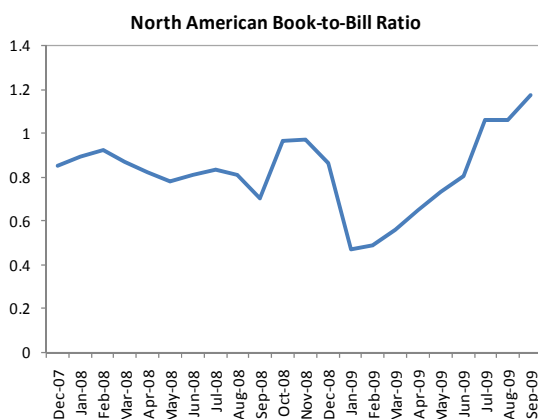
Source: National Statistics Office

12. **The remarkable resiliency of remittance flows to the Philippines contributed to the country’s good performance during the global recession.** While monthly remittance flows have decelerated sharply in 2009 from the double digit growth in US dollar terms, they continued to grow in early 2009 and even accelerated to 9.3 percent year-on-year in July before slowing back to 2.8 percent in August. However, in real peso terms they actually rose by 12.1 percent for the first eight months of 2009, against a 2.9 percent contraction in the same period of 2008 (Figure 12). Strong deployment of workers overseas in 2008, extensive diversification of the overseas Filipino workers—be it in terms of geographic location, skills, gender, and sectors of activity—and wider access to remittance services from financial institutions help explain the resiliency of remittances during the global crisis. The global recession, however, increased precautionary savings among remittance recipients (40 percent of recipient households saved some of the money in third quarter 2009, against 30 percent in third quarter 2008, according to a BSP survey). This increased savings propensity partly explain the contraction in consumption witnessed in first quarter 2009 (the first contraction, on a quarter-on-quarter basis, in over twenty years).

13. **Decreasing external debt and rising foreign exchange reserves provide the country with a significant buffer against short-term shocks.** From \$52.5 billion in March, the country’s external debt stock continued to decline to \$51.8 billion in June

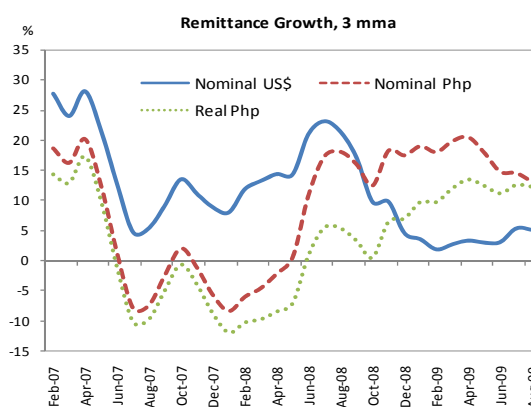
brought by large net debt repayments of banks and monetary authorities of short-term loans. These were more than enough to offset the impact of effects of the appreciation of “third currencies” against the US dollar and the increase of debt from other non-banking system institutions. With pressing need to fund the ballooning fiscal deficit, the external debt of the government rose by another \$600 million. Foreign debt of the corporate sector, buoyed by the surge in trade credits as well as long-term bonds, increased by a sum of \$65 million. The structure of external debt improved, with only 11 percent due in the short term. Gross international reserves cover three times these short-term (residual) maturities.

Figure 11. Electronic exports are recovering.



Source: North American Semiconductor Equipment Industry

Figure 12. Countercyclical remittance inflow in real peso terms



Source: Bangko Sentral ng Pilipinas

Financial Markets and Corporate Sector

14. **Financial markets are roaring ahead, not unlike the increases seen before the crisis.** Renewed confidence led to repricing of equities on the Philippines Stock Exchange (PSE) even with modest inflows of new funds from nonresidents. Equity prices have almost recovered the ground lost after the collapse of Lehman Brothers, with the PSE index now up to about 3,000, its level in early September, up from a trough of 1,704 in mid-September. As the global recovery is firming up and prospects for the Philippine economy improve, the PSE is surging at rates last seen in the heydays of the global boom when global liquidity was abundant. One year on, the extraordinary amount of liquidity injected by global central banks—mainly through unprecedented amount of quantitative easing—and the stabilization of the global economy have renewed the strong appetite towards emerging markets.

15. **The corporate sector witnessed improved profitability but SMEs and export-oriented companies are still reeling from the crisis, even with the worst being over.** As of the first half of the year, aggregate core profits of listed companies increased by 11 percent. Meanwhile, banks have recently turned around losses experienced during the last quarter of 2008, thanks to a strong rebound in financial markets (the stock market and government securities in particular), continued inflow of remittances, and large lending

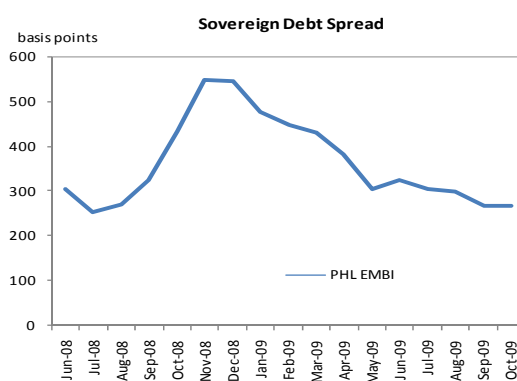
spreads thanks to aggressive policy rate cuts from the BSP (followed by partial and delayed reduction in lending rates from the banks—Figure 20). Consensus profit forecast for PSE listed companies is to increase by 10-15 percent for 2009 and by 20 percent for 2010. Listed companies are, however, not representative of the corporate sector in the country as the Philippines Stock Exchange (PSE) index hardly contains any exporters and manufacturers. Non-PSE companies, and in particular SMEs, have been the most hit by the global recession and, despite reporting improved sales and prospects compared to early 2009, they remain cautious regarding the strength of the recovery (Box 2).

Figure 13. The Global Financial Crisis is History according to the PSE.



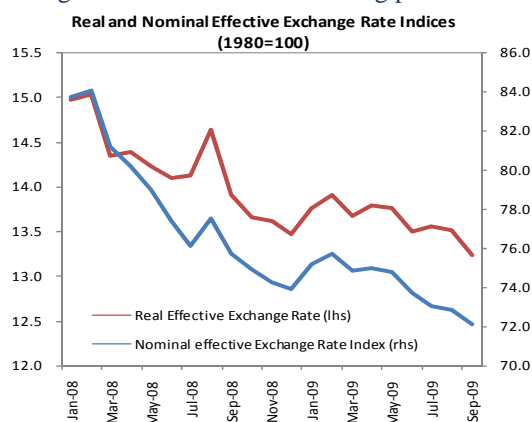
Source: CEIC database

Figure 14. Debt spreads have decreased to pre-September levels.



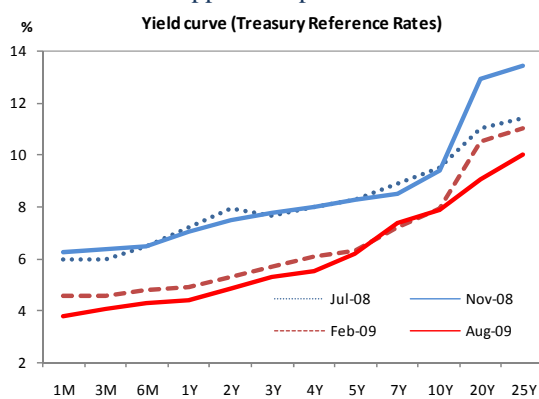
Source: Bangko Sentral ng Pilipinas, CEIC database

Figure 15. The Peso has continued to depreciate against the currencies of trading partners 1/



Source: Bangko Sentral ng Pilipinas
1/ Against major trading partners (US, Japan, European Monetary Union, United Kingdom).

Figure 16. The yield curve has shifted down as risk appetite improved



Source: Philippine Dealing and Exchange Corporation

16. During the downturn, many domestically-owned companies restructured their businesses away from tradable, export-oriented activities into non-tradables.

The food conglomerate San Miguel Corporation is one example⁶ of such a shift, but several other Taipans (family-owned conglomerates) also undertook such a restructuring. This restructuring is partly opportunistic—since the global financial crisis and recession led to several large asset disposal operations from companies seeking liquidity and to deleverage—but could reflect a deeper structural comparative advantage shift: in light of the difficulties to doing business, poor governance and the regulatory capture, Philippine companies may be at a comparative disadvantage to compete with global firms in international markets. However, large domestically-owned companies find they do have a comparative advantage over international competitors to work in regulated areas in the Philippines. These regulated sectors often have guaranteed margins.

17. While the Peso strengthened against the US dollar, it has continued to depreciate against a basket of trading partners' currencies. With decreasing risk aversion in emerging markets, the Peso has appreciated against the US dollar and reached a one-year high in early October of 46.33. However, the relative strength of other currencies (the Yen and the Euro in particular) meant that the peso continued to depreciate in effective (trade-weighted) terms (Figure 15). In the year through September, the Peso depreciated by 3 and 1 percent in nominal and real terms, respectively.

Policies

Monetary Policy

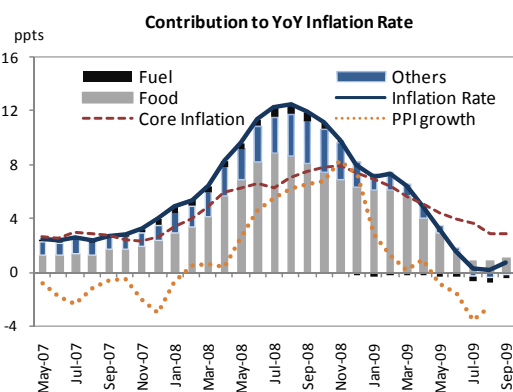
18. As expected, disinflation bottomed out in August, and prices started rising again in September compared to a year earlier—Figure 17. Following the food and oil crisis that peaked in August last year, fuel price increases started to recede from its August 2008 peak of 29 percent and has posted negative inflation since December this year due to the global recession. Food price increases also eventually tapered off mainly because rice prices declined precipitously (Figure 20). As a result, rapid disinflation unfolded in the last twelve months (the monthly inflation rate eased by an average of one percentage point since September 2008). However, as the base effect fades and upward price pressures start to build up with the recovery, the inflation rate rose to 0.7 percent in September from a 22-year low rate of 0.1 percent in August. In the year through September, the CPI inflation rate stood at 3.4 percent, within the central banks inflation

⁶ In 2009, San Miguel Corporations sold several of its traditional activities, including its beer business to Kirin; SMC also issued a (Philippine record) P38 billion bond. With the cash raised, SMC undertook an aggressive strategic transformation program to diversify from its core food, beverage and packaging portfolio, and entered into industries (or is planning to) such as power generation, oil refining, telecoms, water distribution, tollways, and infrastructure (e.g., SMC invested in Manila Electric Co. (Meralco), the country's largest power distributor; it has also signed an option agreement to acquire 100 percent of Sea Refinery Corp., which holds 50.1 percent of the Philippines' largest oil refiner (Petron); SMC also acquired 32.7 percent of Liberty Telecommunications Holdings, Inc. SMC also submitted an unsolicited proposal for the government's Laiban Dam project; finally, in August, San Miguel entered into a non-binding agreement to acquire 35 percent in Private Infrastructure Development Corp., the consortium behind the 88.57-kilometer Tarlac-Pangasinan-La Union Toll Expressway project (Source: SMC's website).

target of 2.5-4.5 percent. A large and positive output gap opened up since 2007 would ensure that core inflation remains subdued in the short- to medium-term.

