

World Bank Office Manila

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Quarterly Economic Update

January 2009



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

Overview

Economic growth has held up relatively well up to now but signs are that the severe global slowdown will further and significantly impact the economy. Notwithstanding a sharp decline from the historic high 2007 growth rates, third quarter GDP growth of 4.6 was in line with first half growth momentum. Some of the third quarter sources of growth, however, are likely to wane, in particular private construction and manufacturing. Indeed, the latest leading data (exports, imports, the labor market, and remittances) point to a further steep decrease in growth. Appropriate monetary and especially fiscal policies should help ensure that GDP grows by 3 percent in 2009.

Inflation prospects have improved, providing the BSP with some room to ease its monetary policy stance. After spiking at 12.5 percent in August, inflation fell to 8 percent in end-2008 thanks to a sharp unwinding of fuel and commodities prices. Core inflation, though falling, remains elevated. Aggressive rate cuts from major central banks around the world and a recent strengthening of the Peso enabled the BSP to cut rates to support growth.

The banking system has proven resilient but is exposed to risk of domestic and external shocks, including through its large holding of sovereign paper. In part due to corporate governance and financial sector reforms following the Asian Financial Crisis, and a reliance on stable financing sources, banks have weathered the financial storm comparatively well, notwithstanding the sharp fall in profit in the third quarter. On average, the sector remains adequately capitalized but a relatively high level of non-performing assets, a slowing economy, and large holdings of sovereign paper could increase stress on the weaker banks.

Controlled fiscal easing will be critical to growth and protecting the poor in 2009; measures are needed to ensure both the scope and quality of the expansion. While a fiscal easing is both desirable and advisable, fiscal space remains limited despite recent gains in fiscal consolidation. Given the World Bank's projected pressure on revenue collection for 2009, the fiscal stimulus being considered could result in a larger than planned deficit. This could prompt a reassessment of the country's commitment to fiscal prudence and medium-term consolidation goals, although the recent \$1.5 billion bond issuance attests to market confidence in the economy to-date. Should the deficit be contained by paring expenditures, the effectiveness of the fiscal stimulus would be impaired. A better policy would be to address the revenue weaknesses directly so as to afford the desirable and most effective fiscal stimulus size and composition, which should be tilted towards targeting households that are most constrained by the slowdown and most at risk from the crisis.

Tax policy measures and rapid tax administration reforms would ensure that policymakers are firmly in control of the fiscal expansion. Increasing and harmonizing tobacco excises and strengthening of the Large Taxpayer Service of the BIR are examples of measures that could prevent a potentially large structural (as opposed to purely cyclical) decrease in the tax-to-GDP ratio. Prompt Congress approval of the 2009 budget and of key revenue bills supported by the Government are an integral part of weathering well the global economic storm.

A. Recent Economic Developments

1. **Economic growth has held up relatively well up to now but signs are that the sharp global slowdown will further and significantly impact the economy.** Buoyed by strong manufacturing and increased spending on public construction, industrial production propped up growth in the third quarter. Headline inflation has receded thanks to the tumble in fuel and commodity prices, but producer and wholesale price inflation remain at elevated levels. While the direct hit from the global financial crisis has been significant (especially for the Peso, the stock market, and bank earnings), it has been comparatively mild and certainly manageable to date. The global economic slowdown is nevertheless affecting—and will continue to do so to a larger extent—the real economy (leading economic indicators such as imports, exports, and remittance growth are sharply down). Government spending buoyed the economy at a much needed time but weaker revenue collection in the latter half of 2008 needs careful monitoring and timely action so as to enable the Government to continue its controlled fiscal loosening.

Real sector performance

2. **The economy suffered a step decline in its growth rate in 2008 (from historical highs) and further decline is already visible from the latest economic indicators.** Following annual growth of 7.2 percent in 2007, GDP growth decelerated sharply (to 4.6 percent) in the first three quarters of 2008 (sharper than its regional peers) and to 4.6 percent in the third quarter (Q3) of 2008 from 7.1 percent in the same period last year (Table 1).¹ Looking at the demand side, the growth drivers were public consumption and investment (which posted a significant rebound, as the Government's plan to boost spending to tackle the food and fuel crisis materialized), and buoyant private consumption (on account of robust remittances, which also benefited from the weaker Peso). Net external demand weakened as exports of electronics and non-factor services tumbled while imports picked up (Figure 1). The latest leading indicators, such as exports, imports of electronic parts, and remittances all point to a worsening macroeconomic stance (see below).

3. **On the supply side, industrial production drove overall growth thanks to strong construction and resilient manufacturing** (Figure 2). Following a slow start in the first half of 2008, public construction accelerated in the third quarter, growing by 20 percent (year-on-year) and consisted mostly of national government infrastructure projects.² Private construction—a sector that traditionally lags the economic cycle—remained robust on account of ongoing residential and office projects (the former have been driven to a large extent by remittances). The manufacturing subsector was the top growth contributor, contributing 1.1 percentage points to overall GDP growth in Q3. Its

¹ In fact, third quarter GDP growth was slightly higher than the revised second quarter growth of 4.4 percent despite higher inflation and the worsening global environment. Downward revisions were observed in exports, while upward revisions were observed in imports, consumption, government consumption, and capital formation.

² These were delayed with the late passage of the 2008 budget law.

expansion was largely due to the sustained double digit growth of food manufacturing, which more than offset the continued decline in electrical machineries manufacturing. As expected, tobacco manufacturing grew significantly, by almost 50 percent, in anticipation of the January 2009 excise tax rates increase.

4. **The services sector, however, continued to underperform.** Having driven the economy for the last 7 years, the services sector reached its lowest growth (3.7 percent) in Q3. Higher transportation costs due to high fuel prices dampened growth in the transportation and trade sub-sectors. A sharp fall in bank earnings, which resulted in a flat growth for the financial services sub-sector, also contributed to the sector's weakness.

5. **The agriculture sector also failed to sustain growth.** Growth slowed considerably to 2.5 percent from 5.7 percent last year and 5 percent in the previous quarter. Early harvest of some crops partly explains the lower production in Q3 (and hence higher production in Q2) while severe typhoon disturbances explain the lower than expected production in other crops like corn. Still high oil prices in the third quarter dampened output of the fishing industry. On a positive note, rice, banana, and sugarcane production remained upbeat. Sugarcane production was also accompanied by a remarkable growth in sugar mill equipments.

Figure 1: Public spending sustained growth...

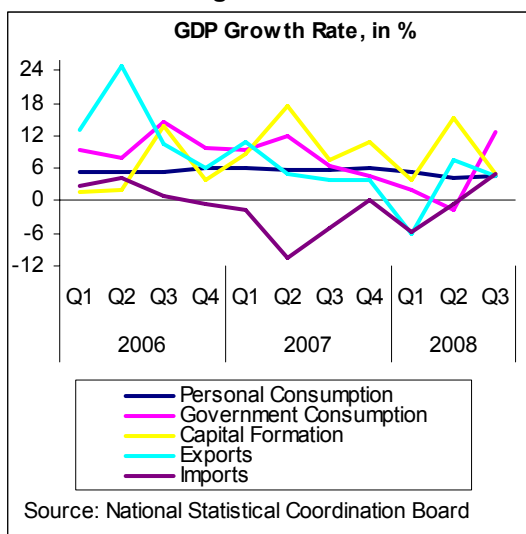
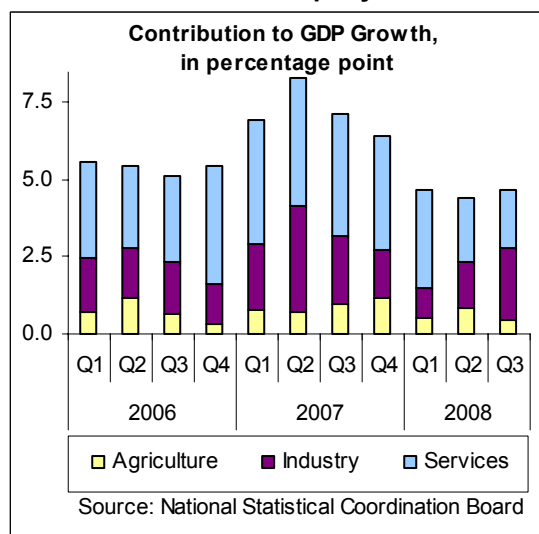


Figure 2: ...while the crucial service sector has rapidly lost steam



6. **The slowdown in economic activity has not affected the labor market significantly to date but potential for a strong weakening is present.** While unemployment decreased in October 2008 to 6.8 percent from its July peak of 7.4 percent, the unemployment was higher than the 6.3 percent posted in October 2007. As the last quarter of the year is usually strong for the labor market (due to seasonal job demand linked to the holiday season), the increase is nonetheless noticeable. A look at job creation numbers also point to a potentially large decrease in employment in the near future: job creation was relatively strong in sectors in which activity noticeably slowed down (e.g., services that might take on seasonal demand ahead of the important holiday

season), while strongly performing sectors (e.g., manufacturing and utilities) posted dismal job creation in light of their projected dimmer growth prospects. Uncertainty regarding the potential large inflow into the labor market of returning OFWs and/or a slowdown in their deployment could also rapidly add to the supply of job seekers at a time when demand is expected to soften.

