

**World Bank Office Manila**

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# **Quarterly Economic Update**

**April 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](mailto:dllorito@worldbank.org)).

## Overview

**While the economy remains relatively resilient we project GDP growth to reach 1.9 percent for 2009 and gradually recover in 2010.** Key factors in our analysis include: (i) external demand dragged down by global recession, (ii) private consumption affected by a projected weakening labor market (large structural increase in the labor force, weak employment, slowdown in net OFW deployment, and pressure on wages) and reduced remittance flows, that pull household income down and undermine consumer sentiment, (iii) private investments projected to contract as business confidence is waning and construction activity decelerates, and (iv) a controlled fiscal stimulus that offsets part of the output gap generated by the private sector. With both the weakening of the labor market and the slowdown in remittances lagging economic activity, GDP growth is projected to weaken throughout 2009 and gradually recover in 2010.

**Labor market conditions are expected to deteriorate significantly in 2009 and through 2010.** Several factors point to this conclusion. First, while signs of a weakening labor market abound, the economic slowdown observed in 2008 and in the first months of 2009 has yet to be transmitted fully to the labor market, as labor market developments trail economic activity. Second, the global recession is likely to lead, again with a lag, to a slowdown in net OFW deployments as global unemployment rises. Finally, a structural factor is also adding to the cyclical factors in weakening the labor market, namely a projected sharp increase in the labor force during 2008-2010 resulting from population dynamics. The deteriorating labor market is estimated to first affect the non-poor urban and young workers and to then spread to the poor as under-employment and informality of jobs rise.

**Remittance flows have sharply decelerated and are projected to post a moderate decline in dollar terms for 2009.** The three-month moving average annual growth rate of total dollar remittances started decelerating rapidly from 23 percent in mid-2008 to 2 percent in February 2009. Inflows from the US—which account for over half of total remittances—have contracted significantly since October. Based on the World Bank’s Remittances global model, and analysis of remittance flows during past simultaneous recession event (i.e., both the Philippines and the host country are simultaneously in a recession), remittances to the Philippines are projected to decrease by 4 percent in US\$ terms.

**The success of the planned expenditure-led fiscal stimulus relies on implementing a controlled fiscal easing.** The potency of public expenditure to support growth depends on the capacity to generate revenues and on the appropriateness and timeliness of the fiscal stimulus. With the tax effort projected to fall markedly in 2009 and front-loading of expenditure on track, fiscal easing in the first half of 2009 is fully taking place. For the second half of 2009, as growth is projected to weaken further, the deficit could rise beyond its budgeted size. This might induce the government to slow down spending to prevent fiscal destabilization as the country nears the 2010 general elections. The government has proposed tax measures to improve revenue but getting Congressional approval on these bills has been challenging and administrative measures take time. Further measures could therefore be considered, such as raising gasoline excises.

## **A. Recent Economic and Policy Developments**

### **A comparatively resilient real sector**

1. **Philippine economic growth slowed markedly in 2008 and decelerated further in Q1 2009 following years of sustained high growth.** Between 2004 and 2007, growth improved on the back of renewed investor confidence itself driven by fiscal consolidation, high global growth, and strong global appetite for emerging markets as an asset class. Strong remittance inflows helped fuel domestic demand. The boom years, however, were disturbed by a series of major external shocks (food and fuel price shock; global financial crisis; global recession). The food and fuel price shocks brought domestic inflation to a decade-high, squeezing real household income and bringing significant hardship to the poor. Then the global financial crisis led to a collapse in domestic asset prices and a disruption of credit markets, bringing corporate and financial sector earnings down and investments on hold. The ensuing global recession is taking its toll on the real sector as exports and remittances fall (as a ratio of GDP), and the quality of the labor market—crucial to maintaining consumer confidence in an economy where consumption accounts for 77 percent of GDP—starts deteriorating. As a result, growth in 2008 slowed to 4.6 percent from a record high of 7.2 percent in 2007. Preliminary estimates point to a drop to 2.1-3.1 percent for Q1 2009 GDP growth (NEDA), potentially less than half the previous quarter's 4.6 percent growth rate. Leading economic indicators confirm the estimated strong decline in economic growth in the first few months of 2009 (see below).

2. **On the production side, a surprisingly strong manufacturing sector compensated for slower growth in agriculture and services** in 2008 (Figure 2). Food manufacturing, which comprises almost half of the sector value-added, and which caters mostly to domestic consumption, contributed 0.9 percentage points to overall growth (almost a fifth of GDP growth). Although the performance of export-oriented firms such as electrical machinery and semi-conductors slowed, their small value-added, estimated at less than 10 percent of final production, hardly affected overall manufacturing sector growth. The key services sector—accounting for over half of GDP and of the total workforce—posted its slowest growth since 2002 (4.9 percent). Except for government services and real estate, all subsectors posted a decline in terms of contribution to growth. Higher inflation dampened growth in trade and the transportation, communication, and storage subsectors while the financial system was badly hit by falling asset prices. The agriculture sector also slowed despite government effort to boost production via the P46 billion (0.6 percent of GDP) FIELDS program.<sup>1</sup>

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<sup>1</sup> FIELDS stands for the six areas of support for the agriculture sector (Fertilizer, Irrigation, Education and training of farmers and fisherfolks, Loans, Dryers and post-harvest facilities, and Seeds of high-yielding, hybrid varieties).

3. **On the demand side, private consumption and public sector spending were the key growth drivers** in 2008 (Figure 1). Although private consumption growth fell from 5.8 percent in 2007 to 4.5 percent in 2008, its growth remained resilient and broadly stable during the year (as the first half included the large food price shock which significantly affected consumer confidence—Figure 3). Remittances, a significant source of household income, grew by 10 percent in peso terms and boosted private consumption during the period of rising inflation.<sup>2</sup> The recovery in government consumption and government investment (in public construction) in the second half of 2008 after contracting in the first half contributed 0.9 percentage points to overall growth. The high growth of private construction, which mostly comprises ongoing commercial and residential projects, made up for the slowdown in durable equipment purchases—these are estimated to have slowed down in Q1 2009 and should continue doing so for the remainder of the year.

Figure 1. While off its highs, growth proved resilient due to consumption

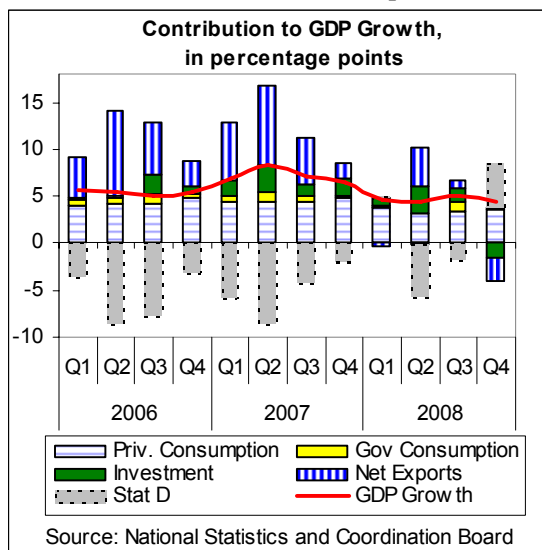
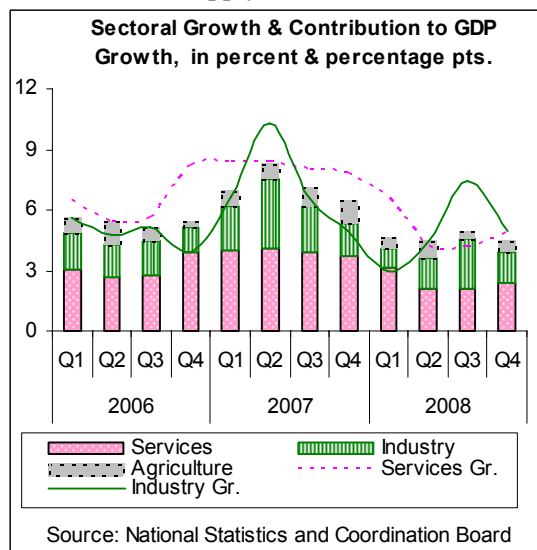


Figure 2. Food manufacturing buoyed growth on the supply side.



4. **The resilience of economic growth in the Philippines contrasts with the performance, up to date, of other countries in the region.** Amid a sharp slowdown in global demand, growth in the region has fallen to record lows, with a few countries contracting at record pace and depth. For example, first quarter economic growth (annual rate) is estimated to have reached its lowest level in ten years both in China and Vietnam, and to have contracted by 11.5 percent in Singapore and 4.2 percent in Korea. Countries

<sup>2</sup> The remittance elasticity of private consumption in the last 10 years is estimated at 0.7; that is a one percent increase in remittances increase private consumption by 0.7 percent. The relationship is very stable over time. Granger causality tests reveal that remittance growth drives consumption at short horizons but that over longer time periods, hysteresis effects are at play: higher consumption levels engendered by remittances later call for continued remittances.

more dependent on exports, especially on single products or single markets have seen their growth fall faster and, in general, deeper.

**The Philippines' overall resilience is also observable in its corporate sector**

5. **Overall, quoted companies have weathered the global economic and financial shocks well to date.** In the first three quarters of 2008, total net earnings of companies listed in the Philippine Stock Exchange fell by 20 percent to P163 billion. Holding firms, financial institutions and services firms suffered the biggest drop in profits—42, 37, and 27 percent respectively (Table 2). The drop in total earnings stems partly from foreign exchange transactions and hedging losses. Pre-payment of debt in the last three years (especially in 2007 when the Peso was strong), however, has served to limit the impact of currency volatility in some firms. Corporations have also deleveraged considerably—with average debt/equity ratios of around 0.5.

6. **The corporate sector faced a more challenging financing environment.** In 2008, the Philippine CEMBI<sup>3</sup> was up by about 400 basis points and has remained elevated in early 2009 while the Philippine stock market value has halved, which curtailed initial public offerings. Large debt issuances of several conglomerates are also pushing up domestic bond interest rates, by as much 400 basis points from only 100-200 basis points prior to the offering. Nonetheless, Peso liquidity in the banking system remains adequate and the central bank has taken appropriate measures to ease liquidity further. In 2009, a survey by the BSP revealed that two-thirds of banks have recently tightened lending standards in terms of documentation and collateralization on concerns that borrowers are more at risk of defaulting on their loans.

7. **The global recession and financial crisis led to plant closures, job cuts and other cost-reducing measures in key manufacturing firms in the Philippines.** While strong profits in recent years and limited leverage provide Philippine companies with legroom to weather the global recession, many multinational companies have reported significant losses in their global operations and are retrenching costs globally. Most firms in the electronics sector have retrenched a significant portion of their workforce and have placed the rest of their 460,000 strong work-force on reduced work hours or on forced leave.<sup>4</sup> Vehicle manufacturers have also announced job redundancies as sales have grown below target, as have garment manufacturers, while about 300 export-oriented furniture, handicraft and footwear companies have closed shop. On the other hand, firms in the services sector, especially those catering mostly to domestic demand, have so far held up well.