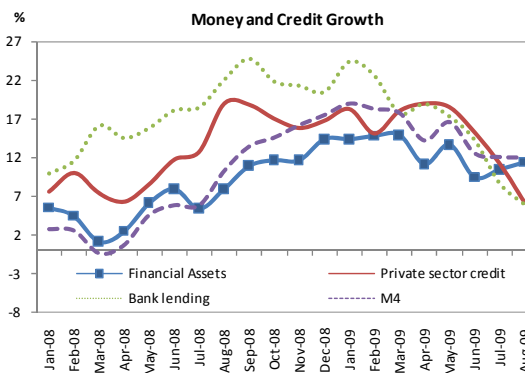
19. **With growth recovering and inflation normalizing, the central bank has kept policy rates unchanged since August.** After easing by a cumulative 200 basis points since December last year, the central bank ended the easing cycle by keeping policy rates unchanged since August. The impact of the easing cycle is, however, expected to continue for the next few months given the policy lag. However, with bank lending rates having only partly matched the BSP rate cuts—lower by only 127 basis points—and with the lending rate cuts broadly stopping in April, the actual easing for the economy has been significantly lower and stopped relatively rapidly (Figure 20).

Figure 17. Inflation troughed as the fuel and food price shocks disappeared, core remains subdued



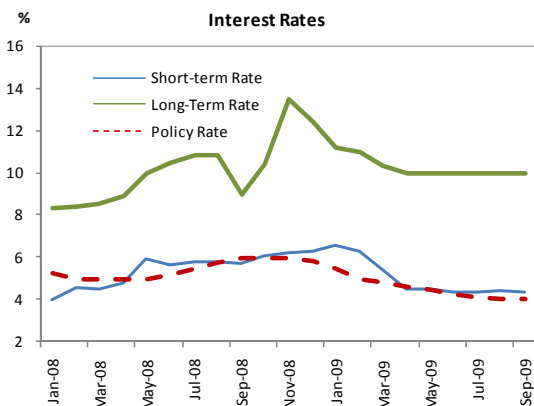
Source: National Statistics Office

Figure 18. Private credit and bank lending growth are fading but financial assets keep growing



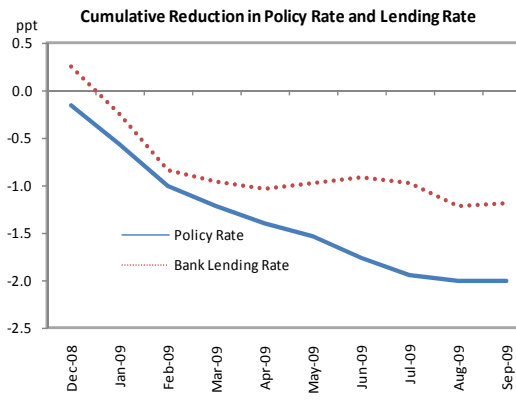
Source: Bangko Sentral ng Pilipinas

Figure 19. Long-short term rate spreads have widened



Source: Bangko Sentral ng Pilipinas

Figure 20. Philippines: BSP's rate cut were initially broadly matched by the banks till April



Source: Bangko Sentral ng Pilipinas

20. **Total outstanding loans have slowed down noticeably.** Growth of outstanding universal and commercial bank loans (net of placements in the central bank) is slowing rapidly (5.9 percent year-on-year growth in August, compared to 8.7 percent July and

double digit expansion since February 2008—Figure 18), while financial assets growth remains robust. Although bank lending, as a share of GDP, remains low in the Philippines by regional standards, banks have significantly tightened their lending, both in terms of quantity and price as indicated by widening margins on loans and collateral, tightening lending standards, and shortening maturities on credit. Banks have placed a large share of their assets in special deposit accounts at the central bank.

Fiscal Policy

21. **The Government’s fiscal stimulus package has started to sustain growth and protect vulnerable groups.** The actual front-loading of the expenditure part of the Economic Resiliency Plan (ERP) into the first half of 2009 has exceeded expectations: implementation capacity had prevented a rapid ramp up of spending in the past, not least in early 2008 during the food and fuel crisis. Not so this time: total budget spending through September grew by 15.4 percent compared to the same 2008 period, while primary (i.e., non-interest) spending, on a GFS basis, increased by 20.6 percent. Through August, capital spending, a core part of the ERP, rose at a staggering 45.5 percent annual rate. As a ratio of GDP, total spending as of the third quarter grew by 1.3 percent of (annual) GDP compared to first nine months of 2008 (Table 1). At the same time, tax collection continues to underperform, with the tax effort shrinking by 1.2 percent of GDP to 9.4 percent in the first nine months of 2009—Table 1). As a result, the overall fiscal deficit grew from 1.0 percent of (annual) GDP in September 2008 to 3.2 percent of (annual) GDP in September 2009 (GFS basis).

22. **Tax collection performance continued to deteriorate in September; most of the reduced tax effort is estimated to be of a structural, rather than cyclical, nature.** As in all previous months this year, tax collection continued to contract (by 8.5 in nominal terms of September, from 17.4 percent August on a year-on-year basis). In August, the magnitude of the contraction far outpaced that observed in previous months and stemmed mainly from Bureau of Customs’ collection (-28.5 percent) but also from the drop in BIR tax collection (-14.4percent). In September, the pace of the decline went back to its original pace in the previous months as BIR collection grew by 1 percent partially offsetting the sustained steep drop in BOC collection. As a result, the tax effort slumped by 0.3 percent and 0.1percent of annual GDP in August and September, bringing the YTD decline in the tax effort to 1.2 percent of GDP (Table 1). It is estimated, conservatively, that out of this 1.2 percent of GDP in lower tax effort, 0.7 percent of GDP stems from permanent tax cuts and base eroding measures (e.g., the cut in the corporate income tax by 5 points to 30 percent, the lower personal income tax base due to the increase in the PIT threshold (RA9504) and the PERA law (RA 9505), the erosion of the VAT base due to the removal of VAT on electricity transmission). The remaining 0.5 percent of GDP in lower tax effort is due to a combination of a cyclical weakness in the

economy, and worsening voluntary tax compliance (a common feature during economic downturns when tax administration is weak to start with⁷).

Table 1. Philippines: National Government Cash Accounts (GFS Basis), 2006-2010

| | 2006 | 2007 | 2008 | | | 2009 | | | | 2010 | |
|--|------|------|---------|---------|------|---------|---------|--------|----------|--------|----------|
| | Act | Act | Jan-Aug | Jan-Sep | FY | Jan-Aug | Jan-Sep | Budget | WB Proj. | Budget | WB Proj. |
| (in percent of GDP) | | | | | | | | | | | |
| Revenue and grant | 16.1 | 15.7 | 10.5 | 11.8 | 15.8 | 9.5 | 10.8 | 15.6 | 14.6 | 15.9 | 15.1 |
| Tax revenue ^{1/} | 14.3 | 14.0 | 9.5 | 10.6 | 14.1 | 8.5 | 9.4 | 14.0 | 12.8 | 14.3 | 13.3 |
| Nontax revenue ^{2/} | 1.9 | 1.7 | 1.0 | 1.1 | 1.6 | 1.1 | 1.4 | 1.6 | 1.8 | 1.5 | 1.8 |
| Total expenditure ^{3/} | 17.5 | 17.4 | 11.2 | 12.7 | 17.3 | 12.4 | 14.1 | 19.4 | 18.4 | 19.0 | 18.2 |
| Current Expenditures | 15.2 | 14.4 | 9.4 | 10.6 | 14.1 | 9.9 | .. | 15.7 | 15.2 | 15.6 | 15.3 |
| Personal services | 5.4 | 5.3 | 3.1 | 3.5 | 5.0 | 3.3 | .. | 5.6 | 5.4 | 6.1 | 5.8 |
| MOOE | 1.7 | 1.9 | 1.2 | 1.3 | 1.9 | 1.4 | .. | 2.5 | 2.1 | 2.1 | 2.0 |
| Allotment to LGUs | 2.3 | 2.2 | 1.5 | 1.7 | 2.3 | 1.8 | .. | 2.6 | 2.6 | 2.6 | 2.6 |
| Subsidies | 0.2 | 0.3 | 0.1 | 0.1 | 0.2 | 0.2 | .. | 0.1 | 0.3 | 0.2 | 0.2 |
| Tax expenditures | 0.3 | 0.5 | 0.5 | 0.6 | 0.8 | 0.5 | .. | 0.7 | 0.8 | 0.5 | 0.5 |
| Interest payment | 5.3 | 4.1 | 2.9 | 3.3 | 3.9 | 2.8 | 3.2 | 4.2 | 3.9 | 4.3 | 4.1 |
| Capital Outlays | 2.3 | 2.9 | 1.7 | 2.0 | 3.0 | 2.4 | .. | 3.6 | 3.1 | 3.2 | 2.8 |
| Net lending | 0.0 | 0.1 | 0.1 | 0.1 | 0.2 | 0.1 | 0.1 | 0.2 | 0.2 | 0.2 | 0.2 |
| Balance (GFS definition) | -1.4 | -1.7 | -0.7 | -1.0 | -1.5 | -2.9 | -3.2 | -3.8 | -3.8 | -3.2 | -3.1 |
| Balance (Government definition) | -1.1 | -0.2 | -0.2 | -0.7 | -0.9 | -2.7 | -3.1 | -3.2 | -3.2 | -2.8 | -2.8 |
| Primary Balance (GFS) | 4.0 | 2.5 | 2.1 | 2.3 | 2.3 | -0.1 | 0.0 | 0.4 | 0.1 | 1.1 | 1.0 |
| <i>Memorandum Items</i> | | | | | | | | | | | |
| Privatization receipts (PHP billions) | 5.8 | 90.6 | 7.5 | 7.6 | 31.3 | 0.8 | 1.1 | 30.0 | 30.0 | 12.5 | 12.5 |
| CB-BOL interest payments (% of GDP) | 0.2 | 0.1 | 0.1 | 0.2 | 0.2 | 0.1 | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 |
| National Government Debt ^{4/} | 63.9 | 55.8 | .. | .. | 56.7 | .. | .. | .. | 59.6 | .. | 59.4 |
| Nominal GDP (PHP billions) ^{5/} | 6031 | 6647 | 7423 | 7423 | 7423 | 7745 | 7745 | 7745 | 7745 | 8337 | 8344 |

Source: Department of Finance, Bureau of Treasury, and Department of Budget and Management.