Inflation and monetary conditions

7. **Headline inflation receded strongly from its mid-2008 peak while inflationary pressures began to ease in December.** December headline inflation at 8 percent (YoY) was sharply off the 12.5 percent peak of August, largely on account of falling food and fuel prices (Figure 3). Reassuringly, core inflation, which increased following general wage increases in mid-2008 and fuel-induced rise in operating cost, finally eased in December (to 7.3 percent) after having steadily risen from end-2007 through November 2008 (when it peaked at 7.9 percent). With central banks around the world aggressively slashing rates, and the Philippines economy weakening, the BSP saw some room to cut its key policy rate by 50 basis points to 5.5 in its December meeting—thereby partly reversing its 100 basis points increase of June-August. The BSP also announced a 4.5 percent inflation target for 2010.

8. **Meanwhile, production costs have remained high, squeezing corporate profits.** Growth in the construction materials wholesale price index (WPI) peaked at 23.3 percent in September but continued to soar at double-digit rates (20.6 percent) in November (Figure 4). Indeed, this has already affected profits and expansion plans of property firms. Even as overall inflation and consumer demand weaken, the manufacturing sector is faced with rising cost (the November PPI rose sharply to 8.5 percent, up from the previous high of 6.9 percent in September). PPI inflation of textiles, fabricated and basic metal products, machinery, rubber and plastic products, beverages, and food remained high.

Figure 3: Overall inflation has eased

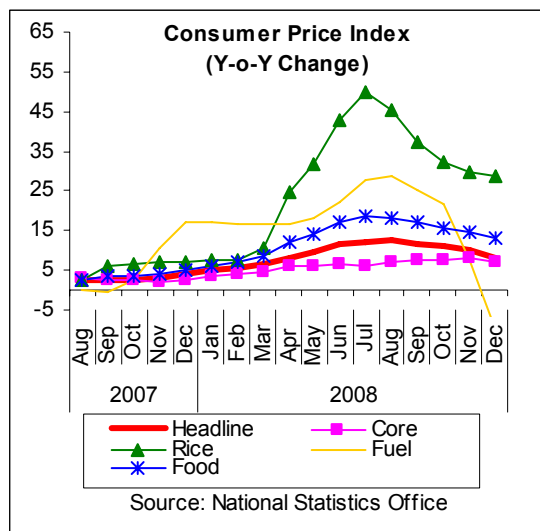


Figure 4: ...but production costs are still elevated

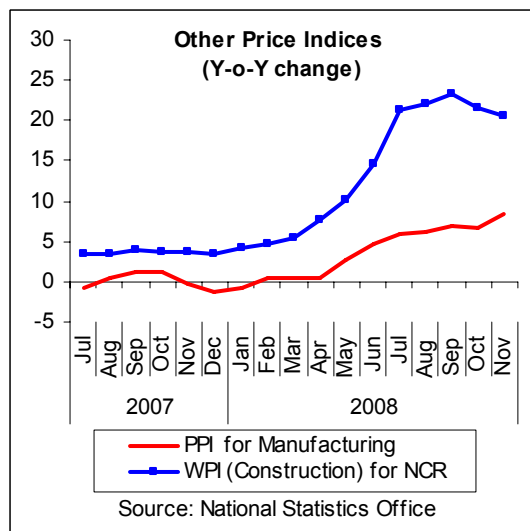


Table 1. Philippines: Selected Economic Indicators, 2004-2008

| | 2004 | 2005 | 2006 | 2007 | 2008 (YTD) ^{1/} |
|---|------|---|------------------|-------|-----------------------------|
| Growth, inflation and unemployment (percent) | | | <i>(percent)</i> | | |
| Gross national product | 6.9 | 5.4 | 5.5 | 8.0 | 5.9 ^{2/} |
| Gross domestic product | 6.4 | 5.0 | 5.4 | 7.2 | 4.6 ^{2/} |
| Inflation (period average); 2000 base year | 6.0 | 7.6 | 6.2 | 2.8 | 9.3 |
| Inflation (end period); 2000 base year | 8.6 | 6.6 | 4.3 | 3.9 | 8.0 |
| Unemployment | 11.9 | 7.9 | 8.0 | 7.3 | 7.4 ^{3/} |
| Savings and investment | | <i>(percent of annual GDP)</i> | | | |
| Gross national savings | 18.6 | 16.6 | 19.0 | 19.7 | 12.0 ^{2/} |
| Gross domestic investment | 16.7 | 14.6 | 14.5 | 15.3 | 11.3 ^{2/} |
| Public sector | | <i>(percent of annual GDP)</i> | | | |
| National government balance | -3.8 | -2.7 | -1.1 | -0.2 | -0.9 ^{4/} |
| Total revenue | 14.5 | 15.0 | 16.2 | 17.1 | 14.4 ^{4/} |
| Tax revenue | 12.4 | 13.0 | 14.3 | 14.0 | 12.9 ^{4/} |
| Total spending | 18.3 | 17.7 | 17.3 | 17.3 | 15.3 ^{4/} |
| Consolidated public sector balance | -4.8 | -1.9 | 0.2 | 0.6 | 0.3 ^{2/} |
| Nonfinancial public sector debt | 95.2 | 85.9 | 73.9 | 61.1 | 60.7 ^{5/} |
| National government debt | 78.2 | 71.4 | 63.8 | 55.8 | 55.6 ^{6/} |
| Money and credit | | <i>(year-end percent change)</i> | | | |
| M3 | 10.3 | 10.3 | 22.7 | 10.6 | 14.6 ^{7/} |
| Credit to the private sector | 4.9 | -0.3 | 6.6 | 8.5 | 15.8 ^{7/} |
| Balance of payments | | <i>(percent change unless otherwise indicated)</i> | | | |
| Merchandise exports | 9.8 | 3.8 | 15.6 | 6.4 | 4.3 ^{2/} |
| Merchandise imports | 8.0 | 8.0 | 10.9 | 8.4 | 15.0 ^{2/} |
| Current account balance (percent of annual GDP) | 1.9 | 2.0 | 4.5 | 4.4 | 0.7 ^{2/} |
| International reserves | | <i>(in billion US\$ unless otherwise indicated)</i> | | | |
| Gross official reserves | 16.2 | 18.5 | 23.0 | 33.8 | 37.1 |
| Change in reserves | -0.8 | 2.3 | 4.5 | 10.8 | 3.3 |
| Gross official reserves (months of imports) | 3.6 | 3.8 | 4.2 | 5.7 | 5.6 |
| External debt | | | | | |
| Total (billions of dollars) | 54.8 | 54.2 | 53.4 | 54.9 | 53.5 ^{8/} |
| Total (percent of annual GDP) | 63.1 | 54.8 | 45.4 | 38.1 | 33.4 ^{8/} |
| Debt service ratio (to exports of G&S and income) | 13.8 | 13.5 | 12.0 | 9.8 | 10.1 ^{8/} |
| Exchange rate (peso/dollar, period average) | 56.0 | 55.1 | 51.3 | 46.1 | 44.5 |
| Real effective exchange rate (2000 = 100) | 86.2 | 92.3 | 102.5 | 112.3 | 120.6 ^{4/} |
| Stock market index (period average) | 1823 | 2096 | 2412 | 3443 | 2631 |

Source: Government of the Philippines, World Bank, IMF

1/ 2008 nominal GDP is based on World Bank estimate

2/ January-September

3/ Annual average using new definition adopted in 2005 and based on 2000 census (except for 2004 which is based on old definition and 1995 census)

4/ January-November

5/ As of March

6/ As of October

7/ As of November; based on the Depository Corporations Survey (previous years are based on the Monetary Survey)

8/ As of September; as reported by the BSP.