8. **Amidst a weakening corporate sector, a silver lining could be emerging for the business process outsourcing (BPO) industry as firms slash costs globally.** In the last decade, the BPO industry has grown at impressive rates and now contributes about 4

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<sup>3</sup> Corporate emerging market bond index

<sup>4</sup> Many electronics firms have not yet resorted to massive retrenchment of their skilled workers in order to minimize rehiring cost—a lesson learned from the 2001 downturn. Nevertheless, firms would be forced to begin laying off workers if demand does not recover by mid-year.

percent of GDP and employs nearly 400,000 people (a 24 percent increase in 2008). The industry also contributed to the rapid growth of the commercial property sector in recent years. The global economic slowdown has had mixed effects on the industry, which can be sub-divided in two: call centers and back-office. On the one hand, several firms, in particular small ones, have begun to see lower revenues, mostly in the call center business, as a result of the slowdown in demand from clients. On the other hand, back-office services are benefiting from increased search for cost savings.<sup>5</sup> The BPO sector expects growth to remain robust in 2009 (at 20-30 percent) and to increase its total employment by about 100,000 jobs. A key bottleneck to growth for the industry, however, remains the availability of qualified staff (i.e., good command of English, willingness to work night shifts, technical knowledge).

### **The financial system weathered the crisis comparatively well**

**9. Several asset classes have posted sharp falls in 2008 before stabilizing or partly recovering in 2009.** Following the strong appreciation of the peso in 2007, the currency depreciated by about 14 percent in 2008 against the US dollar and depreciated another 2.1 percent through end-April 2009. After losing 49 percent of their value in 2008 given the massive sell-off of foreign equity holdings equivalent to about \$1 billion, stock market assets registered a 10.1 percent recovery through end-April (Figure 4). Borrowing spreads, which had fallen below 200 basis points in 2007, jumped to over 800 basis points in October before improving to less than 500 basis points in February (Figure 5). Philippine spreads, however, have over-performed compared to the average emerging market. Notwithstanding the large fall in asset prices, the negative wealth effect should be contained as less than 2 percent of the population is estimated to have investments in equities, fixed-income and other instruments.

**10. Domestic financial markets proved resilient despite the turbulence in the international financial markets.** The banking system as a whole was only mildly affected by the financial turmoil and the banking system remained adequately capitalized as of September 2008 with a capital adequacy ratio (CAR) of 15.3 percent on a consolidated basis (Table 3).<sup>6</sup> The relatively strong capitalization of the banking sector can mostly be traced to the 1997-98 Asian financial crisis that left banks with oversized non-performing loans (NPLs). As a result, contrary to most banking systems in the world, Philippines banks were still working on improving their balance sheets when the global financial crisis hit. This improvement was achieved through recent efforts to increase capital (especially during 2007 as the Peso appreciated markedly) and the adoption of conservative lending and financing practices (lending to the private sector is

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<sup>5</sup> A revealing such example is with banks such as HSBC, Citibank, Deutsche Bank and JP Morgan. They have announced plans to significantly expand their BPO operations in the Philippines as part of their global strategy to cut costs.

<sup>6</sup> As detailed in World Bank (2008a), the Philippines' direct exposure to subprime related distressed credit products appears to be limited with the exception of a handful of banks. The loss associated with decline in sovereign bond prices was greater, albeit still contained, not least because of regulatory changes. Of more concern, however, are off-balance sheet investments and unit trust fund operations equivalent to about 20 percent of assets (P1.2 trillion) which have been hit much harder.

relatively low, at 33 percent of GDP; loan-to-deposit ratio is at a low 70 percent<sup>7</sup>, which reduces the risk of being affected by developments in the wholesale market (Table 3)).

**11. While resilient to date, domestic banks' have significant exposure to ROPs and CLNs.** Banks are vulnerable on account of their substantial investments in marketable bonds, such as Philippine sovereign bonds (ROP) and credit-linked notes (CLN). As of June 2008, holdings of debt securities amounted to P1.2 trillion, of which 26 percent were either held-to-maturity securities or unquoted debt securities classified as loans. The rest which were priced at fair value amounted to 1.6 times the banking system's capital and 17 percent of its asset (IMF Selected Issues Paper, 2009). This makes the Philippines vulnerable to volatility in spreads. Given the banks' large holdings of bonds (estimated at about 17 percent of total assets), mark-to-market losses have contributed to the 36 percent fall in profit through September; these would have been bigger had the central bank not allowed a change in accounting rules to enable banks to avoid further mark-to-market losses on their bond holdings. It is estimated that about 26 out of 32 major banks took advantage of the accounting rule change to avert P30 billion in losses (equivalent to 48 percent of the total profits gained by the whole banking system in 2007).

**12. The authorities promptly implemented measures commensurate with the pressures confronting the domestic financial markets.** The stock exchange approved a circuit breaker rule to halt trading if the benchmark index were to drop by 10 percent from the previous day. The central bank has relaxed accounting rules to enable banks to avoid mark-to-market losses on their government bond holdings via a one-time reclassification, eased its rules on the 100 percent asset cover of bank's foreign currency deposit units, and opened an inter-bank dollar-denominated borrowing and lending facility to manage liquidity constraints of banks. Although domestic liquidity is adequate, the BSP has taken preemptive measures such as lowering the reserve requirement by 2 percentage points, doubling the peso rediscounting facility to P40 billion in November and further increasing it to P60 billion in February of this year to prevent a possible credit crunch. The central bank also increased the loan value of all eligible rediscounting papers from 80 to 90 percent of the outstanding balance of a borrowing bank's credit instrument.<sup>8</sup> A doubling of the limit up to which deposits are insured to P500,000 was signed into law in April (with such a move, PDIC coverage rose from 91 to 97 percent of accounts) alongside a strengthening of PDIC's supervisory power.<sup>9</sup>

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<sup>7</sup> Total loan portfolio, gross (net of amortization) to deposit liabilities ratio. A ratio in excess of 100 means that banks have to rely on financing sources that are more fickle than deposits to finance their loans (sluggishness in deposits is significant, except in the case of bank runs when the financial health of the bank itself is questioned). These other financing sources and strategies have included the rolling-over of large amounts of short-term financing from capital markets.

<sup>8</sup> This is, however, capped at 70 percent of the appraised value of the underlying collateral.

<sup>9</sup> The associated strengthening of the PDIC's balance sheet, however, will only take place over a period of a few years. In the meantime, the law calls for a National Government to directly guarantee depositors for their deposits in excess to P250,000 and below P500,000 per account.

**13. The global financial crisis has revealed problems associated with several rural banks and pre-need companies, highlighting gaps in financial sector supervision.** In the case of the rural banks, weaknesses in the central bank's charter and legal restraints have prevented it from taking proper and timely action against ailing rural banks;<sup>10</sup> these delays have increased the cost to the PDIC to P14 billion, or 28 percent of the PDIC's total equity. Rural banks account for only 3 percent of total bank assets. The BSP's charter does not provide adequate protection to bank supervisors and examiners against legal threat arising from their conduct of bank supervision. Moreover, the law on the secrecy of bank deposits—among the strictest in the world—does not give bank examiners full and timely access to suspicious accounts rendering them powerless in performing their supervision duties. For better prompt corrective action, stronger banking oversight powers are necessary to limit moral hazard. On April 29, 2009, R.A. 9576 was passed into law; it provides for a doubling of the deposit insurance and includes a provision exempting PDIC examiners from the deposit secrecy law so that they can look into deposit accounts that face impending closure. A comprehensive exemption of BSP examiners from the deposit secrecy law, as well as legal protection of BSP staff, is also being considered in the proposed amendments to the BSP charter. Moreover, the central bank has moved to improve its supervisory review process and banks have begun to shift to international financial standards and have moved forward with their respective internal capital adequacy assessment process.

#### **A slow but protracted labor market deterioration**

**14. Contrary to the relatively sound macroeconomic fundamentals at the onset of the global recession, the quality of the Philippines labor market is already weak to start with.** For the past seven years through 2008, the economy grew at 5.4 percent on average per year. Yet, during these prosperous times, the labor market was characterized by (i) a high unemployment rate (7.4 percent in 2008); (ii) even higher under-employment rate (19.3 percent) with a high incidence among the youth, and even skilled (graduates) youth; (iii) high informal sector (mostly in agriculture and services); (iv) a rigid labor market environment (including an outdated and complex labor code); (v) and a falling trend in real wages since 2001.

**15. Notwithstanding the resiliency of the economy, the quality of the labor market is slowly weakening.** The quantity of jobs lost is already large but difficult to fully capture.<sup>11</sup> The unemployment rate continued its steady rise in 2009 (from 7.4 percent in October 2008 to 7.7 percent this January<sup>12</sup>). Along with the slump in exports (annual

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<sup>10</sup> In late February, the central bank filed a P1 billion syndicated Estafa case versus the owner of the Legacy Group which was responsible for the rural bank collapse.

<sup>11</sup> Aside from the 45,000 OFWs and electronic industry workers that have reported job losses, an unknown number of workers have also lost their jobs but are not being reported (e.g., SMEs and export processing zones do not systematically report retrenchment data to the government).

<sup>12</sup> A separate non-government employment survey found unemployment—defined differently from the government—jumping to 27.9 percent in Q4 2008, up from 17.5 a year before (Social Weather Station).

Figure 3. Consumer confidence suffered because of the food and oil crisis...

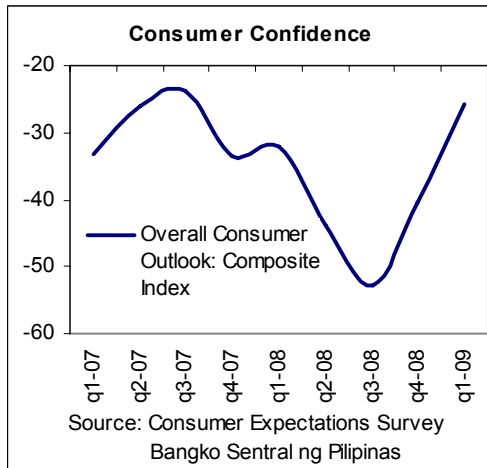


Figure 4. Stock prices fell sharply with massive foreign sell-offs.