1/ Includes document stamp tax and tax expenditures. For 2009, the projections do not factor the negative impact of the typhoons, given the limited information to date.

2/ Excludes privatization receipts (these are treated as financing items, in accordance with GFSM)

3/ Data from the Department of Budget and Management; Allocation to Local Government Units excludes capital transfers to LGUs

4/As defined by the Bureau of Treasury.

5/ Nominal GDP for 2009 and 2010 are World Bank staff projections.

23. Increased spending through August is mostly discretionary, though a structural increase in the wage bill further reduces budget flexibility. Of the 1.3 percent of GDP in higher primary spending, 0.9 percentage points are discretionary and mostly linked to the ERP, 0.2 percentage points consist of automatic fiscal stabilizers (transfers to LGUs that are formula-set based on revenue collection three years ago), and 0.2 percentage points of structural increase in the wage bill related to the Salary Standardization law which aims to decompress the public sector wage grid from the top.

24. While the expenditure part of the ERP is broadly on track, the shortfall in revenues is significantly altering the composition and effectiveness of the stimulus. As envisaged in our previous Quarterly Updates, the large shortfall in revenue collection compared to budget, is significantly altering the composition of the fiscal stimulus. While the design of the ERP allocated only 20 percent of the budgetary part of the fiscal

⁷ Brondolo, J., 2009, "Collecting Taxes During An Economic Crisis: Challenges and Policy Options", *IMF Staff Position Note* No. 09/17, Washington DC, June.

stimulus package to tax cuts,⁸ the split between revenue decreases and expenditure increases is 45/55, respectively. As tax cuts generally have a limited expansionary impact (low fiscal multiplier) but result in a sharp increase in the fiscal deficit, the net benefit from the more expansionary fiscal policy than budgeted is unclear.

25. **As appetite for risk returns, and domestic liquidity remains good, financing needs are met at reasonable costs but at the expense of rising risks.** Thanks to a series of successful global bond issuances in 2009 (\$1.5 billion, \$750 million, and \$1 billion in January, July and October respectively) and successful funding from bilateral and multilateral development partners, the government has been able to finance its growing external needs rapidly and at reasonable cost. However, on the domestic side, as the Treasury deemed the price asked by markets to be too high, bond auctions have been frequently cancelled; this has resulted in a rapid drawdown of Treasury deposits. A successful (peso) retail bond offering in September helped replenish some of the cash buffer. The share of foreign debt has risen noticeably since 2008, which increases foreign exchange risk.

PROSPECTS

External Environment

26. **The global economy is recovering thanks to large fiscal and monetary stimuli across developed and emerging market economies, and because of a shift toward inventory accumulation.** Following a 6.5 percent contraction in the first quarter, the world economy is estimated to have rebounded by 3 percent during the second quarter on account of strong expansionary policies across the globe. This helped prop up demand, reduce uncertainty and restore confidence especially in financial markets. As a result, the IMF is now projecting world output to contract by 1.1 percent in 2009, 0.3 percentage points less than earlier forecasts (Table 2).

27. **The recovery is expected to be sluggish.** In the near-term, the build-up of inventories after a sharp de-stocking at the height of the crisis should eventually slow down and put downward pressure on demand. Narrowing fiscal space would also put a limit on the fiscal stimulus as a source of growth. Countries which suffered from the collapse of asset prices are more likely to have high savings rates.

28. **Commodity prices will continue to rebound for the rest of 2009 and may exert inflationary pressure in 2010, depending on the strength of the recovery.** Commodity prices rallied in the second quarter, reflecting a general feeling that the recession has bottomed out, and there is increasing confidence that public intervention has greatly reduced the probability of another systemic financial sector meltdown (IMF WEO, October 2009). Stronger expansion by emerging and developing economies in 2010 will increase demand for commodities and prices.

⁸ Tax cuts amounted to P40 billion out of the P200 billion budgetary part of the ERP package (another P130 billion in expenditure measures was off budget).

Table 2. World Economic Outlook, 2007-2010

| | 2007 | 2008 | 2009 | 2010 |
|---|---|------|-------|-------|
| | Act. | Act. | Proj. | Proj. |
| | (Percent Change unless otherwise noted) | | | |
| World output | 5.2 | 3.0 | -1.1 | 3.1 |
| Advanced economies | 2.7 | 0.6 | -3.4 | 1.3 |
| United States | 2.1 | 0.4 | -2.7 | 1.5 |
| Euro area | 2.7 | 0.7 | -4.2 | 0.3 |
| Emerging and developing economies | 8.3 | 6.0 | 1.7 | 5.1 |
| Developing Asia | 10.6 | 7.6 | 6.2 | 7.3 |
| China | 13.0 | 9.0 | 8.5 | 9.0 |
| World trade volume (goods and services) | 7.3 | 3.0 | -11.9 | 2.5 |

Source: IMF World Economic Outlook, October 2009.

Output and Demand

We are raising our GDP growth forecast to 1.4 percent for 2009 and 3.1 percent for 2010 (Table 3). The key drivers of our upward revisions are (1) better-than-expected remittance inflows—with remittances now projected to increase by 4 percent in 2009 and 5 percent in 2010—(2) a stronger-than-anticipated recovery in the second quarter of 2009 (the quarter-on-quarter recovery in growth noticeably exceeded those witnessed in past crisis); (3) a stronger fiscal impulse in both 2009 and 2010; and (4) an upward revision in the global outlook. In particular:

- **Strong countercyclical remittances in real peso terms and improving labor market outlook are projected to buoy consumption.** As the economy weakened in 2009, the real value of peso remittances surged (by about 8 percent compared to 0.3 percent in 2008) and is projected to continue doing so for the rest of the year (though for different motives; robust remittance inflows in the fourth quarter will mostly reflect the impact of typhoons Ondoy and Pepeng). As remittances account for a large large of disposable income, especially of the middle and upper income households,⁹ private consumption is expected to remain buoyant (growing by 2.1 percent in 2009). Notwithstanding the continued weakness in the labor market, prospects are improving (e.g., for the first time since the third quarter of 2008, the number of optimists in a central bank survey of businessmen outnumbered the number of pessimists).
- **Fiscal policy is projected to continue to bolster growth, albeit at a slower pace.** For the remaining months of 2009, government consumption and public construction will continue to benefit from the National Government’s primary spending (about 5 percent of annual GDP, in nominal terms). Adding impetus to this is the need to rehabilitate the damages to public infrastructure following the recent typhoons.

⁹ 11.5 percent on average in the 2006 FIES household survey, but this is expected to have grown significantly higher in 2009 as other income sources (especially wages) have been under pressure in 2009. The average also masks strong income inequality in remittance receipts, with the richer households receiving a larger share of their income from overseas remittances (Figure 22).

- **Investments are projected to lag the economic recovery as spare capacity remains and the robustness of final consumer demand remains uncertain.** Real estate construction activity is projected to remain soft throughout 2010 as oversupply across all market segments (office, retail, and residential) affects the industry. While the oversupply is limited compared to that experienced in the aftermath of the Asian Financial crisis, it will nonetheless continued to drag the sector’s short-term growth prospects, but medium-term prospects remain favorable. Foreign direct investments (FDI) are also expected to be lagging the economic recovery, given overall global overcapacity in most sectors. Recent data on the country’s worsening ranking in competitiveness¹⁰ confirm that the structural impediments to FDI have not improved during the economic slowdown. The low level of FDI is, therefore, projected to persist until structural competitiveness issues are forcefully tackled.

29. Post-crisis potential growth is projected to remain below that prevailing during the global boom period. The post-global recession external environment facing developing countries is likely to be less favorable than before. While the Philippine was less affected by both the global financial crisis and the global recession, part of the reasons for this relative good performance can, paradoxically, be traced to structural weaknesses that have led to subdued growth on average.¹¹ This subdued growth stems from a low level of physical capital accumulation and comparatively slow structural transformation from low-productivity to high-productivity activities (World Bank, 2009¹²). The structural weaknesses include inadequate infrastructure, particularly in transport and energy, a weak investment climate due largely to governance concerns, and historically weak public finances. Reforms in these areas have remained pending for a long time and it is difficult to envision a sustained resumption of economic growth without major improvements on all three fronts. Beyond the outstanding structural agenda, the following cyclical factors also point to reduced growth potential:

- **A reduction in global imbalances would likely dampen demand for exports, including overseas Filipino labor (and the associated remittances).** The projected slow increase in Philippine exports reflect (1) the projected slow expansion in world trade volume in 2010, and (2) limited prospects for international market share gains. While overseas demand for Filipino labor in healthcare and other basic services is not projected to remain strong, adjustments in the global economy could result in lower demand in some sectors (e.g., Filipino seafarers would be affected by the slow growth in world trade volume) and the projected continuation of high unemployment in advanced economies.
- **An unwinding of expansionary policies is expected as the economy recovers.** Monetary easing is projected to have run its course and, after a period of stabilization is projected to slowly tighten from 2010 onwards. The large fiscal expansion of 2009

¹⁰ For example, “Ease of Doing Business” and IMF’s October 2009 World Economic Outlook ranking.

¹¹ From 1960 to 2008, while East Asian economies grew at annual rates of between 3.6 and 6 percent in per capita terms, the Philippines only managed to grow at an average rate of 1.4 percent over this period.

¹² World Bank, 2009, *Philippines: Fostering Inclusive Growth*, forthcoming.

is also projected to be followed by a period of paced fiscal consolidation, starting in 2010.

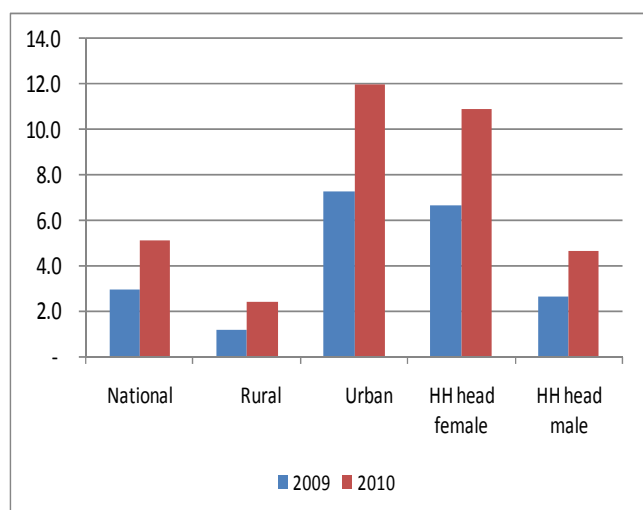
- While a stronger-than-expected global recovery provides upside growth potential, it may also induce spikes in oil and rice commodity prices which would have negative economic but also social consequences.