9. Monetary growth has picked up since July, mirroring the better than expected Q3 economic activity, but potentially planting the seeds of trouble. Fueled by higher

lending and build up of foreign assets owned by the central bank, domestic liquidity expanded by 14.6 percent (YoY) in November after slowing to less than 10 percent in Q2 2008. Excluding lending for financial intermediation, business lending was strong across industries in the services sector. These high growth rates however, are coming from a low base with private credit-to-GDP that had reached a 12 year low of 27 percent in 2007 (against 60 percent in 1997). Consumer lending was driven by the still high growth in credit card and housing loans. Despite the low level of bank lending to the private sector, international experience points to a lowering of lending standards towards the end of protracted growth cycles. This lowering of standards, coupled with a weakening economy and a tapering off of property prices,³ implies that banks' non-performing loans are therefore set to rise (from their already relatively high level).

External sector

10. After twelve quarters of current account surpluses, third quarter current account balance turned negative. A widening trade deficit brought the third quarter current account (and the overall BOP) into deficit, bringing year-to-date balance to 0.9 percent of GDP (against a 4.5 percent surplus in Q3 2007). More recent indicators point to a stronger impact of the global slowdown on the Philippines economy. In October and November, exports declined by an average of 13 percent YoY as electronics which comprise over 60 percent of merchandise exports tumbled, while October imports posted for the first time since May 2007 a decline in annual growth (by 11 percent), mostly due to a combination of lower commodity prices and a sustained contraction in the shipment of electronics parts (mostly for subsequent export) (Figures 5 and 6). The slowdown in imports is expected to continue as domestic economic growth deteriorates, thereby slowing down the growth of the large trade deficit.

11. After a remarkable increase over the past few years, growth in OFW remittances decelerated sharply since October. After rising by double digit rates in the last six months, remittances grew by only 6.6 percent in October-November vis-à-vis the cumulative growth of 17.1 percent in September as the global financial crisis affected incomes of Filipinos abroad. The Government estimates that around 50,000 workers are likely to lose their jobs this year. Deployment, however, continued to be strong as of November at 24.4 percent. This could suggest that remittances are likely to still grow, albeit at a slower pace, in the coming months.

12. The combined impact of the global economic slowdown and the financial crisis has significantly affected the capital account. BSP-registered portfolio investments through the third week of December posted a net outflow of \$1.4 billion in 2008 compared to a net inflow of \$3.6 billion in the same period a year ago. The bulk of the outflow is traced to withdrawal of Peso bank deposits. Non-resident investments in the country, driven by equity placements, remained positive as of September at \$1.4 billion but retracted sharply from the \$2.5 billion posted in the same period of 2007.

³ A slowing property market would also affect banks' balance sheet improvements as the selling of foreclosed properties (a large share of their legacy non-performing assets) would become more difficult and less appealing.

13. **Notwithstanding the global crisis and pressure on emerging market currencies, international reserves still increased in 2008 and remain at a comfortable level.** Gross international reserves (GIR) reached \$37.1 billion at end-2008, an increase of \$3.3 billion compared to end-2007. This GIR level can cover 5.6 months of imports of goods and services and is equivalent to 2.8 times the country’s stock of short-term external debt based on residual maturity. The relatively strong reserves position, however, remains vulnerable to shocks especially if the Peso weakens further (see Figure 7). The BSP’s swap reserves, however, have fallen significantly.

Figure 5: Tumbling electronics imports started in March and are now showing up in export data

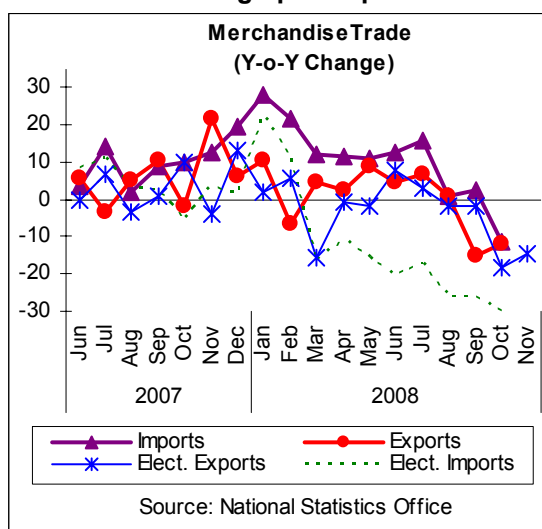
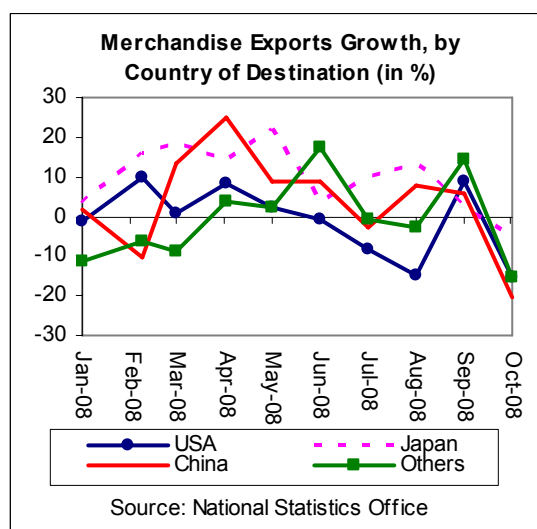


Figure 6: The collapse in exports is geographically broad based



Fiscal performance

14. **Government spending picked up in the second half of 2008, driven by infrastructure and social services spending.** The Government’s decision to increase spending mid-year to limit the impact of rising food and fuel prices and a slowing economy gained traction in July and continued through November (late passage of the 2008 budget law also help explain the slow disbursement in the first half (H1) of 2008). Spending through November reached 15.3 percent of GDP (Table 2). Capital expenditure was a key reason behind the increased spending (2.4 percent of GDP in 2008, a 0.7 percentage point increased compared to 2007). Higher overall subsidies⁴, in particular to the National Food Authority, estimated at around 0.9 percent of GDP, also contributed to higher spending.

15. **Meanwhile, the improved tax performance of H1 2008 has proven to be short-lived as it was mostly based on transient factors.** High commodity (especially fuel)

⁴ Taken to include net lending, subsidies, and tax expenditure support.

prices and a weaker Peso explain a large share of the 26 percent rise in the Bureau of Customs' (BOC) collection through November. This good performance partially offset the weaker collection of the Bureau of Internal Revenue (BIR) whose collection grew by less than half of nominal GDP growth in the same period. Key explanations for the decreasing tax effort include the slowing economy and recent tax policy and administrative measures. The latter include RA 9504 (implemented in July 2008)—which exempts minimum wage earners from paying income tax, raises the personal exemption threshold of individual taxpayers, and increases the rate of optional standard deduction⁵—the weakening of the Large Taxpayers Service of the BIR in April 2008, and the negative incentives that the Attrition Act generates.⁶

Table 2. Philippines: National Government Fiscal Accounts (Cash Basis) 2006-2009

| | 2006 | 2007 | 2008 | | 2009 | |
|--|---|-------|---------|---------|----------------------|-------------|
| | | | Jan-Nov | WB est. | Budget ^{7/} | WB forecast |
| | (in percent of GDP unless stated otherwise) | | | | | |
| Revenue and grant | 16.1 | 15.7 | 14.3 | 15.6 | 16.4 | 14.9 |
| Tax revenue ^{1/} | 14.3 | 14.0 | 12.9 | 14.1 | 15.1 | 13.4 |
| Nontax revenue ^{2/} | 1.9 | 1.7 | 1.3 | 1.5 | 1.3 | 1.5 |
| Total expenditure | 17.3 | 17.3 | 15.3 | 17.0 | 17.7 | 17.1 |
| Current Expenditures | 15.1 | 14.4 | 12.6 | 14.0 | 14.1 | 14.4 |
| Capital Outlays and Net Lending ^{3/} | 2.2 | 2.9 | 2.7 | 3.0 | 3.6 | 2.7 |
| Balance (GFS definition) | -1.2 | -1.6 | -1.0 | -1.4 | -1.4 | -2.2 |
| Balance (Government definition ^{4/}) | -1.1 | -0.2 | -0.9 | -1.0 | -1.2 | -2.0 |
| Memorandum item | | | | | | |
| Privatization | 0.1 | 1.4 | 0.1 | 0.4 | 0.1 | 0.2 |
| Primary balance (GFS definition) | 4.0 | 2.5 | 2.5 | 2.5 | 2.6 | 1.9 |
| National Government Debt ^{5/} | 63.8 | 55.8 | 55.6 | 54.5 | .. | 53.1 |
| Nominal GDP (PHP billions) ^{6/} | 6,033 | 6,651 | 7,524 | 7,524 | 8,276 | 8,276 |

Source: Bureau of Treasury, Department of Budget and Management, and WB staff estimates.