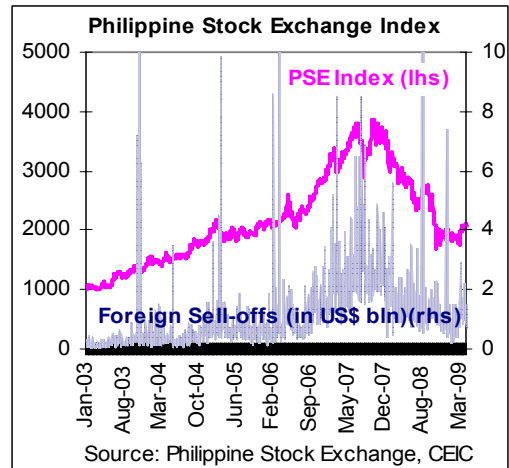


Figure 5. Sovereign and corporate bond spreads widened

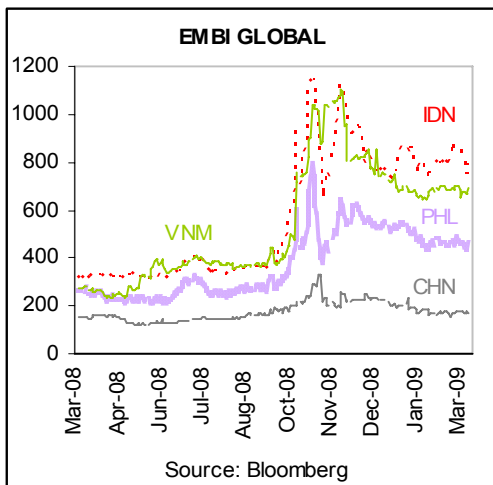


Figure 6. Net job creation started deteriorating in July 2008...

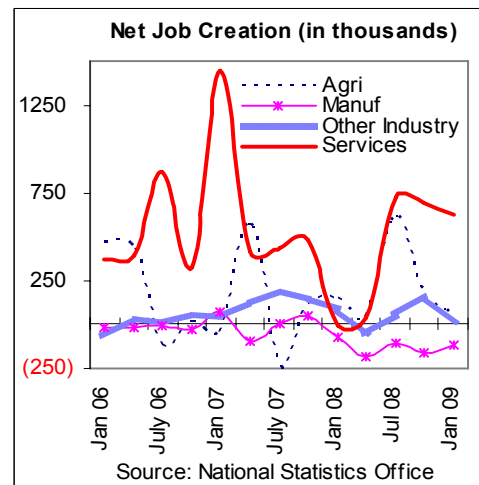


Figure 7 ... unskilled workers are increasingly being hit by the crisis.

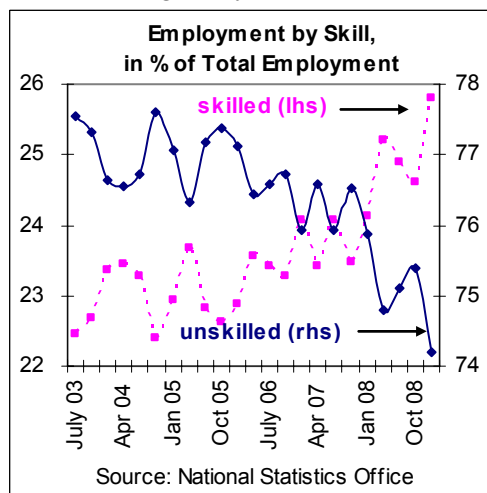
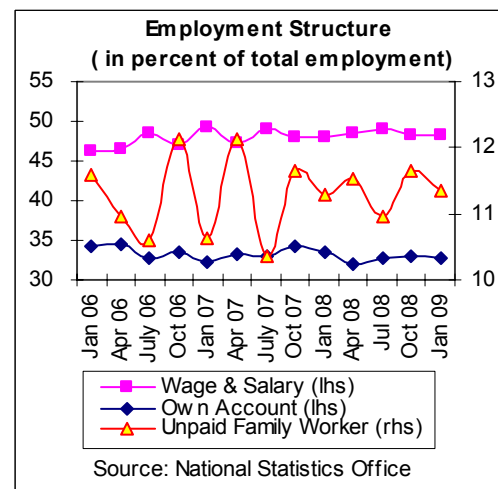


Figure 8 ...but job quality remains broadly stable so far



contraction of about 40 percent in both January and February), the manufacturing sector continued to shed jobs, posting more than 100,000 job losses in January (Figure 6). Starting late last year, data point to a particular worsening of the job market for unskilled workers (Figure 7). Overseas employment—an important safety valve given the rapid growth of the Filipino labor force—also weakened in November, and contracted by 5.8 percent, in December. It again registered strong growth earlier this year but downside risk still lies on the scenario of deeper global downturn. Nevertheless, the services sector continued to create jobs even as the economy slowed down. The underemployment rate remains below 20 percent. Surprisingly, measured employment quality remained broadly stable at this stage (Figure 8).

**16. To respond to the labor market challenges, the government has introduced several measures, including as part of its Economic Resiliency Plan.** Overall, the government estimates that up to 200,000 workers may lose their jobs in 2009. In response, the government announced that it was deferring the implementation of the rationalization plan in several government agencies and ordered government agencies to allot 1.5 percent of their respective maintenance and other operating expenses budget to hire 180,000 temporary workers.<sup>13</sup> The government has also identified several contingency measures to help displaced workers.<sup>14</sup>

#### **A controlled fiscal stimulus?**

**17. To counteract global recessionary forces, the government introduced a fiscal stimulus plan for 2009 and postponed its medium-term balanced budget goal to 2011.** In February, the government announced a 2009 stimulus package, the Economic Resiliency Plan (ERP), of P330 billion (4.1 percent of GDP), of which 88 percent consists of expenditure measures—P160 billion from increased national government (NG) spending, P100 billion to finance extra-budgetary infrastructure projects,<sup>15</sup> and P30 billion for new and temporary additional benefits to Social Security System members—and the remaining 12 percent (P40 billion) consist of general tax cuts (on corporations and individuals). Aside from its strong spending bias (Table 4), a key feature of the design of the ERP is its frontloading of discretionary expenditure (concentrating in H1 2009) as the trough of the economic slowdown is projected by the government to be during that period. As detailed below, the delayed passage of the 2009 budget, which only took effect in March, did not seem to delay the implementation of the ERP to date.

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<sup>13</sup> Executive Order 782.

<sup>14</sup> These include a “payback package” for returning OFWs which include the setting up of a P250 million support fund, skills training to avail of in-demand jobs in other parts of the world, and setting up of Department of Labor and Employment (DOLE) overseas Workers Welfare Administrations desks in the provinces to match OFWs’ skills with available jobs. Moreover, terminated workers of local firms can get government assistance in claiming unpaid salaries or in new job placement facilitation. DOLE has also strengthened reintegration services and livelihood assistance but reports show low participation, especially by OFWs.

<sup>15</sup> The financing source for this fund is yet to be decided but contribution from government financial institutions, social security institutions, and private banks were initially envisaged.

**18. The success of the finely tuned ERP relies on implementing a controlled fiscal easing.** The ERP finely balances the need for fiscal easing which, on the one hand calls for (i) protecting its poorest and most at risk citizens; (ii) boosting the medium-term prospects of the economy (e.g., by relieving infrastructure bottlenecks); and (iii) closing the output gap created by the private sector; and, on the other hand, recognizes the limited fiscal space available. The latter being mostly the result of still high debt level—whose downward path is rapidly affected by shocks to GDP growth and the exchange rate.<sup>16</sup> Containing the current and future fiscal balances to levels consistent with a safe and declining debt level therefore critically requires a *controlled* fiscal easing in 2009: as the ambitious and front-loaded expenditure plans are transformed into actual spending, the budgeted revenue collection also ought to be delivered upon.

**19. A significant weakening of tax collection, however, is materializing and the BIR could post its first *negative* annual nominal collection since at least 1981.** After a successful implementation of the RVAT in 2006, with the tax-to-GDP ratio increasing by 1.3 percentage points to 14.3 percent of GDP, tax effort fell to 14 percent in 2007 and only retained that level in 2008 thanks to a combination of positive one-off developments (Figure 9).<sup>17</sup> These one-offs, while helping the Bureau of Customs (BOC) record high tax collection, were not sufficient to offset the structural decline in collection from the Bureau of Internal Revenue (BIR).<sup>18</sup> BIR collection grew by less than nominal GDP in 2008, the first time since 2003. For Q1 2009, total collection dropped by 0.5 percentage points of GDP compared to Q1 2008 (Table 4), and collection from the BIR and BOC *contracted* by 7 and 12 percent, respectively, over the same period—the contraction (in nominal terms) is all the more striking since annual inflation reached 6.9 percent through March and the impact of the corporate income tax cut (5 points) is not yet captured (as the first big payments arise in April and May). Key reasons for the drop in collection include the slowing economy (and sharp import contraction for BOC collection), recent tax policy and administrative measures such as the effective tax cut on personal income

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<sup>16</sup> As domestic growth falters and the exchange rate reacts to both the fiscal outlook and growth prospects, caution on the debt front is warranted.

<sup>17</sup> These include tax amnesty collections, VAT “windfall” on commodity prices (especially fuel and food) as international prices surged in the first half of 2008, a weak peso, and strong corporate income tax profits paid thanks to the record growth experienced in 2007 (see the January 2009 Quarterly Update for details).

<sup>18</sup> Manasan (2008), after a detailed tax-by-tax analysis of the sources of tax collection from the BIR over the 2005-2007 period, finds that tax leakage (associated with a weakening tax administration) has been increasing rapidly over the period and, through 2007 was masked by positive tax policy changes or the booming economy. As these last two factors have now reversed, the weakening of the tax administration’s capacity is becoming more glaring. See Rosario G. Manasan (2008) “Are recent gains in BIR tax effort sustainable?” *PIDS Policy Notes* No. 2008-07, December 2008.

tax (July 2008),<sup>19</sup> the weakening of the Large Taxpayers Service (LTS) of the BIR (May 2008), and negative incentives that the Attrition Act generates.<sup>20</sup>

**20. Meanwhile the front-loading of ambitious budgeted spending is on track.** While total budgetary spending was broadly constant, as a share of GDP, over the past three years to 2008 (17.2 percent of GDP), spending is budgeted to increase significantly in 2009 (to 18.9 percent of GDP), as part of the government ERP (Table 1; numbers are presented on a GFS basis). First quarter execution reveal that the government has been able to quickly ramp up spending as a share of GDP but, given the ambitious annual spending plans, the front-loading—which is expected to continue through Q2 2009—is still to fully take place as Q1 spending accounted to 24 percent of budgeted annual spending, the same ratio as Q1 2008 out of total 2008 spending. Capital spending was particularly strong in Q1, rising by 59 percent in nominal terms compared to Q1 2008.

Figure 9. Fiscal consolidation stopped after 2006...