Employment and Poverty

30. Pressure on job creation may arise as the government unwinds its fiscal stimulus program. With the narrowing fiscal space, concern on the sustainability of public spending will eventually call for a reduction in spending. As job creation is largely driven by government spending (e.g., the CLEEP program), unemployment may rise with the weakening of public spending. Election-related spending may create additional buffer towards May 2010, especially for the informal labor sector.

31. Notwithstanding measures taken by the Philippine authorities, the global recession is projected to throw 1.4 million Filipinos into poverty by 2010. Based on a macro-micro simulation exercise for the Philippines, the poverty rate is estimated to be 0.9 and 1.5 percentage points higher in 2009 and 2010 respectively as a result of the global recession, compared to what would have been without it. The impact of the crisis on urban areas, the manufacturing and services sectors, and for female-headed households is expected to be particularly high. (Figure 21). Aside from reduced employment and labor earnings due to the slowdown in economic activity, non-labor income is also estimated to be lower due to slower overseas remittances (compared to the no-crisis scenario), both in terms of the number of households receiving and amounts received.

Figure 21. Philippines: Increase in poverty rate due to the global recession 1/ (in percent of the poverty rate without the global recession)



Source: World Bank staff estimates.

1/ Based on FIES 2006 and micro-macro simulations

Balance of Payments and External Debt

32. **Despite the weakness in external trade and foreign financing early on, the overall balance of payment is seen to be resilient through both 2009 and 2010.** Export and imports are expected to fall by a staggering 19 and 18 percent in 2009, respectively. The import contraction, in percentage terms, is of the same magnitude as the that seen in 1998 during the peak of the Asian financial crisis (-18.8 percent); at that time GDP had dropped by 5.8 percentage points, the economy was in a recession, and the peso/US dollar exchange rate had dropped by 39 percent. This sharply contracted the demand for imports but also led to a surge in exports—growth of 16.9 percent—which is in stark contrast with the sudden collapse in exports seen during this global recession. Recovery in both exports and imports, though fragile and linked with suspicions that the recent recovery is mostly driven by restocking of inventories is expected to accelerate over time as the recovery in developed countries gather pace. Indeed, given the structure of Philippines' exports (about two thirds consist of electronics and semi-conductors), the country has benefited less from the large stimulus undertaken in China—exports to China are still declining to date, with the decline even accelerating in recent months. The capital and financial account is expected to register a deficit despite the expected continued return of inflows (which resumed in the second quarter 2009). The current account is projected to be at 3.4 percent and 2.8 percent in 2009 and 2010, respectively.

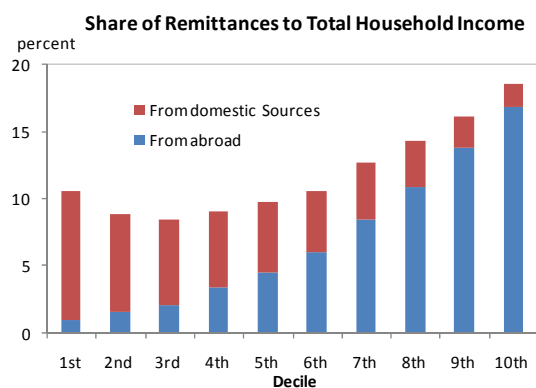
33. **Remittance growth is now projected to grow in 2009, and accelerate in 2010.** Contrary to expectations, remittances inflows have proved resilient in US dollar terms (and strongly countercyclical in real peso terms). With the global recovery gaining strength—and notwithstanding the continued weakness in global labor markets—the resiliency of remittance inflows to the country is expected to continue for 2009 (for a total year-on-year growth rate of 4 percent—though with upside potential due to the impact of the recent typhoons—see below). Moving forward, government efforts to engage in bilateral agreements that provide for more overseas employment will continue to drive more deployment of OFWs. For 2010 and in the medium term, however, subdued global growth will limit remittance growth so that it is not expected to reach its global boom levels.

34. **Typhoons Pepeng and especially Ondoy provide significant upside potential for remittance inflows in and around October 2009.** Recent research shows that remittances in the Philippines act as an insurance to households affected by natural disasters (Yang and Choi, 2007).¹³ As households affected by typhoon Ondoy constitute a large share of remittances flowing into the country, a strong increase in remittance inflows in and around the month of October is expected. Indeed, Ondoy affected metro Manila which is the region where more of overseas remittances are remitted (Figure 23) and it also affected a large amount of middle and upper middle class households—these are also strong beneficiaries of overseas remittances (Figure 22). Based on the Yang and Choi (2007) findings, an average of 60 percent of household income lost through natural disasters is replaced by remittances. Despite the strong upside potential for remittances

¹³ Yang, Dean, and HwaJung Choi, 2007, "Are Remittances Insurance? Evidence from Rainfall Shocks in the Philippines," *World Bank Economic Review*, Vol. 21(2), pp. 219-48.

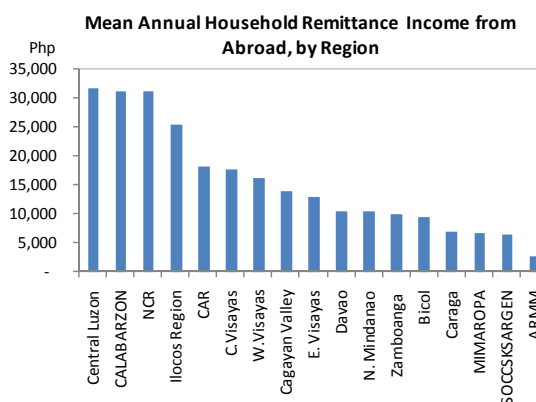
in the remaining months of 2009, the real peso value of remittances is expected to moderately slow down from the strong performance observed in the first half of 2009, as inflation has moderated (notwithstanding the moderate and localized supply shocks stemming from the typhoons) and the exchange rate has appreciated. The remittance impact on private consumption is nonetheless not expected to decrease as the marginal propensity to consume out of remittance inflows is expected to increase sharply compared to the first half of 2009 since (1) the economy is recovering so that precautionary motives are reduced, and (2) the expected temporary surge in remittances is expected to be intended and directed towards immediate reconstruction and rehabilitation needs.

Figure 22. Philippines: Overseas remittances accrue to the middle and upper income classes



Source: National Statistics Office

Figure 23. Philippines: Overseas remittances are remitted to residents of the greater Manila region



Source: National Statistics Office

Monetary Policy

35. **Inflation pressures are projected to remain subdued due to large output gaps and a slow expected pace in closing these gaps.** Despite an expected but localized increase in inflation due to typhoons Ondoy and Pepeng (Box 1), inflation is projected to average 2.9 percent in 2009, against 9.3 percent in 2008. Base effects from rapid increases in fuel and food prices in 2008 (supply shocks) as well as weak economic demand dragged down the year-to-date inflation rate to 3.4 percent in September 2009 with some uptick expected in the latter part of the year (even absent the typhoons' impact). As the global economy recovers, however, inflation is expected to stabilize at a higher level, but are projected to remain within the central bank's inflation forecast of 2.5-4.5 (3.5-5.5) percent in 2009 (2010). Risks, however, are tilted on the upside, as both fuel and food prices could spike anew as the global recovery gets on firmer ground and due to Philippine-specific supply shocks such as the forecasted drought in 2010 which may cause upward pressure on food and overall prices. Large existing output gap and a projected slow closing of the gap toward the forecast horizon limit risks.

36. **With stronger confidence in financial markets, monetary policy is projected to tighten next year.** With the policy lag of earlier easing and improving economic prospects, the central bank is likely to keep policy rates at their current level in 2009. Inflationary pressures have started to show up in early September, as base effects from the surge in prices last year fade, but inflation should be contained through 2009. Tightening of monetary policy may be possible next year when global commodity prices will increase with the global recovery especially in emerging economies.

37. **The surge in financial markets warrants vigilance from the monetary authorities, notwithstanding their limited size and depth in the Philippines.** Surging asset prices are expected to significantly complicate the conduct of monetary policy in many central banks. Indeed, this poses the need to revisit their key operational tenet during the pre-Global Financial crisis, namely that monetary policy should be solely geared toward containing consumer price inflation and not asset price inflation. As the Global Financial crisis too clearly and abruptly revealed, financial markets and asset prices (houses, stock markets) are not separated from the real economy. In the Philippines, financial sector assets are relatively low by regional standards (measured in percent of GDP).¹⁴ Furthermore, the ownership of financial assets is very limited in the population (about 2 percent for stock market shares). Nonetheless, as some asset prices have recently surged—the Philippines Stock Exchange index in particular (₱14)—the potential for exuberant behavior leading to inefficient capital allocation, bubbles and, ultimately, to damages in the real economy calls for (1) constant improvements in financial markets' regulatory and supervisory agencies, and (2) vigilant monetary policy.

Fiscal Policy

38. **The overall fiscal deficit is projected to be contained at 3.8 percent of GDP in 2009 before narrowing to 3.1 percent of GDP in 2010** on a GFS basis. While the overall deficit projections for both 2009 and 2010 are in line with that of the budget, the level and composition of both revenue and expenditure differ markedly from the budget (Table 1). On the revenue side, World Bank staff forecast the tax effort to be lower by 1.2 percent of GDP than budgeted (in line with past budget over-estimation of the tax effort¹⁵). The resulting tax effort would be the same as in 2002 (before the E-VAT

¹⁴ The Philippines ranks at the bottom of regional financial sector asset tables (measured in percent of GDP) with only Indonesia performing worse (when compared to the People's Republic of China, Hong Kong (China), Indonesia, the Republic of Korea, Malaysia, Singapore, Taipei (China) and Thailand. For example, financial sector assets of deposit taking institutions reached 78.8 percent of GDP in the Philippines in 2008, against a regional average of 267.7 percent of GDP and a median of 76.8 percent of GDP. Similar findings arise by looking at assets of non-bank financial institutions, or at the total outstanding bonds (both in percent of GDP)—ADB (2009).