1/ Includes tax expenditures

2/ Excludes privatization receipts (these are treated as financing items)

3/ Includes equity, capital transfers to LGUs, and CARP.

4/ Treats privatization receipts as a revenue item, not a financing one.

5/ As defined by the Bureau of Treasury; Actual data for 2008 is as of October

6/ Nominal GDP for 2008-2009 are World Bank staff estimate/forecast.

7/ WB estimate based on preliminary information regarding the (ongoing) revision of the budget.

16. The Government's fiscal deficit goal, while still on track, is under pressure from falling revenue effort. As of November, the national government deficit (government definition⁷) reached 0.9 percent of GDP (P67 billion) against a 2008 budget

⁵ Government officials estimate the revenue loss of this measure for the six months of 2008 at between P7 to 14 billion (0.1 to 0.2 percent of GDP).

⁶ While the rationale for the Attrition Act is clear, one unintended consequence has been to redirect focus of tax administration officials to meeting short-term (monthly) collection targets at the expense of medium-term reforms needed to improve tax efficiency and collection, and reduce governance issues.

⁷ The Government's definition departs from internationally accepted public finance accounting (e.g., the IMF's Government Financial Statistics Manual (GFSM)) in two important ways: (1) treating privatization receipts as a revenue (rather than a financing item); and (2) not counting spending related to the Central Bank Board of Liquidators (CB-BOL) as an expense. Both of these treatments lead a lower overall fiscal deficit than under GFSM accounting.

target of 1 percent of GDP (P75 billion). Privatization receipts, which contributed 1.4 percent of GDP to total revenues in 2007 year, fell short in 2008 given volatile market conditions. In December, the Department of Finance announced that it successfully sold the Government's share in Petron and expects to book the P22 billion in payment in 2008. The Government's other privatization activities have been deferred to next year.

17. The Government's large cash holdings, abundant domestic liquidity, and a successful foreign bond placement considerably ease financing pressures for 2009.

Although sovereign spreads remain elevated compared to H1 2008 (600 basis points over US Treasuries in January compared to less than 200 basis points then), the level of interest rates on Government paper is in line with those prior to the excess global liquidity period of 2006-2007. In this light, the decision to issue \$1.5 billion in foreign bonds is strategically wise and ensures that the budgeted commercial external bond issuances for 2009 are already fully met. The national government retains sizable deposits with the BSP and the Land Bank (about 4 percent of GDP), which provide a substantial cushion in the short-term (though annual gross financing requirements are also large). Abundant Peso liquidity helps limit financing risks (albeit at a price for the Government and at the potential cost of crowding out the private sector—especially if access to external financing remains limited for the corporate sector going into 2009).

18. The pace of government debt reduction has slowed given slower fiscal consolidation, higher borrowing cost and the weaker Peso. The national government's debt stock improved slightly to 55.6 percent of GDP in October from 55.8 percent in end-2007. From end-September, the Peso's depreciation contributed 1 percentage point of GDP to the increase in the debt stock leading to a slight fall in the share of domestic debt to 57 percent.

Financial and corporate sector developments

19. The banking system has proven resilient but is exposed to both domestic and external shocks, including through its large holding of sovereign paper.⁸ In part due to corporate governance and financial sector reforms enacted following the Asian Financial Crisis,⁹ and a reliance on stable financing sources, banks have weathered the financial storm comparatively well notwithstanding the sharp fall in profit in Q3 (from a high base).¹⁰ On average, the banking system maintains a capital adequacy ratio (CAR) well above the mandatory requirement (though some weaker banks are closer to that requirement). Nonetheless, while the non-performing loan ratio is steadily improving it remains high even before the current slowdown has begun to affect loan quality (Figure

⁸ For a detailed assessment of the sector, see the November issue of the Philippines Quarterly Update.

⁹ These include the tightening of credit underwriting standards, the rationalization of the real estate lending cap of universal and commercial banks, and the continuing clean up of balance sheets.

¹⁰ A slowing economy (starting in Q1 2008), the direct exposure to Lehman Brothers and other distressed global banks, and losses on their foreign exchange transactions and large holdings of Republic of the Philippines paper are the key factors behind the sharp drop in profits.

Figure 7. The Peso has fallen with heightened risk aversion

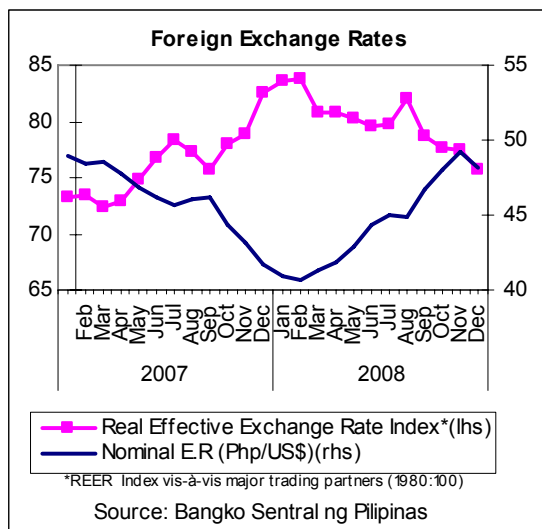


Figure 8. Banks remain well capitalized and their NPLs are trending down

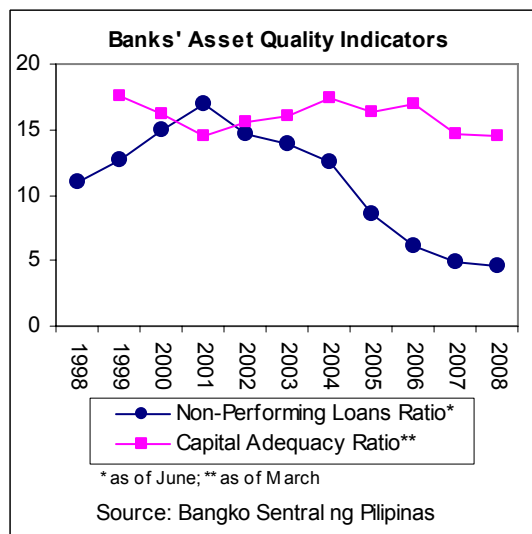


Figure 9. Bond spreads have shot up for emerging markets

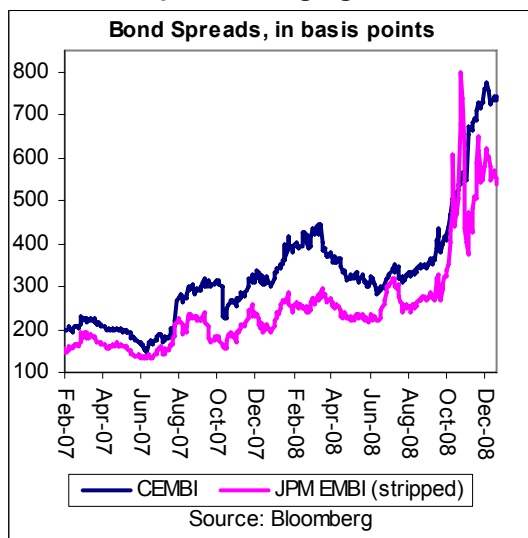
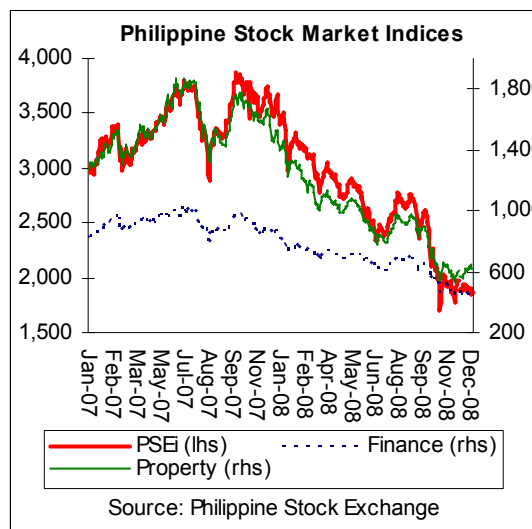


Figure 10. Stocks have not recovered from the massive stock market sell-offs



8).¹¹ Strong provisioning rules and their enforcement is critical to maintain banks' resilience. The industry's conservative banking practices vis-à-vis the private sector are reflected in low loans-to-asset ratio (40 percent)¹² and an intermediation ratio of less than 60 percent. However, banks do have large holdings of sovereign papers, the price of

¹¹ The BSP, however, closed over 13 rural banks in Q4 2008, and a further 3 rural banks declared bank holidays in early January. Rural banks comprise a very small share of total banking sector assets. The cost to the PDIC is not yet fully known but could require the PDIC to take action to replenish its assets.