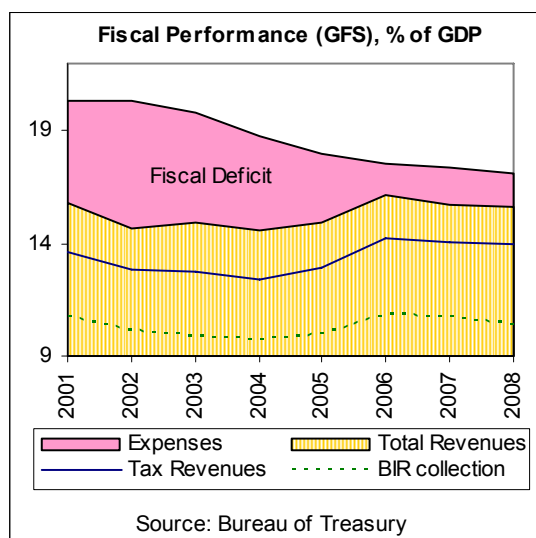
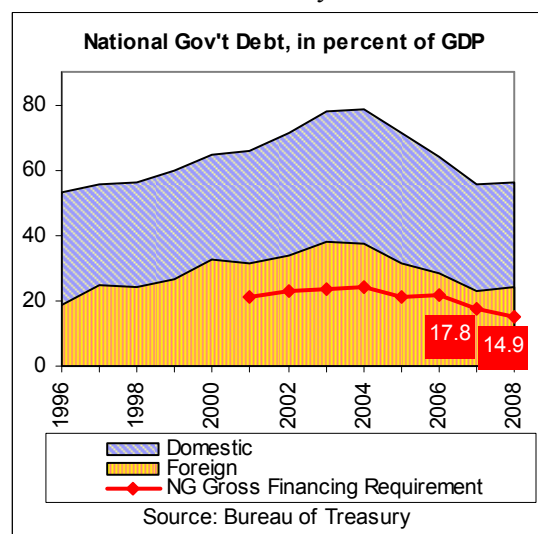


Figure 10. ... and public debt rose for the first time in four years.



**21. As revenue underperforms and spending surges, a gap could emerge between the intended pro-spending ERP and actual implementation of the stimulus.** The design of the ERP fiscal stimulus is correctly biased towards expenditure rather than revenue. Hence, out of a National Government budget fiscal easing of 1.6 percentage points of GDP between 2008 and 2009, expenditure is budgeted to increase by 1.8 points

<sup>19</sup> RA 9504 exempts minimum wage earners from paying income taxes, raises the personal exemption threshold of individual taxpayers, and increases the optional standard deduction rate from 10 to 40 percent of gross income. Government officials estimate the revenue loss of this measure for the six months of 2008 at 7-14 billion (0.1 to 0.2 percent of GDP)—See the November 2008 Quarterly Update for details.

<sup>20</sup> 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.

while revenue increase by 0.2 points (Table 1). However, the significant underperformance of total and tax revenue collection in the first quarter of 2009—which confirmed the underlying weakness in revenue collection observed in the second half of 2008—likely point to a 2009 fiscal outturn that could materially differ from the ERP and budget plans. Far from the budgeted increase in the tax-to-GDP ratio (from 14 in 2008 to 14.3 in 2009), the World Bank is now projecting that ratio to drop to 13.1<sup>21</sup> (Table 1).

**22. The government has proposed tax measures to improve revenue but getting Congress approval on these bills has been challenging and administrative measures take time.** As new tax cuts are introduced (some automatically, such as the corporate income tax cut) and the global recession hits the economy further, the tax effort in 2009 is projected to drop back to pre-fiscal consolidation and RVAT levels. To address this, the Department of Finance (DoF) has pushed Congress for the passage of three revenue measures: restructuring of the excise tax on sin products, rationalization of fiscal incentives, and the simplified net income taxation scheme. The DoF is also correctly resisting the introduction of tax policy measures that would further reduce taxes, such as the proposed Tourism Act of 2009 which would result in annual revenue losses of P6.5 billion (0.1 percent of GDP). Administrative measures to stem the revenue drop have also been introduced in Q1. These include the relisting of large taxpayers delisted last May and a new campaign (“*Oplan Kandado*”) aimed at boosting compliance through the treat of closing down businesses that are tax delinquent. To curtail technical smuggling, the private sector has pushed for the BOC to acquire and auction off goods suspected to be undervalued. Further computerization in the BOC is also underway.

**23. To ensure quality implementation of the fiscal stimulus plan, the government could consider further desirable revenue measures, such as raising gasoline excises.** Petroleum products in the Philippines are lightly taxed by international standards for an oil importing country (though retail prices are not particularly low). Gasoline is the most highly taxed product and has an effective tax rate of about 25 percent of the retail price partly because its specific excise rate (4.35 peso per liter) has been fixed in nominal terms since 1996.<sup>22</sup> Mostly as a result of the non-indexation of gasoline, petroleum excise collection is 1 percentage points of GDP lower in 2008 than it was a decade earlier.<sup>23</sup> Increasing petroleum excises would (i) produce immediate revenue gains and help ensure the fiscal stimulus remained controlled and expenditure-driven so as to maximize its effectiveness and targeting; (ii) improve the progressivity of the tax system as petroleum products are disproportionately consumed by the richer citizens; (iii) reduce negative externalities such as congestion and pollution (both being especially bad in metro Manila) which affect the country’s competitiveness<sup>24</sup> and health outcomes.

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<sup>21</sup> Down from a tax-to-GDP ratio projection of 13.4 for 2009 in our January Quarterly Update ([www.worldbank.org.ph](http://www.worldbank.org.ph)) based on a lower 2008 base, worse Q1 outcome, and downward GDP revision.

<sup>22</sup> Excise on diesel was abolished when the VAT base was broadened and its rate increased (2005/06). Petroleum products are subject to an import tariff of 3 percent and to the VAT of 12 percent.

<sup>23</sup> By comparison, the loss in excise revenue from tobacco is less than a third of that on petroleum products.

<sup>24</sup> Inadequate infrastructure ranks consistently as a top concern in the World Bank’s Doing Business surveys. Higher excises would, *ceteris paribus*, lower road traffic and partly decongestion transport

**24. Failing to contain the projected fall in the tax effort could jeopardize the size of the planned expenditure increase, and/or generate large deficits.** A larger than budgeted overall fiscal deficit could emerge should total revenue collected be closer to the World Bank's projection than to the budgeted one, and budgetary spending commitments be fully implemented. As the government projects GDP to reach its trough in the first half of 2009 and recover thereafter, the negative nominal growth rates posted in Q1 revenue collection would indeed be expected to rebound. However, with the impact of the CIT rate cut not yet affecting collection, and given the large degree of uncertainty regarding the timing of the rebound of the economy (which the World Bank estimates to be later in 2009), significant uncertainty surrounds the budgeted deficit of 2.5 percent of GDP (3.1 percent of GDP on a GFS basis) for 2009. The fiscal stimulus impact and its timing could be affected.

**25. As the external and domestic conditions worsened in 2008, the previously observed rapid decrease in public debt reduction came to a halt.** With higher deficit and borrowing costs, and a weaker peso, the national government's debt stock increased to 56.3 percent of GDP in December from 55.8 percent in end-2007 (Figure 10). The sharp depreciation of the peso since mid-September contributed more than 1 percentage point of GDP to the increase in the external debt stock. Similarly, the national government's stock of contingent debt increased by P61 billion, largely on account of rising direct guarantee on external debt. While the maturity profile of the direct debt stock is dominated by medium and long-term debts, heightened risk aversion and cost containment have led to an increase in the share of short-term debt to total debt by 1.7 percentage points to 18.2 percent.

**26. Significant and rising gross financing requirements heighten risks given the global financial environment.** Gross financing requirements of the public sector are projected to rise from 15.7 percent of GDP in 2008 to, at least, 18.5 and 19.7 percent of GDP in 2009 and 2010, respectively.<sup>25</sup> In late 2008, borrowing spreads on sovereign bonds rose to about 500 basis points while the rate of domestic securities jumped by an average of 200 basis points. Despite this the government took advantage of the still ample global liquidity and issued \$1.5 billion in dollar bonds—the first in the region—at 8.4 percent and 600 basis points above US treasuries. In addition, the government successfully swapped P136.6 billion (\$2.9 billion) in domestic debt in an effort to improve its debt structure and maturity profile. The government plans to increase its programmed \$1.1 billion in ODA borrowings by a further \$650 million this year. Mitigating the high gross financing requirements, the government has a large pool of cash and near cash assets (e.g., Bond Sinking Fund) which lessens rollover risks.

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infrastructure and transportation costs. Although improved infrastructure is necessary to unclog bottlenecks (which the Government's ERP and medium-term plans to boost spending on infrastructure are addressing), raising excises can be part of a short-term solution.

<sup>25</sup> IMF, 2009, "Philippines: 2008 Article IV Consultation," Staff Report, Washington DC.

**A dreadful external sector—except for remittances, which are holding up relatively well**

**27. The Philippines' external position weakened in late 2008, and early 2009 amid collapsing exports and imports, slowing remittances, and capital outflows.** While the first half of 2008 posted strong remittances, moderate growth in exports and imports, and net capital inflow and enabled the country to accumulate a balance of payment surplus of \$1.9 billion, these were quickly eroded later in 2008 as remittance inflows slowed down noticeably, capital outflow intensified, and in recent months, exports and imports plummeted. By end-2008, the balance of payment's position fell to \$89 million—the lowest in 4 years (Figure 11). Likewise, the current account balance shrank to 2.5 percent of GDP from 4.9 percent of GDP in the previous year.

**28. As elsewhere in the region, trade figures have posted record contractions and no clear sign of bottoming out is yet present.** The trade deficit, which widened in the first three quarters of 2008 due to the food and fuel-induced higher import bill, narrowed in the last quarter despite the drastic fall in exports as imports of electronics used in the production of electronic exports also started to free fall in October and have continued to contract (on an annual basis) since (Figure 12 and 13). All major exports categories, such as electronics, electrical machineries, minerals and furniture have suffered significantly.<sup>26</sup> The severe contraction in trade accelerated in the first two months of 2009, with exports (imports) down by 40.6 (34.5) and 39.1 (31.9) percent annually for January and February, respectively. The resulting trade deficit reached \$1.3 billion, a 14.8 percent increase compared with the same two months of 2008.

**29. Aggregate remittances proved resilient—as expected—but a severe contraction in the US and faltering growth in the rest of the world point to downside risks** (Figure 14). Although total dollar remittances grew by 13.7 percent in 2008 and 2.5 percent through February 2009, inflows from the US—which account for over half of total remittances<sup>27</sup>—have been declining rapidly since peaking in June 2008. As a result, the three-months moving average (3mma) annual growth rate of remittances started slowing noticeably in Q4 2008 and ended up almost flat in February. Through February, inflows from the US contracted by 19 percent (3mma YoY) and were mostly offset by strong but decelerating growth (3mma YoY) from Canada (76.1%), Gulf (25%) and the rest of Asia (30%). The strong growth rate coming from these regions—a pattern also seen from the US through mid-2008—could reflect an increase in returning OFWs. While these would typically be sending five percent of their income each month, upon their return they would come back with all of their accumulated savings and/or severance

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<sup>26</sup> Electronic parts imports account for more than 75 percent of Philippine electronics exports value-added. According to industry experts, electronic parts inventory normally last for 30-60 days but some firms which order parts in bulk keep inventories up to 6 months.

<sup>27</sup> Remittances from the U.S. also include money not sent from the U.S. but deposited in a bank that channels the funds through their “mother banks” (or headquarters) located in the U.S.

package. Such a phenomenon would lead to a sharp reduction in remittances in the following months.<sup>28</sup>

Figure 11. The BOP surplus shrank...