¹⁵ As detailed in the Fiscal Risk Assessment chapter of the forthcoming *2009 Philippines Development Report* (World Bank, 2009), while no systematic bias in budget forecasts of the overall fiscal balance emerges over the past five years, biases do exist among its revenue and expenditure components. In particular, tax revenues were systematically (and significantly) over-estimated compared to the budget while non-tax revenues were regularly (but modestly) under-estimated. Expenditure also exhibit systematic bias. Up until 2008, actual spending has been below budgeted amounts. The under-spending mostly arose on personnel services, MOOE, and (very significantly) interest payments.

reforms). On the expenditure side, World Bank staff projects total expenditure in 2009 to be 1 percent of GDP below budget. This is projected to be achieved through a combination of postponement of non-priority discretionary spending and “savings” from systematically over-budgeted expenditures (e.g., interest rate bill). These Staff projections are motivated by two key factors, namely:

- First, the economy has avoided a recession and has showed some encouraging recovery signs so that expanding the fiscal stimulus beyond the envisaged deficit is not warranted. The Government could thus postpone some of remaining discretionary spending including in its fiscal stimulus package—though it is also expected to re-allocate some expenditure towards emergency relief and protection of households affected by typhoons Ondoy and Pepeng (see Box 1 for details of the impact of these typhoons on the Philippine economy)—these are expected to be comparatively limited for 2009 as a large share of the reconstruction work is projected to take place early in 2010.
- Second, by containing the 2009 fiscal deficit to its budget target, this would limit the withdrawal of fiscal impulse for 2010 and therefore reduce the negative contribution to GDP growth from government in 2010. Given its still relatively high public debt level, the Philippine has limited fiscal space to run large deficits over a prolonged time period. A return to fiscal balance by 2013, as aimed for by the Government, will therefore be facilitated (in terms of macro-fiscal management) the lower the 2009 fiscal deficit.

39. **The projected 2009 fiscal easing consists of one third automatic stabilizers, half structural worsening, and discretionary and temporary spending measures.** From 2008 to 2009, World Bank staff projects a 2.3 percent of GDP in fiscal easing (on a GFS basis—Table 1). The composition of that easing is as follows: (1) 0.8 percent of GDP in automatic stabilizers (mainly on tax collection and on transfers to LGUs); (2) 1.2 percent of GDP in a structural deterioration of the fiscal balance, mainly consisting of (1) the permanent tax cuts and revenue base eroding measures passed in 2008 and 2009,¹⁶ (2) a structural increase in the wage bill due to the Salary Standardization law aimed at decompressing the public sector wage ratio, and (3) higher interest rates; and (3) 0.3 percent of GDP in non-automatic, non-structural discretionary spending linked to the Economic Resiliency Plan.

40. **Large priority spending needs, high debt level, and a structural deterioration of the fiscal balance require a moratorium on tax cuts as well as structural and progressive revenue measures.** The Philippine has a low and declining level of national government investment in social sectors and infrastructure despite large needs, as revealed through poor education, health, and infrastructure indicators. Despite its remarkable progress in reducing its public debt-to-GDP ratio, the country still retain a relatively high debt level by emerging market standards. Furthermore, as shown in a stochastic debt sustainability analysis in our July 2009 Quarterly Update, risks to NG

¹⁶ See paragraph 23 for a list of key measures or the World Bank’s *Quarterly Updates* of November 2008 and January 2009 for detailed estimates of the revenue loss of these main measures.

debt are clearly on the upside. Due to the recent weakening of the structural fiscal balance, medium-term fiscal frameworks also clearly point to the limited fiscal space available to reach fiscal balance by 2013 (under realistic revenue projections) unless the tax effort structurally and noticeably improves. The potentially large Ondoy and Pepeng-related reconstruction and rehabilitation needs that could arise in 2010 makes the revenue agenda even more pressing.

41. As advocated in the Government's MTPDP, raising gasoline and diesel excises would efficiently generate revenue from the middle and upper income classes. A number of tax policy measures to increase the tax effort have already been on the agenda of Congress for years. Key among these are the improvement of the structure and rates of tobacco and alcohol excises and the rationalization of fiscal incentives.¹⁷ Both measures are supported by the Department of Finance and the versions of the bills supported by the DoF would improve both the tax effort and tax efficiency in the Philippines. Another measure which is included in the Government's latest Medium-Term Philippines Development Plan (MTPDP),¹⁸ but not yet on the legislative agenda, is to increase gasoline and diesel excises. Such a measure deserves full consideration as it has several important advantages over the other tax proposals, as detailed in our April 2009 Quarterly Update. In the meantime, the government and the appropriate legal and regulatory agencies should assess the extent to which gasoline and diesel retail pump prices reflect a fully competitive market.

42. While the country weathered the global crisis comparatively well, important challenges exist for the country to generate inclusive sustainable growth. In particular:

- Balancing the medium-term need for fiscal consolidation with the risk of a premature unwinding of the fiscal stimulus that would endanger the nascent recovery. Fiscal consolidation is needed to (1) protect and/or increase priority spending in health, education, and infrastructure;¹⁹ and (2) renew the downward trend in the debt-to-GDP ratio so as to reach levels that are less prone to create periods of fiscal stress. Appropriately, from 2009 to 2010, the Government is aiming for a moderate reduction in the overall fiscal deficit. Given the projected increase in economic growth for 2010, the cyclically-adjusted fiscal impulse from 2009 to 2010 is broadly neutral; this strikes an appropriate balance between the fiscal consolidation needs and the need to protect a nascent recovery; and
- Increasing the share of investment in the economy, especially in infrastructure. Key to achieving this objective is to improve the investment climate. A higher

¹⁷ For details on the rationale for each of these measures, see the discussions in our previous Quarterly Updates of November 2008 and January 2009.

¹⁸ http://www.neda.gov.ph/info/MTPDP/Updated_MTPDP%202004%20to%202010.pdf

¹⁹ Though PPPs are envisaged, including P100 billion in the 2009 fiscal stimulus package they are not projected to materialize before 2011 due to the May 2010 general elections and the associated ban on starting new projects ahead of the election and the likely time to have large new projects approved during the change in government

intensity of investment would raise the potential growth rate of the economy (it would also rebalance the economy away from its high consumption share—though, by boosting potential output, this would not necessarily mean reducing consumption per capita over the medium-term).

Table 3. Philippines: Selected Economic Indicators, 2007-2013

| | Actual | | | | Projections | | | | | |
|---|--------|------|------|------------------------|-------------|-------|-------|-------|-------|---------------|
| | 2006 | 2007 | 2008 | YTD 2009 ^{1/} | 2009 | 2010 | 2011 | 2012 | 2013 | |
| Growth, inflation and unemployment (percent) | | | | | | | | | | |
| Gross domestic product | 5.3 | 7.1 | 3.8 | 1.0 | 1.4 | 3.1 | 4.0 | 4.3 | 4.5 | ^{5/} |
| Inflation (period average); 2000 base year | 6.2 | 2.8 | 9.3 | 3.4 | 2.9 | 4.5 | 4.0 | 4.0 | 4.0 | ^{6/} |
| Savings and investment | | | | | | | | | | |
| Gross national savings | 19.1 | 20.3 | 17.8 | 20.9 | 17.0 | 16.6 | 16.4 | 16.2 | 16.3 | ^{5/} |
| Gross domestic investment | 14.5 | 15.4 | 15.2 | 15.7 | 13.6 | 13.8 | 14.0 | 14.0 | 14.0 | ^{5/} |
| Public sector | | | | | | | | | | |
| National government balance (GFS basis) ^{1/} | -1.4 | -1.7 | -1.5 | -2.9 | -3.8 | -3.1 | -2.7 | -2.6 | -2.4 | ^{7/} |
| National government balance ^{2/} | -1.1 | -0.2 | -0.9 | -2.7 | -3.2 | -2.9 | -2.4 | -2.3 | -2.1 | ^{7/} |
| Total revenue ^{2/} | 16.2 | 17.1 | 16.2 | 9.5 | 15.0 | 15.2 | 15.3 | 15.2 | 15.0 | ^{7/} |
| Tax revenue ^{2/} | 14.3 | 14.0 | 14.1 | 8.5 | 12.8 | 13.3 | 13.6 | 13.6 | 13.6 | ^{7/} |
| Total spending ^{2/} | 17.3 | 17.3 | 17.1 | 12.3 | 18.2 | 18.0 | 17.7 | 17.4 | 17.1 | ^{7/} |
| National government debt | 63.9 | 55.8 | 56.9 | 54.5 | 59.6 | 59.4 | 59.2 | 59.1 | 58.5 | ^{8/} |
| Consolidated non-financial public sector balance | 0.2 | 0.7 | 0.4 | ... | -2.1 | -2.0 | -0.9 | 0.1 | 0.5 | |
| Consolidated non-financial public sector debt | 73.9 | 61.1 | 60.0 | ... | 62.0 | 61.8 | 61.0 | 60.5 | 60.1 | |
| Balance of payments | | | | | | | | | | |
| Merchandise exports | 15.6 | 6.4 | -2.6 | -30.3 | -19.0 | 3.0 | 5.1 | 5.5 | 5.8 | ^{7/} |
| Merchandise imports | 10.9 | 8.7 | 5.0 | -30.8 | -18.0 | 6.5 | 7.0 | 7.0 | 7.0 | ^{7/} |
| Remittances (expressed in US\$) | 19.4 | 13.2 | 13.7 | 3.7 | 4.0 | 5.5 | 8.0 | 9.0 | 9.5 | ^{7/} |
| Current account balance (percent of annual GDP) | 4.5 | 4.9 | 2.5 | 5.2 | 3.4 | 2.8 | 2.3 | 2.2 | 2.3 | ^{5/} |
| FDI (billions of dollars) | 2.8 | -0.6 | 1.3 | 0.8 | 0.4 | 0.5 | 0.6 | 0.8 | 0.9 | ^{5/} |
| Portfolio Investment (billions of dollars) | 3.0 | 4.6 | -2.6 | 0.4 | 0.1 | 0.5 | 0.7 | 0.7 | 0.7 | ^{5/} |
| International reserves | | | | | | | | | | |
| Gross official reserves ^{3/} | 23.0 | 33.8 | 37.6 | 42.5 | 42.3 | 44.2 | 45.1 | 46.7 | 48.0 | ^{6/} |
| Gross official reserves (months of imports) | 4.2 | 5.7 | 6.0 | 7.8 | 7.7 | 7.6 | 7.3 | 7.0 | 6.7 | ^{7/} |
| External debt | | | | | | | | | | |
| Total (billions of dollars) ^{4/} | 51.29 | 45.8 | 38.9 | ... | 42.5 | 41.0 | 39.2 | 37.8 | 35.7 | |
| Sovereign Spreads (EMBI plus, in basis points) | 154.0 | 206 | 325 | 357.0 | 340.0 | 350.0 | 350.0 | 350.0 | 350.0 | ^{6/} |

Source: Government of the Philippines, World Bank

1/ Excludes privatization receipts (these are treated as financing items, in accordance with GFSM) and includes CB-BOL restructuring revenues and expenditures

2/ Government definition

3/ Includes gold

4/ Worldbank definition

5/ YTD for 2009 is as of June

6/ YTD for 2009 is as of September

7/ YTD for 2009 is as of August

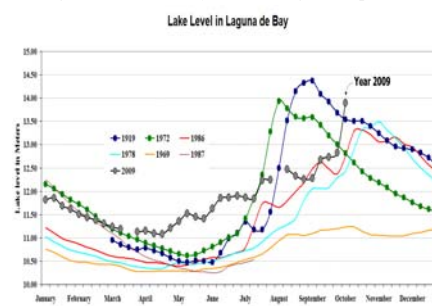
8/ YTD for 2009 is as of July

Box 1. Economic and Social Impact of Typhoons Ondoy (Ketsana) and Pepeng (Parma)

The Philippines is one of the most disaster prone countries in the world. The 2009 Mortality Risk Index of the United Nations' International Strategy for Disaster Reduction (UNISDR) ranks the Philippines as 12th among 200 countries most at risk from tropical cyclones, floods, earthquakes and landslides (with the country particularly exposed to each of these risks, and also to volcanic eruptions). Figures from the National Disaster Coordinating Council (NDCC) reveal that between 1990 and 2006, the country incurred an average annual direct damage to agriculture, infrastructure, and private property of around P19.7 billion (in real 2005 prices), or about 0.5 percent of GDP. An average of 1,009 lives is lost every year, with typhoons accounting for 74 percent of the fatalities, 62 percent of the total damages, and 70 percent of the agricultural damages. An average of 20 typhoons hit the country every year, five of which cause serious damages.