¹² Exposure to sectors that are under strain globally is also limited. For instance, lending to the real estate sector accounts for less than 15 percent of total lending or about 3 percent of GDP.

which has tumbled since September,¹³ and their exposure to households, SMEs, and exporting sectors will strain profits further as the economy decelerates. The overall liquidity risk of the industry is limited as banks maintain a liquidity ratio of 55 percent and rely on (stable) deposits—as opposed to fickle wholesale financing—to finance its loans (gross loan-to-deposit ratio of 72.9).

20. Quantitative easing through pre-emptive regulatory measures has been used appropriately to increase liquidity and maintain financial system stability. Although domestic liquidity is good, the BSP has taken preemptive measures such as lowering the reserve requirement by 2 percentage points¹⁴ and doubling the Peso rediscounting facility to P40 billion to prevent a possible credit crunch. A doubling of the PDIC's deposit insurance guarantee to P500,000 is also being considered by Congress (with such a move, the PDIC would cover 97 percent of accounts in the country, against 91 percent currently). The increased deposit coverage should be accompanied by stronger banking oversight powers so as to limit moral hazard.

21. The corporate sector has remained resilient to date but a few sectors are facing very testing times and signs of a general decline in the business climate abound. Third quarter financial numbers remain positive for most corporations with a few exceptions related to foreign exchange losses and financing difficulties to roll-over debt or finance capital expenditures. A few sectors (e.g., electronics) are facing a severe and sudden contraction in their business environment with limited visibility going forward. The sharp and sustained fall in equity prices points to a general weakening in corporate profits. Spreads on corporate debt paper have risen more sharply than sovereign ones, which could challenge corporate debt servicing and dampen corporate expansion plans (Figures 9 and 10).

B. Macroeconomic Prospects and Policies

The global environment

22. Amid an already sharp growth slowdown in developed countries, prospects point to a possible deep and long-lasting global downturn. The United States, Japan, and the Euro Zone are already in recession with severe output contraction realized or expected for Q4 2008; contraction is expected to continue in 2009 (Table 3). Significant uncertainties exist regarding the length and severity of the recession in the developed countries and the forecast below are subject to large downside risks. With falling import demand from the G3, the World Bank also projects world import volume to contract for the first time since 1982 after growing by 7.4 percent in 2007 and moderating to a projected 5.8 percent growth in 2008 (Table 3). Increased risk aversion and capital

¹³ To contain the impact of this rapid price fall, the BSP has allowed a change in accounting rules to enable banks to avoid mark-to-market losses on their government bond holdings.

¹⁴ The BSP estimates that every one-percentage point reduction in the reserve requirement frees up about P30 billion (0.4 percent of 2008 GDP) into the financial system.

outflows from emerging markets and a dislocation in global finance are also limiting trade finance for some countries.

23. East Asian economies have not been spared from the crisis, although most are better positioned than others to weather the storm. Since the Asian Financial Crisis, most Asian countries' public finances, external balances, and banks and corporations' balance sheets have been strengthened through structural reforms. These have helped to insulate the region from the full impact of the crisis. Nevertheless, many countries are back in the grey zone, with growth expected to slow considerably given lower export demand from developed countries, lower private consumption due to declining real income¹⁵ and higher unemployment, and lackluster investment due to risk aversion, high costs of financing, and reduced growth prospects. The latest data coming from key countries in the region point to Q4 2008 as being worse in terms of output contraction than Q1 1998 (the height of the Asian Financial Crisis) and early indicators for Q1 2009 are also sobering. In light of this, World Bank regional growth prospects are subject to significant downside revision (Table 3). At this stage, the pace of poverty reduction is expected to slow although a reversal is not anticipated for the region as a whole.

Table 3. Selected Countries GDP Growth, World Trade, and Oil Price Prospects

| | 2007 | 2008f | 2009f |
|---|------|-------|-------|
| (annual percentage change, unless otherwise stated) | | | |
| East Asia | 9.0 | 7.0 | 5.3 |
| Developing East Asia | 10.5 | 8.5 | 6.7 |
| <i>of which</i> | | | |
| China | 11.9 | 9.4 | 7.5 |
| Indonesia | 6.3 | 6.0 | 4.0 |
| Memorandum items: | | | |
| Developed economies | | | |
| US | 2.0 | 1.7 | -0.5 |
| Eurozone | 2.6 | 1.3 | -0.6 |
| Japan | 2.0 | 1.0 | 0.1 |
| World Trade | 7.4 | 5.9 | -2.1 |
| Oil Prices (\$/bbl) | 71.1 | 105.0 | 60.0 |

Source: The World Bank Development Economic Prospects Group; f-forecast

24. In response to the sharp global slowdown, many countries in the region have taken a more expansionary macroeconomic stance. Countries that tightened their monetary policy only a few months ago to contain inflation have reversed their stance via a variety of policy instruments and liquidity injection. After ensuring adequate liquidity, most countries have now moved to providing fiscal stimulus. Major fiscal stimuli were introduced in China, Korea, Malaysia, and Thailand. China's \$586 billion stimulus package is the biggest in the region and is financed by both the central and local

¹⁵ Though the recent decline in inflation is dampening that effect

governments and the financial system. The country, as it did during the Asian crisis,¹⁶ is fully utilizing the fiscal space provided by its low overall fiscal deficit and debt level to undertake a sizeable fiscal expansion.

25. One silver lining for the world's poor from the global slowdown is the sharp plunge in commodity prices. In its latest report, the World Bank's Prospect Group forecasts a 26.4 percent reduction in oil prices for 2009 and a 23.2 percent reduction in the price index of non-oil commodities. Given the increasing likelihood of an extended global slowdown, commodity prices may fall further, which would benefit the poor as their budget is disproportionately affected by food price developments.

Implications for the Philippines

26. The Philippines entered the slowdown from a much better macroeconomic position than it did in prior downturns. Since 2003, (non-financial) public sector debt has significantly improved from more than 100 percent of GDP to slightly above 60 percent in 2007. Improvements in both national government and non-financial public sector deficits stemming from tax reforms and expenditure restriction contributed, alongside a large privatization program, to the rapid pace of debt reduction. Importantly, as the global financial crisis is making financing for emerging markets more costly and scarce, for the first time in a generation, the Philippine economy is entering a major downturn from a current account surplus position. The recent balance of payment surpluses, in large part due to strong remittances, have enabled the country to accumulate large foreign exchange reserves. However, the country's large projected external gross financing needs expose the country to refinancing risk especially if global risk aversion continues (Table 5).

27. Nevertheless, there is no escaping from the global slowdown and the Philippines will be affected due to the openness of its economy. Although the exports-to-GDP ratio has fallen in recent years from 50 in 2000 to 34 today, a single product group, electronics, still commands a significant share of total export (60 percent). This lack of export diversification, coupled with a specialization in an industry with significant and prolonged cycles, is a major risk for the economy in 2009. Electronics exports have already taken a hit but are projected to continue to be under pressure going forward. Empirical analysis reveals a strong and significant causality between electronics parts imports and electronics exports (46 percent with a lag of 4 to 6 months).¹⁷ Since March 2008, imports of electronics parts have contracted by an average of 19 percent, and Q3 contraction was even higher at 23 percent.

¹⁶ During the Asian crisis, although China's overall fiscal deficit package was relatively modest (around 1 percent of GDP), one crucial aspect of the package was its leveraging: most of the stimulus was geared towards capital spending on projects for which the central government was only a co-financier (guarantee provisions were provided to some of the private investors).

¹⁷ A recent global slowdown is illustrative: during the dot com bust, Philippine electronic exports plunged by 17 percent after electronic part imports dived by 27 percent.

28. Remittances are expected to remain resilient in the near-term. Significant inertia and transaction costs in OFW deployment would likely delay the full impact of the global slowdown so that its full effect will likely be visible only in a few months time. Remittance growth is projected at 4 percent next year and will be driven mainly by remittances from OFWs employed in recession-proof industries and areas. Downside risk to that projection is significant and would have important implication for the economy (Table 4). In particular, if the global economic slowdown is more protracted than expected, the likelihood of cuts in OFWs increases. Remittances are also affected by macroeconomic prospects and investment opportunities at home; this motive for remittance might become weaker as the Philippines economy, and the property sector in particular, slow down. Box 1 gives an overview of global remittance flows.

29. Falling prices and rising real Peso-value of remittances could buoy private consumption but higher unemployment will likely offset these gains. After increasing to 9.3 percent in 2008, inflation is projected to decline to 6.5 percent in 2009. Despite the price relief, weaker domestic and external demand is expected to lead to a rise in unemployment. Significant uncertainty surrounds the unemployment forecast as the size of the OFWs that might have to return to the country is subject to large uncertainty and their number is very large (4-5 million workers versus a total workforce in the Philippines of 36.2 millions, and 2.7 million unemployed in 2007).