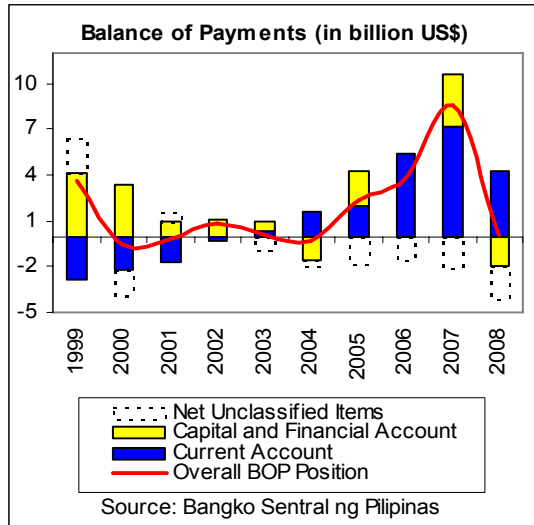


Figure 12. ... and the trade deficit ballooned.

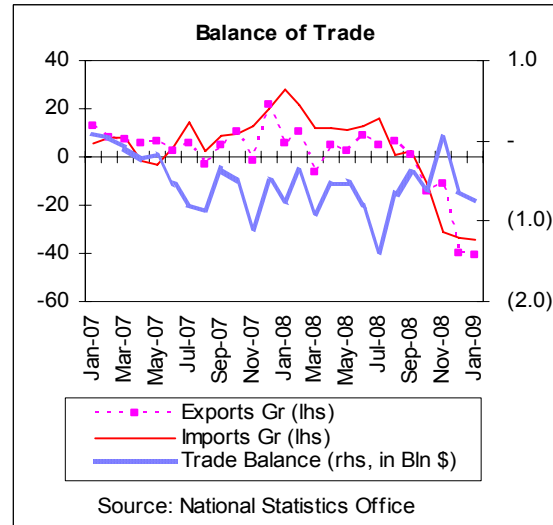


Figure 13. Exports collapsed, driven by the electronics sector.

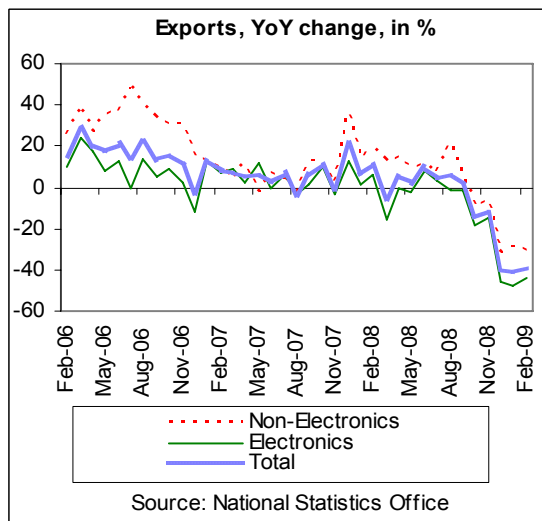
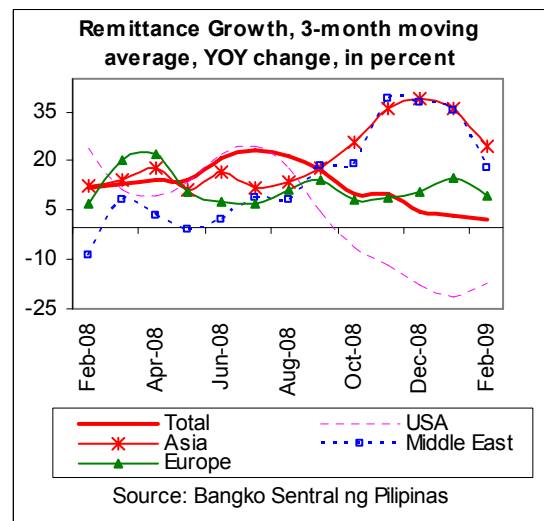


Figure 14. Remittance growth is declining fast as US inflows are collapsing



**30. Capital inflows were directly hit by the global recession and financial crisis.** Portfolio investments posted a net outflow of \$2.6 billion in 2008 compared to a net inflow of \$4.6 billion in the same period a year ago. Most of the outflow is traced to withdrawal of Peso bank deposits which likely served as holding accounts for withdrawn

<sup>28</sup> As data on returning OFWs are not systemically processed and available, disentangling between a post-collapse surge in remittances due to returning OFWs and a more sustained surge stemming from the relatively recent increase in deployment or from counter-cyclical remittance behavior is difficult.

equity investments. Through mid-March this year, net inflow of central-bank registered portfolio investment returned to positive. Non-resident direct investments in the country, driven by equity placements, remained positive as of end-2008 at \$1.5 billion but are considerably smaller than the \$2.9 billion posted in the same period last year. Several large investments, such as Hanjin's second shipyard in Mindanao, have encountered start-up delays due to the global recession and financial crisis.

**31. Gross international reserves (GIR) continued to grow in 2008 and 2009, but safety margins have thinned.** GIR reached \$37.6 billion in end-2008, an increase of \$3.8 billion compared to end-2007. This level can cover 6 months of imports of goods and services and, more importantly, is equivalent to 3.17 times the country's stock of short-term external debt based on residual maturity. In January, reserves improved further to \$39.2 billion after the government received proceeds from a \$1.5 billion bond issue and Transco privatization. The country's GIR has remained stable as of March. The relatively strong reserves position, however, remains vulnerable to shocks especially if the Peso weakens further. To smooth excessive sudden exchange rate volatility, the BSP has intervened in the foreign exchange market using a mix of GIR, swap markets, and non-domestic forward markets (NDF). For 2008, the BSP's swap position fell by more than \$10 billion.

### **Monetary developments are positive and broadly growth supportive**

**32. Inflation prospects continue to improve for 2009.** The sharp increase in food prices in 2008 was the main driver of headline inflation (Figure 15). At its peak, rice inflation reached 50 percent (July 2008). At the same time, fuel prices also rose sharply till October 2008, bringing significant hardship to the transport sector and inducing a second round effect on production cost.<sup>29</sup> Since December, pump prices have fallen year-on-year as demand for crude oil fell globally. Core inflation, along with manufacturing costs, has begun to fall since December as inflationary pressures started to recede more sharply. Even so, construction costs remain at elevated levels and resumed their upward trend early in 2009, further affecting profits and expansion plans of property firms (Figure 16). Headline inflation is down to 4.8 percent in April and is projected to trend downward for the remainder of 2009 as domestic consumption weakens, the output gap widens, and the exchange rate remains broadly stable (with a moderate depreciation).

**33. Falling inflation and growth, and weak prospects enabled the BSP to cut policy rates, although monetary policy is turning out to be partly procyclical.** BSP, the central bank, had initially raised policy rates by 100 basis points in mid-2008 to limit inflationary spillovers. As the main macroeconomic concern quickly shifted to the deteriorating global economy which consequently pushed inflation down, the central bank reversed its policy stance. Since December, the central bank cut the key policy rate by a total of 150 basis points bringing the key policy rate (overnight reverse repurchase rate) to their pre-food crisis level of 4.5 percent. The surge in inflation experienced in

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<sup>29</sup> To mitigate the rise in fuel prices, the government gradually removed the tariff rate on oil but eventually resumed levying the tax after fuel prices began to fall in September.

2008 and the more muted increase in the policy rate resulted in large negative real interest rates (Figure 16). As the economy slowed down from its record growth of 2007, the easing in real rates—coupled with a depreciation of the exchange rate—helped support growth though mid 2008. However, as inflation decelerated sharply since then, the large negative real rates evaporated. The exchange rate depreciation, however, accelerated in Q4 2008, thereby limiting the impact of the change in real rates. The inflation outlook and expectations remain in line with the BSP’s inflation targets for both 2009 and 2010.

Figure 15. Inflation soared then receded, following fuel and food price changes

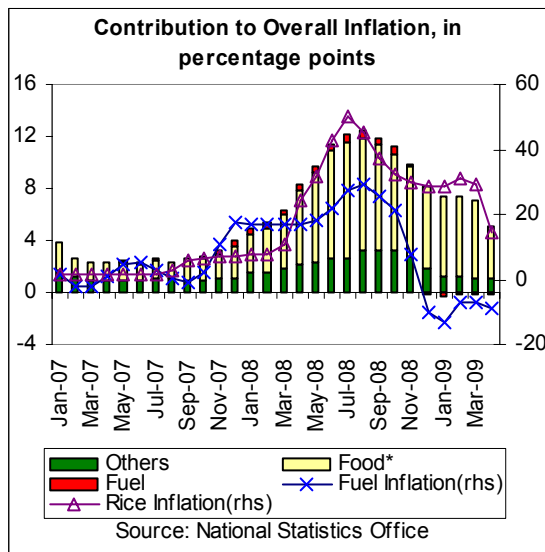


Figure 16. Construction and core inflation remain elevated; real rates are less negative

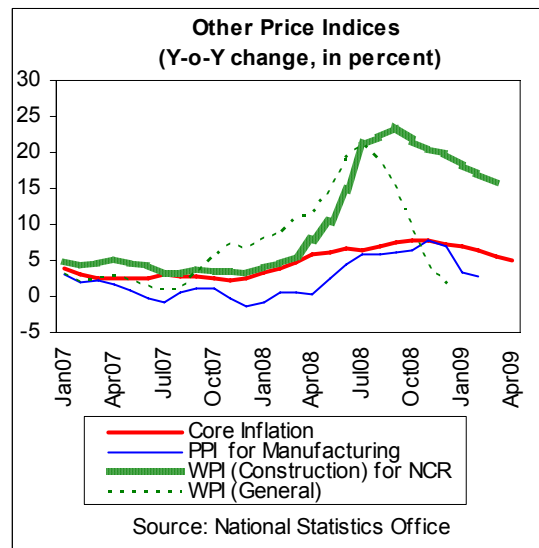


Figure 17. Despite the global credit crunch, domestic credit grew rapidly... from a low base

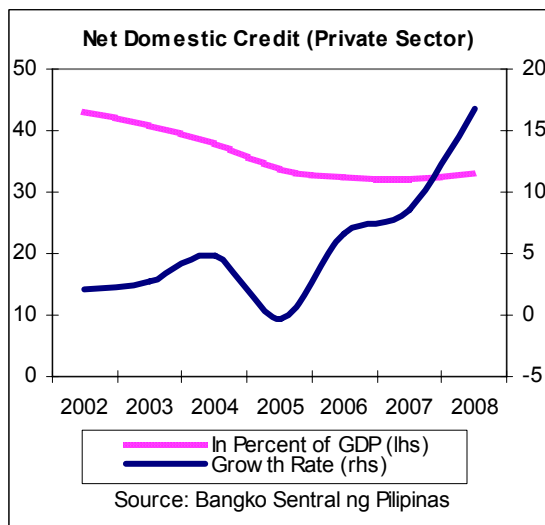
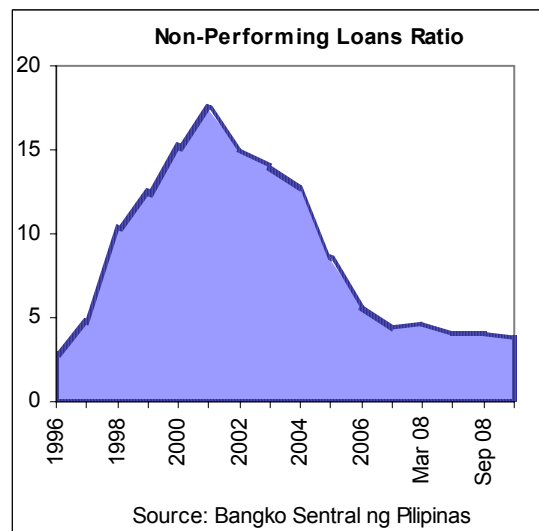


Figure 18. NPLs have receded to pre-Asian crisis levels but have likely plateaued



**34. Fueled by higher lending and a build up of foreign assets owned by the central bank, domestic liquidity continues to expand robustly.** M3 grew by 14.6 percent in February as business lending remained strong across industries in the services sector (excluding lending for financial intermediation). Higher consumer lending was driven by sustained growth in credit card and housing loans. The high growth of lending, however, is coming from a very low base with a private credit-to-GDP ratio of 33 percent in 2008 compared to 60 percent in 1997 (Figure 17). As the slowdown is beginning to affect the quality of credit, banks have tightened their credit assessments and lending policies (including by charging higher rates).