Within a week in September and October 2009, the Luzon region of the Philippines was hit by two severe typhoons. On September 26, 2009 typhoon Ondoy (international name Ketsana) brought a record-high deluge of rainfall in Metro Manila and nearby provinces causing massive floods (the worst in over 40 years).^{1/} The unprecedented amount of rain caused dam reservoirs to fill up (e.g., Laguna Lake which borders metro Manila; in two days, the lake's elevation increased by 1.2 meter causing the lake's already high volume of water to jump from 4.1 to 5.3 billion m³ so that excess volume reached about 2.5 billion m³—text Figure 1). To prevent the pressure of water from breaking the dams, water had to be released, swelling the rivers downstream and causing them to overflow their banks and flood surrounding areas. Shantytowns located on these banks aggravated the flooding as they encroached on river and canal flows and their garbage choked off pumping stations.^{2/} A few days later, on October 3, typhoon Pepeng (international name Parma)—a category 5 (most powerful) typhoon—hit the northern part of the Philippines, causing extensive damages and floods. Pepeng left the shores of the country for 5 days but then turned back to hit northern Luzon again, making a total of three landfalls. One month after Ondoy, 21 municipalities remained flooded with water of at least 50cm. Bankoff (2003)^{3/} provides an historical account of floods in Manila and the reasons for natural hazards to turn into non-natural disasters.

Text Figure 1. One Century of Lake Laguna Depth Data



Source: Laguna Lake Development Authority

At the request of the Government of the Philippines, the World Bank, in collaboration with other development partners and government agencies, is preparing a Post-Disaster Needs Assessment (PDNA). The PDNA will assess the extent of damages from these typhoons and prepare the ground for reconstruction. The assessment will, in particular, look at the post-disaster needs of the social, productive and infrastructure sectors, among others. Preliminary findings from this comprehensive quantitative assessment are expected by mid-November. Pending (and independent of) the PDNA findings, an indicative economic and social impact of typhoons Ondoy and Pepeng is as follows:

Social:

- **As of October 20 2009, the flood had left at least 902 people dead, and affected about 8.7 million people, of which 1.5 million were displaced either in camps or with relatives.**^{4/} While the two typhoons hit very different parts of the country, with Ondoy devastating the densely populated greater Manila region and Pepeng affecting the mostly agricultural northern Luzon region, the affected population is similar among the two typhoons (464 and 438 death from Ondoy and Pepeng, respectively, and 4.3 million and 4.4 million affected people from Ondoy and Pepeng, respectively). 561 evacuation camps were set up in the aftermath of the typhoon Ondoy, providing accommodation for about half a million people during the peak of the crisis. Properties (i.e., houses, roads, bridges and cars) were severely damaged.
- **Ondoy is expected to worsen urban poverty and the urban poverty gap could rise noticeably; Pepeng would mostly affect rural poverty (its incidence, gap and severity).**
 - *Large and consecutive negative shocks hit the poor and near poor over the past two years.* These include the 2008 food price shock and this year's slowing economy that weakened job quality and quantity. Given this series of large and consecutive shocks, the near poor that were hit by Ondoy and Pepeng had likely exhausted most of the small safety nets they could have had at the beginning of 2008. The floods and landslides likely washed away whatever assets remained.
 - *The urban poor and near poor have been disproportionately affected by the Ondoy-related floods* as many large slums, makeshift dwellings, and lower priced houses were along the river banks, canals and *esteros*. 3.4 million poor and 1.9 million near poor lived in the National Capital region (NCR) and Calabarzon; two areas that have been the worst flood-affected (2006 FIES data). For each 10 percent of these near poor falling into poverty (190,000 people), the national poverty rate would rise by 0.2 percentage points.
 - National poverty incidence, based on preliminary findings, could have increased by 0.1 to 0.3 percentage points as a result of Ondoy (latest official poverty rate is 32.9 percent in 2006). A similar order of magnitude is tentatively expected from Pepeng.
 - The poverty gap and poverty severity area also expected to have widened noticeably.^{5/}

1/ 441mm of rain fell over the 24-hour period of September 26, against a 391mm average monthly rainfall for September; this also exceeds the 1967 one-day deluge of 331mm.

2/ Manila creates some 6,700 tons of trash every day, of which only 700 tons are recycled (ADB).

3/ Bankoff, 2003, "Constructing Vulnerability: The Historical, Natural and Social Generation of Flooding in Manila," *Disasters*, Vol. 27, pp.95-109.

4/ Source: NDCC, Situation Report No. 36 on Tropical Storm Ondoy (Ketsana) and Typhoon Pepeng (Parma), October 20, 2009.

5/ The poverty gap measures how far households lie below the poverty line. Poverty severity also takes into account the poverty gap, but places a higher weight on households that are further away from the poverty line. See the World Bank's forthcoming *Philippines: Fostering Inclusive Growth* report for details on poverty trends and developments.

Box 1 (continued). Economic and Social Impact of Typhoons Ondoy and Pepeng

Social (continued):

- **Pepeng has pushed up prices of some agricultural products (mostly vegetables)**, as key access roads and bridges have been destroyed between the key agricultural region of Northern Luzon and the national capital region. While the government promptly introduced a price freeze on key staple products after Ondoy, a temporary increase in inflation is expected as a result of this supply shock. The increase in food prices, as in 2008, would negatively and significantly impact poor and near poor households' budget and diet.

Economy:

- **Ondoy and Pepeng are estimated to have directly subtracted between 01 to 0.4 percentage points to 2009 GDP growth.** The estimate takes into account the large share of metropolitan Manila in the country's total GDP, and the impact on agriculture as central and northern Luzon contribute to over half the country's rice production. In Manila, a major economic impact was the reduced capacity that companies faced in the immediate aftermath of Ondoy (while some companies were directly affected by the floods, most were significantly indirectly affected as a large share of employees was unable to report to work for days). A large number of small businesses was significantly hit, including the traditional Sari-Sari family stores. The magnitude of the indirect costs—and ultimate macroeconomic impact—of typhoon Ondoy depends to a large extent on the impact on consumer sentiment (see below), especially ahead of the crucial Christmas season, and overseas remittances. The insurance industry estimates insured private sector damages at P15 billion; given the limited insurance coverage against floods, actual private sector losses are far higher. Pepeng's main economic impact is on the agricultural sector.
- **Pepeng had a large impact on agriculture since it hit Northern Luzon, the region's main source of vegetables and rice; Ondoy hit predominantly urban areas.** As of October 20, their combined damages is estimated at P18.5 billion. The two typhoons hit the Philippines during the wet season crop (May to October). As a result, almost all of the wet season crop has been destroyed in affected areas. While the dry season crop only starts in November (and finishes in April), unless rehabilitation work (e.g., irrigation systems) in the affected areas begins immediately the dry season cropping could be significantly and negatively impacted and would lower agriculture production in 2010.
- **Industry could be more significantly affected as some plants have been flooded in Manila.** While only a few large factories have been directly and materially been flooded—these include steel and glass processors located along the Pasig river and the factories of Unilever Philippines and Alaska Milk Corp—the (insured) losses incurred in terms of stocks and inventories during the flooding is expected to delay the resumption of production. While disruptions to industrial production are not yet clear, they could potentially be very disruptive as export-oriented SMEs are still reeling from the collapse in exports from the global recession and have weak financial standing (see Box 2 for details).
- **The services sector is expected to be moderately and temporarily impacted, with trade, transportation and personal services most affected.** Airport and ports disruptions were temporary; road transportation was materially affected for weeks. With key transport arteries cut off, vegetable prices in Manila soared as vegetables are sourced from Northern Luzon. Some, especially small, retailers in Manila have suffered large losses on working stocks and inventories; for the large part these are uninsured. Certain property markets most seriously affected by floods—Marikina, Pasig, Bulacan, Cavite—would likely see prices collapse, creating large negative wealth effects to their owners. Companies were significantly affected by the unavailability of staff in the few days immediately after Ondoy's impact; this limited their output (e.g., the BPO sector reported that less than half of staff was present for work on Monday September 28).
- **On the demand side, consumption is expected to slow down temporarily due to negative wealth and possibly income effects.** While the poor have been disproportionately hit by the floods, middle class households seem to have been significantly affected and have lost cars and expensive household goods that could take time to be replaced (refrigerators, A/C units, etc). Most of these households do not hold flood insurance, or at least, not insurance that covers for "acts of gods". Past natural disasters, however, point to a partial offset as additional remittance are sent to cope with the crisis (Yang and Choi, 2007⁶); middle class households account for a large share of remittances in normal times.
- **The impact on the fiscal balance could be noticeable, both due to higher spending needs and weaknesses in revenue.** On the expenditure side, the direct costs include infrastructure damages (estimated, as of October 20, at P9.3 billion), emergency relief and assistance to affected families (P0.4 billion). Indirect costs are potentially significantly higher but yet unknown. These would mostly reflect policy decisions on how to assist the most vulnerable citizens (e.g, permanent relocation programs, slums upgrading, water management improvements). Revenue collection is expected to be affected both directly and indirectly. The direct impact will arise due to damages and losses that will reduce corporate and income tax collections, value added tax (including through an increase in credit refund requests). The indirect impact will mostly stem

6/ Yang, Dean, and HwaJung Choi, 2007, "Are Remittances Insurance? Evidence from Rainfall Shocks in the Philippines," *World Bank Economic Review*, Vol. 21(2), pp. 219-48.