Table 4. Outlook for Remittance Flows to Developing Countries by Source Region, 2008-09 1/

| Growth Rate (%) | Base case | | Remarks |
|----------------------|-----------|-------|--|
| | 2008e | 2009f | |
| US | -2.9 | 1.4 | Construction sector slowdown |
| Euro Zone | 7.9 | -7.6 | Effect of euro-\$ exchange rate |
| GCC | 37.6 | -9 | Decline in oil prices from 2008 level |
| Other high income | 10.30 | 0.90 | Economic slowdown and exchange rate effect |
| Developing countries | 17 | 9.5 | |

Source: Migration and Development Brief, Migration and Remittances Team, World Bank, Nov 2008.

1/ Remittances are defined as the sum of workers' remittances, compensation of employees, and migrant transfers. In US dollar terms.

30. Private sector investment, which has so far remained resilient and is driven by construction, is likely to slow in the coming quarters. With the exception of construction, all other components of capital formation recorded flat or negative growth in the third quarter. Private sector construction consists mainly of ongoing office and residential constructions that begun prior to 2008 and not new construction. New office and residential projects have seen some delays in project commencement given falling demand and still elevated prices of construction materials.

31. GDP growth in Q4 2008 is projected to grow by 3.6 percent, putting 2008 growth at 4.3 percent. Given projected slower private domestic and external demand, growth in Q4 should be buoyed by public consumption and investment. With only 68 percent of the 2008 estimated primary cash disbursement spent as of Q3, public consumption and investment could potentially add 1.2 percentage points to Q4 growth. Given the aforementioned developments, next year's growth is likely to be lower at 3 percent (Table 5).

Table 5. Philippines: Medium-Term Macroeconomic Framework, 2006-2010

| | 2006 | 2007 | 2008p | 2009f | 2010f |
|--|------|------|-------|-------|-------|
| GDP growth | 5.4 | 7.2 | 4.3 | 3.0 | 4.1 |
| CPI inflation (average) | 6.2 | 2.8 | 9.3 | 6.5 | 5.5 |
| Merchandise Exports growth ^{1/} | 15.6 | 6.4 | 0.2 | -1.0 | 1.5 |
| Merchandise Imports growth ^{1/} | 10.9 | 8.4 | 9.0 | 1.5 | 3.5 |
| Remittances (transfers) growth (US dollar terms) | 19.4 | 13.2 | 13.0 | 4.0 | 7.5 |
| FDI (billions of dollars) | 2.8 | -0.5 | 1.0 | -0.5 | 0.3 |
| Portfolio investment (billions of dollars) | 3.0 | 3.1 | -1.4 | 0.5 | 0.7 |
| International reserves (billions of dollars) | 23.0 | 33.8 | 37.1 | 37.2 | 37.4 |
| International Reserves (months imports GFS) | 4.2 | 5.7 | 5.7 | 5.6 | 5.4 |
| External gross financing needs (billions of dollars) ^{2/} | 10.2 | 6.9 | 12.7 | 12.0 | 11.7 |
| (Percent of GDP) | | | | | |
| Gross domestic investment | 14.5 | 15.3 | 15.3 | 14.9 | 15.4 |
| Current account | 4.5 | 4.4 | 1.8 | 1.4 | 1.2 |
| Gross national savings | 19.0 | 19.7 | 17.1 | 16.3 | 16.6 |
| Trade deficit | -5.7 | -5.7 | -7.9 | -8.7 | -9.1 |
| Tax revenue | 14.3 | 14.0 | 14.1 | 13.4 | 13.7 |
| Privatization | 0.1 | 1.4 | 0.4 | 0.2 | 0.2 |
| Expenditure | 17.3 | 17.3 | 17.0 | 17.1 | 17.0 |
| National government balance | -1.1 | -0.2 | -1.0 | -2.0 | -1.8 |
| National government balance net of privatization | -1.2 | -1.6 | -1.4 | -2.2 | -2.0 |
| National government primary balance | 4.1 | 3.8 | 2.9 | 2.0 | 2.2 |
| Consolidated public sector balance | 0.2 | 0.6 | -1.0 | -2.0 | -2.1 |
| National government debt | 63.8 | 55.8 | 54.5 | 53.1 | 51.1 |
| Non-financial public sector debt | 73.9 | 61.1 | 61.5 | 60.6 | 58.6 |
| External debt (World Bank definition) | 51.3 | 45.7 | 40.0 | 41.2 | 38.6 |

Source: GOP for historical, World Bank for projections, based on understanding of current policies

1/ based on BOP-concept

2/ Defined as current account deficit plus short-term debt by residual maturity (public and private)

Policies

32. In 2009, the Government faces the difficult challenge of bracing the economy for the impact of a worsening global slowdown. Since the release of the November issue of the Philippines Quarterly Update, headline consumer price inflation has considerably improved given the sharp fall in key commodity prices. In addition, the central bank's tight monetary policy stance in the second and third quarters also helped limit inflationary pressures. With inflation no longer a major concern, though risks certainly remain, the Government faces the difficult challenge of ensuring macro-fiscal stability and using appropriate fiscal policy to buoy the domestic economy, subject to not undermining the long-term fiscal position of the country and unduly increase fiscal risks.

Monetary and exchange rate policies

33. Downward momentum in inflation and cuts in policy rates elsewhere provide space for monetary easing. Despite easing inflation since September, the BSP kept the

overnight borrowing and lending rates unchanged at 6 and 8 percent respectively until its December meeting, mindful of upside inflationary pressures as indicated by high core inflation, a build-up of domestic liquidity, and the weaker Peso. For 2009, given our prospects for both inflation and the real economy, we see room for further cuts, especially once core inflation, WPI, and PPI start receding to moderate levels.

34. Foreign exchange market intervention by the BSP should continue to focus on limiting disruptive exchange rate volatility. During 2008, the central bank unloaded a large amount of foreign exchange (\$8.2 billion from January to December 2008)¹⁸ to temper disruptive swings in the Peso as the currency depreciated through the year. Debt service and limited foreign borrowing (given the recent difficulty in taping markets after September) also put pressure on GIR. Looking forward, given heightened global uncertainty and increased risk aversion towards emerging markets, the BSP could be even more selective in its interventions aimed at smoothing fluctuations in order to maintain an adequate level of reserves. The successful \$1.5 billion in foreign bond issuance of January 2009 will also help maintain GIR at a comfortable level in the short-term.

Fiscal policy

35. The scope for fiscal easing depends on two requisites that existed in early 2008: the availability of fiscal space and medium-term fiscal sustainability. The important fiscal consolidation achieved in mid-decade and broadly maintained through 2007 provided the Government with some fiscal space going into 2008. With elevated inflation (especially food and fuel) bringing significant hardships to the poor and dampening growth prospects, the Government wisely postponed its balanced budget goal for 2008 to allow for spending increases in subsidy (mainly rice through the weakly targeted and costly NFA program), social protection, and infrastructure.¹⁹ The Government also correctly resisted calls for tax cuts (such as on the VAT) and advocated instead to earmark “windfall” VAT collection (i.e., extra VAT collection on account of higher commodity prices) to fund subsidies to the poor and vulnerable, including electricity rebates, scholarships, and low interest lending. For 2008, the overall fiscal balance of the national government (excluding one-off privatization revenue) is projected to be broadly the same as in 2007 (Table 2).

36. For 2009, countercyclical fiscal policy is appropriately envisaged but controlling the magnitude of the fiscal easing could be challenging. While the 2009 budget submitted to Congress does not contain an explicit stimulus package, Government officials and Congress are currently discussing the size and content such a package could contain. The focus of discussions has, appropriately, been on increased expenditure to

¹⁸ This has mostly been undertaken through a run down of the BSP’s foreign exchange swap position (a decrease of \$11.5 billion from January to November to \$1.6 billion), while GIR increased by \$3.3 billion for 2008 (to \$37.1 billion). Total spot and swap reserves therefore decreased by 17.7 percent in 2008.