### **Poverty and Social Update**

**35. The food crisis that hit the Philippines in 2008 and the global recession exposed the vulnerability of households to external shocks.** At the height of the food crisis in 2008, food inflation hit 18.6 percent (year-on-year). Filipino households are highly vulnerable to food price shocks as an average household spends 40 percent of its total spending, while for poor households the share reaches 60 percent (with rice accounting for a third). It is estimated that at the height of the food crisis in July 2008, poverty headcount may have increased by 3.6 percentage points and the income gap of the poor increased by 1.6 percentage points. This brings an additional 3 million Filipino households into poverty. Vulnerable households' limited assets were likely significantly depleted by the food price crisis so that their ability to cope with a slowing economy is severely constrained. The combined effects of these consecutive shocks could substantially set back the fight against poverty in the Philippines. Progress in tackling poverty in the years preceding the food price shocks were already limited as poverty incidence actually increased between 2003 and 2006 (to 32.9 percent).

**36. Vulnerable households have developed coping mechanisms during crisis situations, but these are often insufficient and can worsen poverty in the long run.** Experience from past crises also show that families mitigate the impact of income shocks by changing eating patterns, receiving transfers from relatives/friends, or withdrawing children from school.<sup>30</sup> Households also turn to selling or pawning productive assets to finance regular consumption needs. Pawnshops provide an easy lifeline for those who cannot borrow from banks. However, credit comes at a higher cost further jeopardizing future household earnings. As of January 2009, pawnshop lending was reported to have increased by 10 percent.<sup>31</sup>

**37. Given the likely costs of the crises on both short- and long-term poverty, a proactive and comprehensive response is required.** While it may be tempting to target sectors most directly hit by the global recession, past crises have shown that the impact

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<sup>30</sup> World Bank, (2001) "Philippines Poverty Assessment."

<sup>31</sup> GMA News Report (<http://www9.gmanews.tv/largevideo/latest/37366/Moneylenders-pawnshop-do-brisk-business-amid-crisis>)

quickly trickles down to other sectors and affect the wider economy. Comprehensive actions are therefore required to provide immediate assistance to vulnerable Filipino households against income shocks, facilitate economic adjustments, and minimize long-run costs of the crisis. Supporting households through cash transfers can provide such immediate support. Conditional cash transfer programs such as the *Pantawid Pamilyang Pilipino Program* (4Ps) have the added advantage that it also addresses the negative impact shocks could have to long-term human development outcomes. The success of a program such as the 4Ps, however, is contingent upon a good targeting system. Effort is underway to roll-out an objective national household targeting system that can be used to identify groups that need the most assistance especially at crisis time.

## **B. Prospects**

### **38. Global economic prospects point to a deep and long-lasting global recession.**<sup>32</sup>

The unprecedented fall in global production and economic activity in Q4 2008 and early indicators for the first few months of 2009 point to a deep and long-lasting recession for both high income and developing countries. The World Bank is now looking at world GDP to contract by 1.7 percent and world exports by 6.1 percent. Commodity prices are expected to decline further (Table 4). With the latest leading economic indicators pointing to a sharper downturn in 2009, previous projections of a strong recovery in 2010 have become less likely.

**39. The Philippines is entering the global recession from a stronger position than it did in previous crises given the fiscal and other reforms undertaken recently.** Since 2003, non-financial public sector debt has significantly improved (but remains elevated), and, importantly, 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 (Table 5).

**40. A few sectors are facing a particularly challenging economic environment.** These include:

- **Export-oriented firms, especially semi-conductor manufacturers, which are reporting massive losses in revenues due to the collapse in global demand.** Semiconductors and other electronics manufacturers such as automotive parts which account for 60 percent of total exports have seen demand fall by as much as 60 percent in recent months. Firms serving the export industry, such as transportation, are also being affected. Other export industries reporting a sharp downturn in activity include the labor-intensive garments, furniture, footwear, and handicraft industries. The agribusiness and mining sectors have also been affected with the fall in commodity prices. To protect exports from deteriorating further,

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<sup>32</sup> World Bank (2009) “Battling the forces of global recession,” East Asia & Pacific Update, April, Washington D.C.

the government granted the request of various export groups for P1 billion in export promotion funds and various temporary tax breaks.

- **The banking sector** *as asset quality and revenue stream will be under pressure as the global recession impacts the domestic economy.*<sup>33</sup> Following the significant impairment provisions and mark-to-market losses that resulted from the global financial crisis, earnings and asset quality will be under further pressure in the short- to medium-term as banks face a slowdown in deposits (including from lower remittances) and loan growth—the latter reflecting both lower demand for credit and tightened lending criteria. Non-performing loans are also projected to rise, especially from the exports and property-related sectors (more specifically the high-end residential and commercial real estate sectors). On the positive side, are the expected decrease in interest rates which should improve banks' margins.
- **The property sector**, *where signs of weakening prices and oversupply abound.* In recent months, demand for housing, especially from Filipino workers abroad, has dropped. This is expected to only affect, in a significant way, new projects as significant pre-selling is standard practice in the housing construction sector. Preliminary information, however, point to a rising discontinuation of real estate purchases and to price discounting on condominium projects nearing completion. A surge in construction aimed at providing office space for the BPO sector has also led to large over-supply in this market. Nevertheless, banks' exposure to real estate has been limited. So far, housing loans have not soured and banks are cautious in approving new housing loans. Banks have also financed existing projects with conservatively collateralized loans. Business loans for real estate, renting, and business services continue to gain pace. However, a prolonged slowdown could add additional stress to the sector.

**41. Notwithstanding the Philippines' relative strength, some leading economic indicators point to a continued deterioration of the economy in the near-term.** These include:

- *Car sales started to decline* in the fourth quarter after eight quarters of robust growth. The contraction of commercial vehicles sales (accounting from 65 percent of sales) points to weakening business activities. Car financing however remains favorable despite the crisis and have helped push the sale of passenger cars into positive territory in the first quarter of 2009 (see Figure 19). Likewise, demand for electricity contracted in the first two months of 2009. Industrial usage expectedly declined for the third month in a row as manufacturing activities slowed down (Figure 20).

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<sup>33</sup> A similar assessment came out from Moody's in March as it changed its outlook for the Philippines banking sector from "stable" to "negative", citing expectation of lower banking earnings and worsening balance sheets in the future.

- *Corporate earnings fell* significantly in 2008 (by as much as 50 percent in some large conglomerates) though most companies still managed to report profits. Lower earnings, higher cost of borrowing, and heightened risk aversion have dampened expansion plans in 2009.
- *Investment in durable equipment and capital imports contracted* in the last quarter of 2008 after posting progressively slower growth in the previous quarters. Foreign direct investment inflows also slowed in the last quarter of 2008 and with the announced shut-down of several multinational companies, FDI is likely to deteriorate further in 2009, especially during the run-up to the 2010 general elections as investors shift to a ‘wait and see’ mode. The latest confidence index of the central bank’s business confidence survey plunged to its lowest level in seven years.

Figure 19. Car sales contracted....

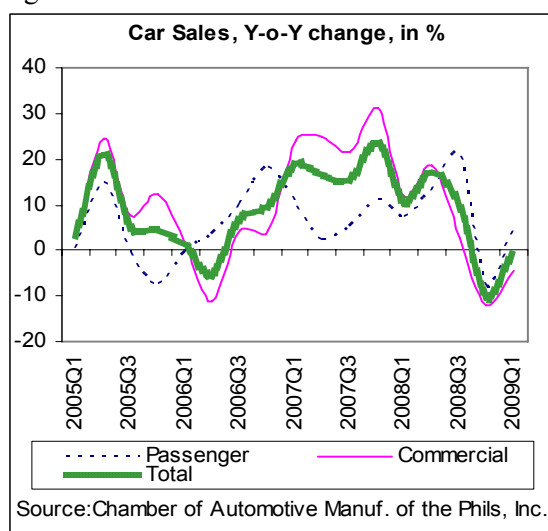
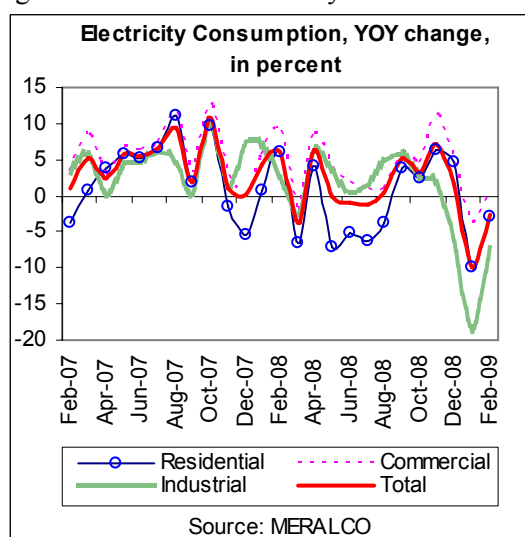


Figure 20. ...as did electricity sales.