Box 1 (end). Economic and Social Impact of Typhoon Ondoy and Pepeng

Economy (continued):

from lower consumption and profits though their extent is not clear. Reconstruction efforts and the need to replace lost furniture and household goods would offset a projected decrease in discretionary consumption purchases. To date the government has submitted to Congress a supplementary budget calling for additional spending of P10 billion due to the typhoons. Key discretionary emergency assistance measures introduced by the Government to date (both budgetary and off budget) include:

- A one-year deferment of housing, salary, and other loans worth P32 billion by pension funds such as the Social Security System (SSS) and the Government Service Insurance System (GSIS) as well as the Home Development Mutual Fund (Pag-Ibig).
- Another P15 billion in liquidity will be provided by Pag-Ibig's lending of P150,000 per borrower for home repairs (depending on the interest rate charged, this measure could have a budgetary impact, or become a quasi-fiscal activity).
- The provision by Philhealth of three months of advance reimbursement to all hospitals affected by the typhoons.
- DOLE is considering introducing an emergency employment program for displaced workers.

Financial Market Reactions

Markets took a benign view of both typhoons Ondoy and Pepeng. Equity prices fell by 1.3 (0.4) percent on the opening day immediately following the impact of Ondoy (Pepeng) but Asian markets were mostly down, some significantly more than the Philippines. Immediately after both typhoons, the Peso slightly depreciated against the US dollar; though this followed several weeks of strong appreciation, with the peso/dollar reaching annual lows. After Ondoy, bond prices fell slightly at the short end (secondary market rates for 91-day or shorter went up by 7 basis points) but actually rose for longer-dated bonds. Sovereign spreads on Philippines global bonds remained towards their 2009 lows.

Looking ahead, given projected climate changes, the Philippines ranks among the top 10 countries whose economic activity is most at risk from an intensification of storm surges (Dasgupta et al, 2009).^{7/} The Philippines also count three cities among the top 25 cities whose population is at risk of being affected by storm surges (Manila ranks as number one, Taguig is 23rd, and Kalookan is 25th). Out of a larger sample of the 327 largest (i.e., with population above 100,000 inhabitants) coastal cities world-wide most at risk of storm surges, the Philippines contains, by far, the largest number of cities at risk (48), with Indonesia ranking second with 28 cities. The population in these at-risk Philippine cities account for 18.3 percent of the global in-cities population at risk.

^{7/} Dasgupta, S. B. Laplante, S. Murray, and D. Wheeler, 2009, "Climate Change and the Future Impacts of Storm-Surge Disasters in Developing Countries." CGD Working Paper 182, Washington, D.C.: Center for Global Development.

Box 2. The Global Recession and the Philippines' Corporate and Business Sectors—Results from a Field Survey Assessment^{1/}

To better understand the impact of the global recession on the Philippines corporate and business sectors, the World Bank undertook a rapid small scale survey of companies and their employees as well as several industry associations.^{2/} This assessment should be read alongside the earlier assessment (July Quarterly Update—Box 4) which focused on an analysis of available financial data. Given the delay in publishing financial accounts, the current update provides a more timely reading of the pulse of the corporate sector but also of smaller SMEs and the informal sector in the Philippines.

The electronics and Semiconductor industries, which account for about 60 percent of the country's exports, was the hardest hit but reacted swiftly by cutting costs to survive. Most companies have limited reliance on local banks for financing as they are (1) supported by foreign mother companies (medium- to large firms), or (2) retained earnings (small companies). Companies reacted swiftly to the collapse in demand by adjusting their costs to fight for survival. Smaller companies providing outsourced, low-value, and labor intensive services such as visual inspection and assembly and packaging suffered more, with some reporting revenue drops of 70 to 80 percent year-on-year in the first quarter of 2009. With the industry leaning heavily on labor intensive processes, a wave of labor cost-saving measures was introduced in January 2009.^{3/} Capital spending was frozen except for essential projects (e.g., minor software purchases aimed at improving efficiency; critical repairs necessary for operations); the few who needed new machines opted to rent them citing a surplus of unused machines and the necessity to preserve cash flows. Operational overhead were also the focus of most cost-cutting measures, with power cost cutting being a primary target. Despite the industry being in distress, most companies avoided permanent closure. Aside from the high profile closure of Intel's and Celestica's operations no other large permanent closure has occurred. The industry has shown slight improvement through the second quarter of 2009 (many companies have increased production work days back up to 5 days per week by June or July 2009), but recovery prospects, while positive, remain uncertain.

The furniture and wood product export industry experienced distress during the crisis and is seeing nascent competition from China as a result of the crisis. Composed of many locally-owned SMEs, many of the challenges this industry faces run parallel with challenges faced by other smaller export industries. Furniture and wood products exporters entered the crisis with profitability under strain due to the continuous strengthening of the Peso up to mid 2008. The industry was strongly affected by falling consumer demand and a drying of credit in late 2008. With foreign customers asking for extended payment terms, firms that could not gain access to enough cash in this traditionally financing-dependent industry could not survive. These led many of the smaller firms to cease operations. Total export of furniture, fixtures and other wood products fell by 20.5 percent year-on-year in the first half of 2009. The piece-wise labor force, which includes informal labor, was the first to be affected. Most firms tried to retain highly skilled craftsmen and skilled machine operators. However, given the scale of the crisis, it was unavoidable for companies to send even permanent workers into unforced leaves (some companies reported work days to have hit lows of 2 to 3 days per week). The industry remains weak and its outlook dependent on reaching new markets (Asia Pacific, and the Middle East) and remaining price and product competitive against new competitors, especially Chinese firms moving up-market.^{4/} It therefore aims to move up the value chain by producing more premium designs and improving productivity.

1/ This box summarizes the findings of a survey which is detailed in Le Borgne and Sarmiento, 2009, "The Global Recession and the Philippines' Corporate and Business Sectors—A Field Survey Assessment" World Bank office in Manila, October

2/ The survey ran from August 15 to September 15, 2009. Given its limited sample size, it does not portend to provide a statistically representative view. Instead, it focuses on the most exposed industries with the aim of detailing the extent and diversity of the global shock's impact; describing the measures companies took; detailing policy measures that helped firms as well as those they would have liked to have; and providing a brief outlook.

3/ Measures included dismissal of temporary staff, mandatory use of leave, reduction—without compensation—of the working week (sometimes to two days), of production shifts from 3 to 1, and, as a last resort, layoffs of permanent staff. At the lowest point in production (early 2009), contractual workers saw their pay reduced by as much 64 percent. For many, this resulted in earnings 44 percent lower than a fully employed minimum wage earner. Employees that came from the provinces and did not have sufficient social or familial support to survive these conditions were forced to voluntarily resign to find work elsewhere.

4/ China, which was previously focused on large, mass-manufacture orders, is now also competing in the smaller-quantity, custom-made market—the market Philippines firms principally compete in.

Box 2 (continued). The Global Recession and the Philippines' Corporate and Business Sectors—
Results from a Field Survey Assessment

Export promotion assistance and a relaxation of the labor code were the two policy measures companies most availed of; companies however stressed the high cost of doing business as a structural competitiveness issue, which, in times of crisis, pushes many of them over the hedge. Policy measures to reduce the cost of doing business during the crisis include the Philippine Port Authority recent 50 percent reduction of wharfage fees for exporters.

The informal local garments, bags, footwear and electronics trade industry is posting sharply reduced sales, especially at the lower price range and non-necessities. Sales have been dropping since the beginning of the year for this segment. About 25 percent of survey respondents reported that they feel the crisis has not bottomed out yet. Total year to date revenue contraction for the informal trade of garments, bags, shoes and electronics is estimated at about 35 to 40 percent. Individuals in the minimum wage segment who have experienced the brunt of the crisis are now cautious to spend.

The economic slowdown is not materially affecting large retail conglomerates while it is benefiting small informal (Sari-Sari) family stores. On the manufacturing side, companies with established brands, wide distribution and sufficient financial capability to cut prices and absorb the negative impact on profits are faring much better than smaller and financially weaker players during the crisis. On the retailing side, middle class consumers, though being more price sensitive, continue to shop with large retailers as these are more convenient and have used their volume as leverage to get discounts and additional promotions from their suppliers. However, Sari-Sari store—where a significant share of retail sales still takes place—are also playing an increasing role in light of the crisis as they sell products in small quantities (suitable for as little as one-day-use). Their consumers do not have the cash needed to travel to large outlets to purchase their daily needs. The current crisis has impacted the retail industry far less than during the 1997/98 Asian financial crisis since a majority of the products on the shelves in the Philippines are imported but the peso has been broadly stable during 2009.

The impact of the crisis so far has been modest on the property sector; especially compared to expectations and to the 1997/98 Asian financial crisis. While during the midst of the global financial crisis in Q3 and Q4 2008, prospects for the property sector were relatively gloomy, and a few large companies were thought to be at risk of going bankrupt, the sector weathered the crisis relatively unscathed—though rental and sales prices of all segments have been contracting, sometimes sharply, and some temporary over-supply does exist (but at a third of the level reached after the Asian financial crisis). This unexpected performance stems from the twin resiliency of the business process outsourcing (BPO) sector and the surprising resiliency of workers' remittances. The former continue to be a key force behind demand for office space, while the latter directly contributed to the strong demand for condominium (though demand has noticeably shifted away from the top end and towards the lower end of the market). Prospects are favorable for the industry as a dramatic drop in supply and still robust demand (mainly from the BPO sector) is projected to sizably shrink the excess supply. The industry would continue to be highly dependent on remittances.

The BPO industry continued to grow strongly during the crisis and is poised to emerge structurally stronger from the crisis. While the industry grew by 26 percent in 2008, it is projected to grow by about 20 percent in 2009, following a dip to 15 percent (year-on-year) during the first half of 2009. Despite reduced transactions per customer and reluctance of some of the hard-hit US business segments to invest effort and cash to transition to a third party service provider amidst uncertain times, industry growth remained good. Softness in the first half of 2009 was also linked to voice-services catering to the retail industry (especially the US where several large retail chains went bankrupt). A strategic response from BPO service providers has been to introduce new services and to expand into new markets. The global recession intensified the need for companies to review their cost structures, operating processes, and value added chains. This is leading to a renewed wave of outsourcing with sectors that experienced large disruptions (e.g., banking) being the quickest to react: a large number of large banking groups are significantly expanding their presence in the Philippines. The global BPO sector is strategically looking for a back up to India (India plus one strategy) and the Philippines seems to have established itself as the preferred choice (given comparable cost, language and technical skills), thereby firmly establishing its relatively new industry on the global map.