¹⁹ The social protection budget of the Department of Social Welfare and Development was increased in September via supplementary funding by P7.2 billion.

protect the poor, and additional infrastructure spending so as to quickly pump prime the economy and maintain employment (consideration is being given to spend over 60 percent of the annual budget in H1 2009 compared to 30 percent in H1 2008). While these are desirable policies, their ultimate success will depend on the efficiency, quality, and transparency of actual spending. However, key to controlling the fiscal easing while going ahead with the needed additional expenditure will be to deliver the ambitious programmed revenue. In particular, at 15.1²⁰, the programmed tax-to-GDP ratio would be the highest since 1998, a feat that is envisioned to be achieved despite large tax cuts, no offsetting tax policy measures, and the recent weaknesses in domestic tax collection.²¹

37. Notwithstanding the desirability of a fiscal easing, not all fiscal expansions are created equal. A carefully designed and implemented fiscal package is crucial to protecting the economy and the poor. Theoretically, public spending on goods and services has a large multiplier effect on the economy and its direct impact is more certain than those of tax cuts or transfers (these can be saved rather than spent).²² Spending on priority social spending and infrastructure (including maintenance) are often good candidates for scale up. A fiscal expansion should, however, not be perceived as endangering medium-term fiscal sustainability as it could then become counterproductive through adverse effects on financial markets, exchange rates, interest rates, and consumption. This is all the more relevant given uncertainty as to the length and depth of the global slowdown (and the negative impact a further worsening of the global outlook would have on public finances, including through the realization of contingent liabilities that could add to the already relatively high public debt level).

38. With this in mind, the scope and content of fiscal loosening envisaged in the Philippines for 2009 could be strengthened. First, based on spending plans being considered and the World Bank revenue projections, the size of the deficit could materially exceed the level currently budgeted; such a deficit could raise questions regarding the credibility of the country's medium-term fiscal consolidation efforts; policy measures to prevent such a deficit to occur are likely but are projected to mostly fall on expenditure containment rather than on revenue raising measures in a pre-election year.²³ Second, based on World Bank baseline scenario, the composition of the effective fiscal loosening in for 2009 compared to 2008 (0.7 percentage point of GDP) will be heavily

²⁰ This is calculated from the Government's programmed revenue as stated in the budget and the World Bank's GDP projection.

²¹ It should be noted that large differences between budgeted revenue collection and outturn are not uncommon. A recent example is 2007 where the budgeted tax-to-GDP ratio was 15.3 while the outturn reached only 14.0 (this was actually lower than the 2006 outturn of 14.3).

²² See Olivier Blanchard et al. "Fiscal Policy for the Crisis," IMF Staff Position Note (December 2008) for a recent overview of the evidence regarding the desirable composition of fiscal packages to confront the current global financial crisis and economic slowdown.

²³ Although frontloading of the spending plans into the first half of the year is desirable to sustain growth at its weakest point, it also runs the risk of leaving the Government with few options to contain the deficit for the year should revenue collection turn out to be weaker than budgeted—as projected by the World Bank. This being said, for front-loading to occur, timely passage of the budget law would have to happen, which is not yet the case, in line with recent historical trend.

tilted towards revenue, with total expenditure only projected to rise by 0.1 percentage points (Table 5); a composition which is less effective at reviving growth (lower fiscal multiplier) and protecting the poor. Third, the content of the specific revenue measures themselves is also not the most effective in helping revive a slowing economy.²⁴

39. To maximize cost effectiveness, efficiency, and progressivity of the fiscal easing, spending will need to be well-targeted. Targeting should focus on programs and projects with high employment content and that are in areas and sectors that are hit hardest by the crisis. These could include ongoing infrastructure programs, the acceleration of new and small-scale infrastructure projects, and the scale-up of targeted social protection and safety nets that can also serve as automatic stabilizers. In particular, ensuring that the Government's conditional cash transfer program is well-targeted could help cushion the impact of income, health, and other shocks on the poor, as shown in countries like Indonesia and Brazil. In addition, early release of fiscal transfers to local government units would ensure delivery of basic services is maintained.²⁵ Spending transparency is also crucial. It is important that information on all spending is openly and easily available to some level of detail to allow better monitoring and evaluation of the impact of policies and gauge the efficiency of spending given scarce resources.

Tax policy and administration

40. Reversing the steady decline in tax revenue will be key to having a credible and controlled fiscal easing in 2009. After briefly rebounding in 2006 following the VAT reform, the tax-to-GDP ratio has renewed its downtrend (that started with the Asian crisis a decade ago) and is projected by the World Bank to continue doing so in 2009. The decline is due to tax cuts, non-indexation of excises, and more generally a complex tax policy system coupled with a tax administration which is perceived in governance surveys as highly corrupt. The poor revenue performance of the last few months is clearly a source of concern. While the Government's goal for 2009 is to maintain (and even grow) the revenue base, additional measures are likely to be required to achieve that end. Prompt Congress approval of key revenue bills supported by the Government are crucial to help the country weather well the global economic storm.

²⁴ Tax savings from general corporate income tax cuts or increases in personal income tax (PIT) threshold are likely to be saved rather than reinvested or consumed as corporations face uncertainty as to the future demand for their products and households are uncertain about current and future income and wealth. However, the exemption of minimum wage earners from PIT should be more effective. Effective stimulus measures should target households and companies that are cash/credit constrained and that because of the global crisis are forced to pare down spending and investment (e.g., a conditional cash transfer aimed at a poor, and therefore cash constrained, households—a measure being considered by the Government).

²⁵ A review of the internal revenue allotment formula with a view to making it more progressive (i.e., increasing transfers to poor LGUs) could also be initiated as this would ensure a more uniform delivery of public services across the country (see the World Bank's World Development Report 2009 "Reshaping Economic Geography" for a rationale for providing uniform public services amidst inherent geographic concentration of economic growth within countries). Currently, only population and land area are key variables in the determinant of the allotment.

41. However, based on current policies, the tax effort is expected to fall in 2009, both vis-à-vis the budgeted target and the 2008 outturn. The projected downturn in the tax ratio owes to a combination of (1) one-off factors inflating 2008 collection; (2) tax policy measures that will reduce the 2009 tax base; and (3) a slowing economy. The first factor includes “windfall” revenue from high commodity prices (especially VAT on fuel) and taxes collected through the tax amnesty program in 2008; these generated 0.4 percent of GDP in 2008. The second factor (tax measures)—as detailed in the World Bank’s November Philippines Quarterly Update²⁶—could cost between 0.5 to 0.7 percent of GDP, while the non-indexation of specific excises and fees to inflation would also weaken tax buoyancy given the high inflation rate. Finally, the slowdown in economic growth that started in 2008 will negatively impact 2009 tax collection as some large tax sources have lagged and have historically fallen more quickly than economic activity during downturns (e.g., corporate income tax). Our baseline projection for the tax-to-GDP ratio is therefore 13.4 percent for 2009 (factoring some tax administration improvements), compared to 15.1 percent for the national government budget, and 14.1 percent for 2008 (World Bank estimate).²⁷

42. Additional tax policy measures and administration reforms seem warranted for the Government to achieve its intended fiscal easing. Several tax policy measures are being considered but, given the latest discussions, their revenue impact is not projected to compensate for the recent tax cuts. These include: (1) the fiscal incentives rationalization bill which provides income tax holiday incentive to registered exporters and strategic activities but phases out these incentive six years after enactment of the law; (2) the simplified net income taxation scheme (SNITS)²⁸, and (2) the tobacco excise tax rationalization bills: various versions exist but HB 3759 has the highest revenue impact given its single rate provision.²⁹ Under the best case scenario, wherein all these bills are signed into law in early 2009 and made effective by mid-year, the total revenue impact is estimated at 0.3 percent of GDP, still lower than the projected decline of 0.5-0.7 percent of GDP.

43. Tax administration reforms that would both help with short-term revenue gains while paving the way for long-term reforms are desirable. Increased budgetary resources for BIR and BOC in 2009 would enable such efforts, especially through the

²⁶ The tax policy measures introduced include the reduction in the corporate income tax rate from 35 to 30 percent (beginning January 2009), the full year implementation of RA 9504 (implemented in July 2008), and the PERA law (to be implemented in January 2009 although as of writing, the implementing rules and regulation have not been completed).

²⁷ While the gap between the budget and the World Bank forecast is substantial, it is worth noticing that it is of the same magnitude as the difference between budget and outturn in 2007.

²⁸ A bill on the simplified net income taxation scheme (SNITS) was recently passed by the Lower House and is projected by the DOF to raise P11 billion in annual revenue. The aim is to improve compliance and tax collection from self-employed and professionals through limiting expense deductions to core business expenses.