- *New construction projects are on hold, at best.* Although private construction has remained upbeat as a result of large ongoing residential and office building projects which began several years back, several new projects without adequate financing are reported to have been pushed back. The condominium market is reportedly reeling from weak remittances in selected areas of the country. Temporary shutdowns of several local cement plants also indicate falling demand from real estate and construction this year. Increased vacancy of commercial spaces also point to a slowdown in private construction.
- *Merchandise imports and exports are still severely contracting.* The contraction in import of capital goods—which leads export developments in the Philippines—remained strong in January-February (declines of 33.2 and 43.3 percent, respectively). Major electronics firms such as Intel and

Panasonic have shut down parts or all of their operations. Industry experts project electronics exports to significantly contract in 2009. North-American book-to-bill ratio is still poor. Similarly, non-electronics exporters have also reported a significant decline in orders and industrial production is contracting rapidly. The Philippines' strong economic linkages to developed countries provide it further downside risks.<sup>34</sup>

- *Remittances are projected to decrease.* Based on the World Bank's Migration and Remittances Team's global model, and analysis of remittance flows to the Philippines during past simultaneous crisis or recession event<sup>35</sup> (i.e., both the Philippines and the host country are simultaneously in a downturn), remittances to the Philippines are projected to decrease by 4 percent in nominal US\$ terms. Significant uncertainty and downside surrounds this projection as no historical precedent exist in the history of the Philippines OFWs where all host countries are simultaneously in a severe economic downturn, asset prices are all depressed, and all labor markets are deteriorating fast. Experience from the Asian crisis shows that Filipino OFWs are very geographically mobile, leaving countries in recession and moving to more prosperous ones.
- *Tax revenues are weakening rapidly* (¶18), which, coupled with frontloading of a large increase in public spending, could imply a fiscal tightening for end 2009 (to contain the deficit).

**42. Lagging economic indicators—especially the labor market—also point to further deterioration of the economy during 2009 with a slow recovery in 2010.** The quantity and quality of jobs is expected to worsen significantly. Several factors all point to this conclusion. First, while signs of a weakening labor market abound (¶15), as labor market developments trail economic activity, the economic slowdown observed in 2008 and in the first months of 2009 has yet to be translated fully to the labor market.<sup>36</sup> Second, the global recession will, again with a lag, lead to a slowdown in net OFW deployments as global unemployment rises. Finally, a structural factor is also adding to the cyclical factors in weakening the labor market, namely a projected sharp increase in the labor force during the 2008-2010 period.<sup>37</sup>

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<sup>34</sup> Trade linkages with the US, directly and indirectly through third countries, account for as much as 12 percent of GDP. It is estimated that Philippine GDP growth falls by 0.4 to 0.6 percentage points for every 1 percentage point fall in US growth. Trade linkages, as well as financial linkages, with Japan, Korea, Taiwan, and the European Union are also significant. Moreover, a big bulk of remittances, estimated at 70 percent, comes from developed countries.

<sup>35</sup> To be published as a chapter of the forthcoming 2009 Philippines Development Report.

<sup>36</sup> For example, a growing number of workers might no longer be accommodated under the current cost cutting measure of forced leave and reduced working hours.

<sup>37</sup> The labor force is projected to increase from a 2000-2007 average of 2.73 percent to a 2008-2010 average of 4.9 percent (a 73 percent increase), due to population dynamics (ILO). The unemployment rate

**43. The deteriorating labor market will first affect the non-poor urban and young workers and will then spread to the poor as under-employment and informality rise.**

A forthcoming World Bank study reveals that urban workers are expected to be first affected by the global recession and domestic slowdown.<sup>38</sup> Regions that have a high degree of economic activity will also be the ones that would be the most affected from unemployment and underemployment (e.g., national capital region). The non-poor—who are most at risk to unemployment spells—are expected to be most affected in the short-term, while the poor—who will be impacted by the rise in underemployment and informality—could be most affected over the medium- to long-term.

**44. Given global prospects and emerging domestic conditions, economic growth is projected to slow to 1.9 (2.8) percent in 2009 (2010), with significant downside risks.**

Box 1 highlight some of these downside risks by analyzing the magnitude of the peak-to-trough changes in GDP and its components during the past major crisis and economic slowdowns that the Philippines has faced (1991 and 1998). The analysis reveals that, should this downturn be of the same magnitude as the average downturns, then real GDP growth for 2009 would reached -0.1 percent (similar to the latest IMF projection for the country). The following underlies our projections for 2009 and 2010:

- *External demand dragged down by global recession.* With a rapidly falling external demand and accelerating contraction in capital imports, total exports are projected to contract by more than 13.1 percent in 2009—a fall comparable to the 2001 slowdown where exports fell by 16 percent (and electronics by 27 percent). A recovery towards the end of the year is possible provided import of electronic parts show signs of recovery by mid-year. In 2010, exports are expected to rebound by 2 percent but total export value would still be lower than 2006 level.
- *Private consumption affected by weakening labor market and remittance flows.* Private consumption is expected to moderate further as a worsening of the labor market (weak employment, slowdown in net OFW deployment, and wages) and weak remittances<sup>39</sup> pull household income down and undermines consumer sentiment. With consumption accounting for 77 percent of GDP, the slowdown in consumer spending is projected to profoundly affect growth. Nonetheless, private consumption has historically proven to be resilient even during economic slowdowns (such as in 1998). With both the weakening of the labor market and the slowdown in remittances projected to be lagging compared to economic activity, GDP growth is projected to be weaken throughout 2009 and gradually recover in 2010.

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is therefore likely to increase further by April due to new entrants to the labor market numbering about 1.5 million (of which 500,000 are new graduates).

<sup>38</sup> The study will be published as a chapter of the forthcoming 2009 Philippines Development Report.

<sup>39</sup> Remittances, though smaller, will continue to provide support to private consumption growth as their real Peso value is expected to hold relatively well given the projected inflation and exchange rate.

- *Private investments projected to contract as construction activity decelerates.* Although private construction remained upbeat till end-2008, ongoing residential and office constructions have been the main driver, not new building projects. This coupled with falling investor sentiment, higher borrowing cost, and lower corporate earnings are expected to slow overall fixed capital formation, in particular durable equipment and capital imports. The experience during past slowdowns, which saw investment fall by 16 and 7 percent in 1998 and 2001, indicates a downward bias to the current baseline projection for investment. With external demand and private domestic demand taking a back seat, the economy is projected to be buoyed by public consumption and investment.
- *Public spending offsetting part of the output gap generated by the private sector.* The potency of public expenditure to support growth, however, depends on the government's capacity to generate revenues and on the appropriateness and timeliness of the fiscal stimulus. With the tax effort projected to fall in 2009 (₱18) and front-loading successful (₱19), fiscal easing in the first half of 2009 is fully taking place. For the second half of 2009, as growth is projected to weaken further, the deficit could rise beyond its budgeted size. This might induce the government to slow down expenditure spending and stop the fiscal stimulus so as to maintain fiscal discipline as the country nears the 2010 general elections.

**45. Despite the global slowdown and increased risk aversion, the country's public and external debt will remain sustainable, barring a major shock.** Under the baseline scenario, the national government's debt stock is expected to fall over the medium-term to about 49 percent of GDP from 56 percent in 2008, albeit at a much slower pace compared to previous years and after a moderate increase over the next 5 years as the fiscal stimulus takes place and growth remains subdued. Debt-sustainability analysis reveal that the country's public debt remains broadly sustainable over the medium-term but the results are sensitive to growth and exchange rate shocks. Similarly, the country's external debt dynamics will remain sustainable and on a down-trend over the medium-term but is also sensitive to exchange rate shocks.

### Box 1. Comparing the Current Slowdown With Past Philippine Crises

A simple statistical analysis of growth trends around the 1991 and 1998 recessions reveals the following points:

- Peak-to-trough GDP decline reached almost 7 percentage points on average while the peak-to-trough of investments decline was wider at 30 points. Fiscal policy, in each crisis, turned out to be pro-cyclical (Table B.1).
- Assuming the current slowdown were to mirror developments experienced in 1991 and 1998, 2009 growth would fall to -0.1 percent as all components of expenditure except private consumption would contract (Table B.2). This would be significantly worse than our base case GDP growth rate estimate of +1.9 percent—but very close to the recent IMF projection for the country. Key to our 1.9 percent growth projection are an effective—but controlled—counter-cyclical fiscal policy and a current account surplus. However, the statistics below do point to significant downside risks in light of the global recession.

Table B.1 Average GDP Growth During Crisis Years (t = 1991,1998)

	t-2	t-1	t	t+1	t+2	t+3	Σ peak to trough
Private Consumption	4.8	5.2	2.9	2.9	3.3	3.7	-2.6
Government Consumption	5.6	5.7	-2.0	2.9	6.2	0.4	-8.6
Capital Formation	16.5	13.8	-16.8	2.9	15.9	0.7	-30.4
Fixed Capital	16.8	13.2	-12.7	2.1	14.3	-2.8	-26.9
Construction	15.6	14.8	-13.5	2.2	18.9	-9.4	-27.9
Durable Equipment	21.0	13.1	-13.6	1.9	10.9	4.1	-30.2
Exports	12.1	9.5	-7.4	4.0	11.6	8.2	-22.4
Imports	16.0	11.8	-7.9	2.9	7.9	9.0	-26.1
Gross Domestic Product	6.0	4.1	-0.6	1.9	4.0	3.1	-6.9

Source: National Statistics and Coordination Board

Table B.2 Estimated GDP Growth 2009-13 (t=2009)

	t-2 2007	t-1 2008	t 2009	t+1 2010	t+2 2011	t+3 2012
Private Consumption	5.8	4.5	2.2	2.3	2.6	3.0
Government Consumption	8.3	4.3	-3.4	1.6	4.8	-0.9
Capital Formation	11.2	4.2	-26.3	-6.6	6.4	-8.8
Fixed Capital	11.8	3.7	-22.3	-7.5	4.7	-12.4
Construction	21.3	6.3	-21.9	-6.3	10.5	-17.9
Durable Equipment	4.5	1.7	-25.0	-9.5	-0.5	-7.3
Exports	5.6	0.0	-16.9	-5.5	2.1	-1.3
Imports	-4.5	-1.1	-20.8	-9.9	-5.0	-3.9
Gross Domestic Product	7.2	4.6	-0.1	2.4	4.6	3.6