Box 3. Philippines: NFA and the Social Safety Net One Year After the Food Crisis

One year after the food and fuel crisis hit the Philippines, we review progress made in the social protection system. The 2008 food and fuel crisis pushed an estimated 3 million Filipinos into poverty and widened the poverty gap and poverty severity (World Bank Quarterly Update, November 2008). During the crisis, in order to protect the poor, the government deepened and broadened the National Food Authority's (NFA) rice subsidy program as this was the only available, though not ideal, social protection system with enough scale to reach a large number of poor (other, smaller, measures included cash transfers to electricity lifeline users, cash subsidies to the elderly who have no regular income or access to social security, fertilizers and seed subsidies, and school feeding programs).

As a subsidy program for the poor, NFA rice subsidy program suffers from serious deficiencies, not least: (1) limited assistance reaching the poor (the poor only get 16 percent of their rice consumption from the NFA; based on a subsidy per kilo of rice of 25.4 peso in 2008 (the difference between the shadow^{1/} market price and the NFA subsidized selling price), this is equivalent to a cash transfer of P1,599 per year per household or to 36.6 kilos of rice bought at the (shadow) market price of P43.7/kg); (2) high leakage to the non poor (about half of NFA rice is consumed by the 66 percent of the population which is not poor); (3) a very expensive program due to limited operational efficiency of NFA. In 2008, the NFA delivered between P8.4 and P25.1 billion worth of consumer subsidy to the poor^{2/} and a total rice subsidy of between P17.6 and P52.8 billion. Yet, the total cost for public finances, on an accrual basis, of the NFA for 2008 reached P72 billion (1 percent of GDP)—Table 3. Hence, assuming NFA did distribute all the rice it reportedly distributed—which is three times higher than what recipients are reporting receiving—the fiscal cost of the NFA would still exceed the cost of subsidizing rice by P21.8 billion. These P21.8 billion (\$470 million) in annual cost can be taken as the administrative cost of the NFA to operate the subsidy program. Thus, for every peso-equivalent given to the poor through the rice subsidy program, the Philippine taxpayers spend between 3 to 8.6 pesos.

In the aftermath of the food crisis the government decided to better target the poor and to do so more efficiently; one key measure was to target NFA rice subsidies to the poor. To better target the poor, NFA started limiting, in early 2009, the sale of subsidized non-commercial rice grain to holders of Family Access Cards (FACs) issued by the Department of Social Welfare and Development (DSWD) in Metro Manila, or/and to those listed in Rice Allocation Ledgers (RALs) in the field offices of the NFA. The success of this improved targeting is yet to be seen as NFA is reporting an increase in rice sales of 54 percent in the first five months of 2009 against the same period of 2008. While the international purchase price of rice by the NFA has decreased noticeably, it remains much higher than in 2006 (prior to the food price shock). As a result, the 2009 budget points to a limited decrease in the fiscal cost of NFA in both 2009 (P63.1 billion) and 2010 (P51 billion) compared to 2008 (P74.6 billion)—Table 3.

A second set of measures to improve the targeting, coverage, and cost efficiency of social protection was the development of a National Household Targeting System for Poverty Reduction and a conditional cash transfer (NHTS-PR and CCT, respectively). The government, through the DSWD, developed an efficient and functional NHTS-PR and used this system to launch a large scale CCT program (called *Pantawid Pamilyang Pilipino Program*, or 4Ps), first aimed at reaching 376,000 households by end 2008, and now planned to reach 1 million households as a response to the global recession's impact on the poor. CCT beneficiaries can receive a maximum annual cash payment of P15,000 (\$320)^{3/} per year. 2008 data reveal that the average household received an annual transfer of P10,630. In light of the total administrative budget allocated to DSWD to set up and administer the program for the first 376,000 households, every peso given to the poor through the CCT cost taxpayers 0.5 pesos.^{4/} This cost is expected to decrease sharply over time as (1) the 2008 administrative cost include a large one-off program start up cost and (2) the administrative running costs include an important fixed cost element which is being spread up as the CCT is being scaled up from 376,000 to 1 million households. The 4Ps is expected to increase the recipients' total incomes, on average, by 23 percent, to reduce poverty incidence in targeted areas by 6.1 percentage points, the income gap by 7.6 percentage points and poverty severity by about 5 percentage points.

Box 3 (continued). Philippines: NFA and the Social Safety Net One Year After the Food Crisis

Reallocating NFA's fiscal support to the CCT would enable the government to cover 100 percent of the country's poor (25 percent with NFA^{5/}), with each poor household receiving 7 times the NFA subsidy. While during the 2008 food and fuel crisis, options available to protect the poor on a large scale basis were mostly limited to the NFA rice subsidy program, this is no longer the case in 2009 thanks to the successful launch of the CCT. Given the high cost of reaching the poor through the NFA rice subsidy program both compared to the CCT and in absolute terms, refocusing the NFA outside of its rice subsidy operations and reallocating the NFA fiscal support to the CCT would generate major social protection gains for the Philippines and a drastic improvement of the welfare of the poor. Reallocating the P63.1 billion in public support NFA is receiving in 2009 to the CCT, and assuming that, due to the CCT scale up, the cost of sending P1 to the poor falls by half the 2008 level of 0.5 peso (a realistic estimate as discussed above), this could cover about 4.7 million poor households (100 percent of the poor in the Philippines), with each receiving on average P10,630 per year (the current yearly average for the first set of 376,000 CCT households). Given that the CCT is already budgeted to cover 1 million poor households, should the government decide to limit the CCT coverage to the poor, then savings of P11.5 billion would arise. It should be noted that the NHTS-PR can also be used to improve the efficiency, targeting, and coverage of the poor from other social protection programs, such as the Food-for-School Program (applying NHTS-PR would, for instance, reduce FSP's leakage to the non-poor from 62 to 24 percent).

Table 4. NFA: Financial Accounts, Fiscal Cost, and Benefits to the Poor, 2006--2010

| | 2006 | 2007 | 2008 | 2009 | 2010 |
|---|--------|--------|--------|---------|---------|
| | Act. | Act. | Act. | Budget | Budget |
| (in billion peso) | | | | | |
| Total Assets | 35.8 | 26.4 | 58.2 | 54.5 | 60.8 |
| Total Liabilities | 82.6 | 68.6 | 133.3 | 162.6 | 194.2 |
| Net Worth | (46.9) | (42.2) | (75.1) | (108.1) | (133.4) |
| Budgetary Support | 0.9 | 16.1 | 41.7 | 30.1 | 25.7 |
| Total NG Support | 0.9 | 16.1 | 39.2 | 30.1 | 25.7 |
| National Government subsidies | 0.9 | 16.1 | 2.0 | 4.0 | 8.0 |
| Net Lending | - | - | 2.5 | - | - |
| Others 1/ | - | - | 37.2 | 26.1 | 17.7 |
| Memorandum items | | | | | |
| Total public support to NFA 2/ | 19.3 | 11.4 | 74.6 | 63.1 | 51.0 |
| Breakdown based on rice reported to be consumed | | | | | |
| Subsidy for rice consumed by the poor | 3.0 | 3.2 | 8.4 | 7.5 | 5.0 |
| Subsidy for rice consumed by the non-poor | 3.3 | 3.5 | 9.2 | 8.3 | 5.5 |
| NFA operational costs | 13.0 | 4.8 | 57.0 | 47.3 | 40.5 |
| Breakdown based on rice reported sold by NFA | | | | | |
| Subsidy for rice consumed by the poor | 9.0 | 9.5 | 25.1 | 22.5 | 14.9 |
| Subsidy for rice consumed by the non-poor | 10.0 | 10.5 | 27.7 | 24.9 | 16.5 |
| NFA operational costs | 0.3 | (8.5) | 21.8 | 15.8 | 19.5 |
| Public cost of sending P1 to the poor through NFA: | | | | | |
| Upper bound 3/ | 6.3 | 3.5 | 8.6 | 7.9 | 9.5 |
| Lower bound 4/ | 2.2 | 1.2 | 3.0 | 2.7 | 3.3 |
| Public cost of sending P1 to the poor through CCT: 5/ | ... | ... | 0.5 | n/a | n/a |
| Consumer subsidy per kilo of NFA rice 6/ | 11.5 | 11.4 | 25.4 | 22.8 | 15.2 |

Source: DBM, Budget of Expenditures and Sources of Financing (fiscal years 2009 and 2010).

1/ Other NG support refers to Non-cash support (mainly tax expenditures related to import tariff on rice).

2/ Total public support is the sum of budgetary support and the change in the net worth of the NFA. Indeed, the large annual deterioration of the NFA's net worth will eventually give rise to a large recapitalization from the national government.

3/ Based on the consumption of NFA rice reported by the poor in the 2006 FIES survey.

4/ Based on scaling up the share of NFA rice reportedly received by the poor in the 2006 FIES to the sales volume that NFA is reporting.

5/ Based on data covering the first set of the CCT program (covering 376,000 poor). The total budget for that program was P5 billion, of which P3.2 billion was spent in cash transfer, and P1.8 billion in administrative costs. It should be noted that the administrative cost is expected to sharply decrease as 2008 included start up costs of the CCT program. A 15 percent leakage to the non-poor is assumed, in line with international experience with CCTs.

6/ Calculated as the difference between the import price of rice (including customs tariff) and the NFA selling price for subsidized rice.

1/ The price of an imported kilo of rice after clearing customs. It exceeds the domestic "market" retail price as the domestic price market is regulated (the average retail price of regular milled rice in 2008 was P29.4 per kilo).

2/ The large range of estimated benefit accruing to the poor are obtained as follows: the lower value is based on the consumption of NFA rice reported by the poor in the 2006 FIES survey (only 34 percent of the total quantity of rice NFA reported selling); the higher value is obtained by scaling up the share of NFA rice reportedly received by the poor in the 2006 FIES to the sales volume that NFA is reporting. The first number is clearly a lower bound as it includes some under-reporting from households (a common problem is household surveys), while the second number is an upper bound as it assumes there is rice loss in NFA operations. Yet, pilferage, damage in storage, loss in transit, and possible diversion of NFA stocks into the private commercial market are possible leakages.

3/ The 4Ps provides a monthly education grant of P300 per child for 10 months up to a maximum of 3 children conditional on school attendance and a monthly health and nutrition grant of P500 to those with children 0 to 14 years old or pregnant women conditional on their compliance to agreed health conditions.

4/ Assuming a leakage of 15 percent to the non-poor which is in line with international experiences—however the true leakage rate is expected to be lower since the 376,000 households were selected exclusively from the poorest barangays of the 20 poorest provinces of the country.

5/ Jra, S. and A. Mehta, 2008, "Effectiveness of Public Spending: The Case of Rice and Subsidies in the Philippines," ADB Working Paper No. 138.

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