²⁹ The bill provides for a single specific tax rate of P14 per pack on machine-packed cigarettes from the current P2.23 for low-priced to P26.06 for premium price (mostly imported cigarettes). A related bill proposes to rationalize the excise tax rates of alcohol products.

recruitment of skilled professionals.³⁰ The recent focus of the BIR leadership to strengthen its Large Taxpayers Service (LTS) is also commendable. Such a reform has the potential of not only increasing revenues but also improving taxpayer services and providing a pilot reform that could later provide a blueprint for further reforms. At the same time, ongoing tax compliance and collection reform measures should be forcefully pursued.³¹ Focus on these compliance-improving measures is warranted by a provision in the 2009 budget to institutionalize the RATE, RATS, and RIPS programs as permanent offices in the BIR, BOC, and DOF respectively. Together, these reforms could generate 0.1 to 0.3 percent of GDP in additional collection.

44. There is significant scope for increasing control over and improving services to the country's largest taxpayers. The Large Taxpayer Service (LTS) is a crucial office in the tax administrations of many countries as they increase control and services over the country's largest taxpayers, which normally contribute 50 to 80 percent of total tax revenues. Several countries that have successfully introduced LTS have seen improving tax compliance and higher tax revenues. Staff in LTS are usually selected based on higher standards and are better trained compared to staff in non-LTS offices. Having an LTS has also proven to be an important mechanism for maintaining revenue collections at a reasonable and sustainable level while the rest of the tax administration is being modernized. Box 2 provides background to the state of the LTS in the Philippines.

45. While the increase in BIR and BOC resources is welcome, there is also the need to improve performance monitoring and evaluation in BIR and BOC. The passage of the Attrition Act in 2005, which punishes or rewards revenue officials based on meeting or not meeting collection goals, appears to have redirected focus away from the equally important medium- to long-term reform programs such as clean-up and expansion of the taxpayer database, improvements in the registration and collection processes, and audit selection and processes. Partly as a result, tax collection since 2007 has not been sustained. To help improve the sustainability of tax revenues and the quality and efficiency of tax collection, a proper balance between immediate revenue collection and structural reforms needs to be restored.

46. Complementary to efforts aimed at maintaining sound and sustainable public finances, significant benefit would arise from a better understanding and disclosure of fiscal risks. Fiscal risk can be broadly defined as the possibility of deviations of fiscal outcomes from what was expected at the time of the budget or other forecast. A number of countries, especially in the region, have recently undertaken a systematic and comprehensive assessment of their fiscal risks and have published such assessments, often as part of their annual budget submission to Parliament (e.g., Indonesia in 2007). Empirical evidence reveals that fiscal risks are indeed sizeable enough to have significant

³⁰ The 2009 budget provides for a 36 percent budgetary increase for the BIR, in part to hire 3,400 new technical personnel such as examiners and lawyers. A pending law, the Salary Standardization Law III, which provides higher salaries to technical staff and managers would also help improve professionalism

³¹ These include expanding the tax base via third party information sharing and strengthening enforcement via the Run After Tax Evaders (RATE), Run After the Smugglers (RATS), and Revenue Integrity Protection Service (RIPS) programs. See the November issue of our Quarterly Update for details.

macroeconomic consequences at times; among these key sources of risks are unexpected changes in macroeconomic variables (e.g., sharp exchange rate depreciations), contingent liabilities in the banking system, other parts of the public sector (GOCCs), or the government's interactions with the private sector (e.g., PPPs).

Box 1. Global Remittance Flows

The slowdown in remittance flows to developing countries is expected to deepen in 2009, but remittances will exhibit resilience compared to private capital flows and official aid. With the current crisis becoming increasingly global, the environment for remittance flows to developing countries in 2009-10 appears uncertain for four main reasons: (1) The economic slowdown in the high-income OECD countries including the United States and Western Europe (which account for almost two-third of remittance flows to developing countries); (2) Impact of the financial crisis on developing countries (which account for half of migrants from developing countries); (3) Impact of a fall in oil prices on the economies of the Gulf Cooperation Council (GCC) countries; and (4) Uncertainty about exchange rates. The growth of remittance flows is expected to slow significantly from 6.7 percent in 2008 to negative 0.9 percent in 2009 under the base scenario, but recover in the medium term to 6.1 percent in 2010.

The impact on remittance flows to recipient developing regions will depend on the prospects for recovery of growth and employment in the respective migrant-destination countries. For the Philippines, the United States is a major source of remittances and hence, if the United States goes into a prolonged recession, remittances will be adversely affected although not expected to decline significantly given the increasing number of overseas Filipinos working in immune sectors such as education and healthcare.

Remittance flows from oil-rich GCC countries have accounted for about 80 percent of new deployments of Overseas Filipino Workers. A continuation of the recent decline in oil prices, which have fallen over 60 percent from the peak, would make the GCC economies more vulnerable. Combined with the impact of the financial crisis on the banking sector of these countries, this could potentially lead to a significant deceleration in construction activities in which a large number of migrants have been employed in recent years. Under the base scenario, remittance flows from GCC countries would fall by 9 percent in 2009 in nominal dollar terms compared to an increase of 38 percent this year. While some layoffs are to be expected in the construction sector in the GCC countries, it is unclear whether the numbers would be large enough to result in a net outflow of migrants from wealthy GCC countries with ample oil and financial reserves. The relationship between oil prices and immigration to the GCC countries was evident during the 1970s, but this relationship has been weak or non-existent since the 1980s.

There are several reasons for the resilience of remittance flows during economic downturns in remittance-source countries: (1) Remittances are sent by the cumulated flows of migrants over the years, not only by new migrants of the last year or two. This makes remittances persistent over time. If new migration stops, then over a period of a decade or so, remittances may stop growing. But they will continue to increase as long as migration flows continue. (2) Remittances are a small part of migrants' incomes, and migrants continue to send remittances when hit by income shocks. (3) Because of a rise in anti-immigration sentiments and tighter border controls, especially in the U.S and also in Europe, the duration of migration appears to have increased. Those staying back are likely to continue to send remittances. (4) If migrants do indeed return, they are likely to take back accumulated savings. Also the "safe haven" factor or "home-bias" can cause remittances for investment purposes to return home during an economic down turn in the host country. (5) Several high-income OECD remittance source countries are likely to undertake large fiscal stimulus packages in response to the financial crisis. This increase in public expenditure, if directed to public infrastructure projects, will increase demand for both native and migrant workers. Also documented migrants are likely to send more remittances to their families, to make up for a fall in remittances by undocumented migrants.

Box 2. The Large Taxpayers Service in the BIR

The Large Taxpayers Unit (LTU) is a crucial office in the tax administrations of many developing and emerging countries. The rationale for having an LTU is to increase control over the country's largest taxpayers, which normally contribute 50 to 80 percent of total tax revenues. Several countries that have successfully implemented LTUs have seen improving tax compliance and higher tax revenues.

In the Philippines, the BIR's Large Taxpayers Service (LTS) (a third level office headed by an assistant commissioner) was created in 1999; it initially covered 630 of the country's largest taxpayers and accounted for 32 percent of BIR's tax revenues. As the premier office in the BIR, attention was given to forming an elite group of highly respected and competent examiners, in line with international best practices. To carry this out, LTS staff, in particular examiners, were selected via a stringent recruitment process that involved an interview with top management, a written exam, and a psychological exam. Successful applicants were then required to take core trainings (both formal and on-the-job) on the end-to-end audit process including industry profiling and benchmarking, international financial reporting standard, and audit of complex industries such as banking and insurance. In the succeeding years, training on computerized audit tools such as the CAATS became a standard requirement. A strong performance management system with office level reward system was also put in place.

Over the years, the number of LTS taxpayers was gradually increased although application of the criteria for enlisting and delisting large taxpayers was not automatic and consistent. By end-2007, the LTS accounted for about 60 percent of total BIR collections and included 1,325 companies. The increase in the number of large taxpayers, especially in the latter years, however, was not complemented by a commensurate increase in the number, caliber, and capacity of LTS staff, in particular examiners. Moreover, the original recruitment method was discontinued after the initial implementation and the LTS training program lost steam given budget cuts. The weakening of the LTS and the decision to rebalance the distribution of collection goals contributed to the delisting of about 500 large taxpayers from the LTS in early 2008, many of which satisfied the large taxpayer criteria. The delisting brought down the collection share of LTS to about 50 percent.

From an elite group of BIR examiners that was carefully selected in 1999 and given advanced and specialized training, the current roster of LTS examiners is generally undertrained and appears inadequate in number (at least prior to the delisting). Less than a quarter of the original high caliber examiners have remained in the LTS while the majority have either moved to other offices or have resigned. In mid-2007 a major reassignment of personnel led to the transfer of a significant number of original LTS examiners to the field; they were replaced by examiners from the field, many of whom had no previous LTS experience.

In January 2009, the new Commissioner of the BIR relisted the delisted large taxpayers and embarked on a program to strengthen the LTS.