Source: World Bank staff estimates

Table 1. Philippines: Selected Economic Indicators, 2004-2010

	<u>Actual</u>					<u>Projections</u>					
	2004	2005	2006	2007	2008	YTD 2009 <sup>1/</sup>	2009	2010	2011	2012	2013
<b>Growth, inflation and unemployment (percent)</b>	<i>(percent)</i>										
Gross national product	6.9	5.4	5.5	8.0	6.1	...	...	...	...	...	...
Gross domestic product	6.4	5.0	5.4	7.2	4.6	...	1.9	2.8	4.0	4.5	5.0
Inflation (period average); 2000 base year	6.0	7.6	6.2	2.8	9.3	6.4	4.5	4.0	4.0	4.0	4.0 <sup>7/</sup>
Inflation (end period); 2000 base year	8.6	6.6	4.3	3.9	8.0	4.8	...	...	...	...	...
Unemployment	11.9	7.9	8.0	7.3	7.4	7.7	...	...	...	...	...
<b>Savings and investment</b>	<i>(percent of annual GDP)</i>										
Gross national savings	18.6	16.6	19.0	19.7	17.8	...	17.0	16.4	17.0	18.0	18.8
Gross domestic investment	16.7	14.6	14.5	15.3	15.3	...	15.2	15.1	15.5	15.8	16.1
<b>Public sector</b>	<i>(percent of annual GDP)</i>										
National government balance <sup>2/</sup>	-3.8	-2.7	-1.1	-0.2	-0.9	-1.5	-2.6	-2.4	-2.2	-2.1	-1.9 <sup>4/</sup>
Total revenue	14.5	15.0	16.2	17.1	16.0	2.9	15.1	15.0	15.1	15.2	15.4 <sup>4/</sup>
Tax revenue	12.4	13.0	14.3	14.0	14.0	2.5	13.1	13.4	13.6	13.9	14.1 <sup>4/</sup>
Total spending	18.3	17.7	17.3	17.3	17.0	4.4	17.7	17.3	17.2	17.2	17.3 <sup>4/</sup>
National government debt	78.2	71.4	63.8	55.8	56.3	...	56.5	56.1	54.6	52.8	49.4 <sup>5/</sup>
<b>Money and credit<sup>3/</sup></b>	<i>(year-end percent change)</i>										
M3	10.3	10.3	22.7	10.6	15.6	14.6	...	...	...	...	...
Credit to the private sector	4.9	-0.3	6.7	8.5	16.8	15.1	...	...	...	...	...
<b>Balance of payments</b>	<i>(percent change unless otherwise indicated)</i>										
Merchandise exports	9.8	3.8	15.6	6.4	-2.6	-39.9	-13.1	2.0	5.0	7.2	9.0 <sup>6/</sup>
Merchandise imports	8.0	8.0	10.9	8.7	5.0	-33.3	-10.0	3.1	4.5	5.0	6.2 <sup>6/</sup>
Remittances (expressed in US\$)	12.8	25.0	19.4	13.2	13.7	2.5	-4.0	2.0	5.0	8.0	8.0 <sup>6/</sup>
Current account balance (percent of annual GDF)	1.9	2.0	4.5	4.9	2.5	...	1.8	1.3	1.5	2.2	2.7
<b>International reserves</b>	<i>(in billion US\$ unless otherwise indicated)</i>										
Gross official reserves	16.228	18.5	23.0	33.8	37.6	38.9	37.4	37.7	37.8	37.7	39.1 <sup>4/</sup>
Gross official reserves (months of imports)	3.6	3.8	4.2	5.7	6.0	...	6.5	6.3	6.0	5.7	5.5 <sup>4/</sup>
<b>External debt</b>	<i>(in billion US\$ unless otherwise indicated)</i>										
Total (billions of dollars)	54.8	54.2	53.4	54.9	53.9	...	...	...	...	...	...
Total (percent of annual GDP)	63.1	54.8	45.4	38.1	32.0	...	...	...	...	...	...
Debt service ratio (to exports of G&S and income)	13.8	13.5	12.0	10.1	9.6	...	...	...	...	...	...
Exchange rate (peso/dollar, period average)	56.0	55.1	51.3	46.1	44.5	47.9	...	...	...	...	...
Real effective exchange rate (WB Estimate)	86.1	91.2	101.9	110.9	119.4	121.2	...	...	...	...	...
Stock market index (period average)	1823	2096	2412	3443	2631	1934.0	...	...	...	...	...

Source: Government of the Philippines, World Bank

1/ 2009 nominal GDP is based on WB estimate

2/ Based on Government's definition

3/ From Depository Corporations Survey

4/ YTD 2009 is as of March

5/ YTD 2009 is as of January; For unemployment: Annual average using new definition adopted in 2005 and based on 2000 census (except for 2004 which is based on 1995 census)

6/ YTD 2009 as of February

For Trade: Exports and Imports numbers in YTD 2009 is based on NSO definition; historical and projections are BOP-based

7/ As of April

8/ External Debt as reported by the BSP

Table 2. Philippines: Corporate Profits, 1st-3rd Quarter 2007-2008

	Net Income			Revenues		
	1Q- 3Q 2008	1Q- 3Q 2007	% Change	1Q- 3Q 2008	1Q- 3Q 2007	% Change
PSEi	125.27	143.09	(12.5)	1,183.80	1,062.66	11.40
Financials Sector	21.84	34.42	(36.5)	208.53	208.99	(0.22)
Industrial Sector	47.97	44.52	7.7	915.30	767.82	19.21
Holding Firms Sector	27.22	47.03	(42.1)	346.95	309.52	12.09
Property Sector	21.14	18.40	14.9	92.70	74.86	23.84
Services Sector	39.67	54.23	(26.8)	341.27	315.87	8.04
Mining & Oil Sector	4.96	4.44	11.8	25.52	23.10	10.46
Small and Medium Enterprises	0.01	0.01	(1.9)	0.05	0.04	12.95

Source: Philippine Stock Exchange

Table 3. Philippines: Banking Sector Indicators, 2003-2008

	2003	2004	2005	2006	2007	2008 Q3
<b>Capital adequacy</b>						
Total capital accounts to total assets	13.1	12.6	12	11.7	11.7	11.1
Capital adequacy ratio (consolidated basis) 1/	17.4	18.4	17.8	17.5	15.7	15.3
<b>Asset quality</b>						
NPL ratio 2/	16.1	14.4	10.3	7.5	5.8	5.1
NPA ratio 3/	13.2	11.8	8.8	6.9	5.8	5.6
Distressed asset ratio 4/	27	25.3	20	15.7	13	12.5
NPL coverage ratio 5/	51.5	58	73.8	75	81.5	83.4
NPA coverage ratio 6/	30.9	33.2	39.2	37.3	39.7	43.4
<b>Profitability</b>						
Return on assets	1.1	0.9	1.1	1.3	1.3	1.0
Return on equity	8.5	7.1	8.8	10.6	10.8	8.7
Cost-to-income ratio	..	65.5	64	66.5	65.2	72.9
Liquid assets to deposits	47.9	53.2	53.1	52.1	51.9	51.7
Loans (gross) to deposits	80.3	73.4	72.4	69.3	70.9	69.5

Sources: Philippine authorities and IMF staff calculations.

Note: ROPA = Real and Other Property Acquired. ROPA is a measure of the stock of foreclosed properties held by a bank

1/ as of the second quarter of 2008

2/ Nonperforming Loan (NPL) Ratio (excluding IBL)

3/ (Nonperforming loans + ROPA) over total gross assets

4/ Ratio of (NPLs + Gross ROPA + current restructured loans) to (Gross total loan portfolio + Gross ROPA)

5/ Ratio of loan loss reserves to NPLs

6/ Ratio of valuation reserves (for loans and ROPA) to NPAs

Table 4. Philippines: National Government Fiscal Accounts (GFS Basis), 2006-2009

	2006	2007	2008		2009		
	Act	Act	Q1	Est.	Q1	Budget	WB Proj.
	(in percent of GDP unless stated otherwise)						
Revenue and grant	16.1	15.7	3.3	15.6	2.9	15.9	14.7
Tax revenue <sup>1/</sup>	14.3	14.0	2.9	14.0	2.5	14.3	13.1
Nontax revenue <sup>2/</sup>	1.9	1.7	0.4	1.6	0.4	1.6	1.6
Total expenditure	17.3	17.3	3.8	17.2	4.5	18.9	17.9
Current Expenditures	15.2	14.6	3.1	14.0	3.7	15.3	14.8
Capital Outlays and Net Lending <sup>3/</sup>	2.1	2.7	0.7	3.2	0.8	3.6	3.0
Balance (GFS definition)	-1.2	-1.6	-0.5	-1.5	-1.5	-3.1	-3.1
Balance (Government definition) <sup>4/</sup>	-1.1	-0.2	-0.4	-0.9	-1.5	-2.5	-2.6
Memorandum item							
Privatization receipts	0.1	1.4	0.1	0.4	0.0	0.4	0.4
CB-BOL interest payments	0.1	0.2	0.1	0.2	0.1	0.2	0.2
Primary balance (GFS definition)	4.1	2.7	0.1	2.3	-0.1	1.1	1.1
National Government Debt <sup>5/</sup>	63.8	55.8	..	56.3	..	..	56.5
Nominal GDP (PHP billions) <sup>6/</sup>	6,033	6,648	7,498	7,498	7,984	7,984	7,984

Source: Bureau of Treasury, DBM, IMF and WB staff. Accounts presented on a modified cash basis.

1/ Includes document stamp tax and tax expenditures

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

3/ Includes equity, capital transfers to LGUs and CARP - land acquisition and credit.

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

5/ As defined by the Bureau of Treasury

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

Table 5. Global Economic Prospects 1/

	2007	2008est	2009f	2010f
World GDP	3.7	1.9	-1.7	2.3
High income countries	2.6	0.8	-2.9	1.6
Developing countries	7.9	5.8	2.1	4.4
East Asia	10.5	8.0	5.3	6.6

Source: World Bank Development Prospects Group

1/ Percent change per annum unless otherwise indicated.

Table 6. Philippines: Selected Economic Indicators During Times of Crises

	1984	1985	1986	1990	1991	1992	1997	1998	1999	2007	2008 YTD	2009
<b>External</b>												
GDP Growth (at constant prices)	-7.3	-7.3	3.4	3.0	-0.6	0.3	5.2	-0.6	3.4	7.2	4.6	...
Exports Growth (goods) 1/	7.7	-14.1	4.6	4.7	8.0	11.1	22.8	16.9	16.1	6.4	-2.6	-39.9
Current account balance (in % of annual GDP) 2/	-3.6	-0.3	3.2	-5.8	-1.9	-1.6	-5.3	2.4	-3.8	4.9	2.5	...
Foreign Exchange Reserves (in \$ billion) 3/	0.9	1.1	2.5	2.0	4.5	5.3	8.8	10.8	15.1	33.8	37.6	38.9
(In months of imports of goods and services)	1.5	2.1	5.0	1.8	3.9	3.8	2.1	3.3	4.0	5.7	6.0	6.2
(In percent of short-term ext. debt, based on residual maturity)	..	..	..	..	..	..	..	..	..	256.3	316.8	294.3
External Debt (% of annual GDP) 3/	77.5	86.7	94.4	69.0	71.5	62.7	61.6	82.3	76.6	45.7	31.9	...
Of which: Short-term external debt	30.1	29.8	18.0	10.0	10.9	9.9	14.3	9.0	6.5	4.9	4.9	...
<b>Fiscal</b>												
Fiscal Balance (% of GDP) 4/	-1.9	-1.9	-5.1	-3.5	-2.1	-1.2	0.1	-1.9	-3.8	-0.2	-0.9	-1.5
Government Debt (% of GDP) 5/	23.6	24.9	61.7	55.7	53.9	64.4	55.7	56.1	59.6	55.8	56.3	56.8
<b>Money and Banking</b>												
Domestic Credit (% change) 6/	0.6	-7.3	-29.7	28.1	7.8	24.6	28.7	-3.1	-1.1	5.2	16.8	13.7
Loans (gross)-to-deposit ratio (in percent) 7/	..	..	..	..	..	..	..	..	91.3	71.0	69.5	...
Capital Adequacy Ratio 8/	..	..	..	..	..	..	..	..	17.5	14.7	14.3	...
Non-performing loans (percent of total) 9/	..	..	..	..	..	..	..	11.0	12.7	4.9	4.6	...

Source: Philippine authorities, nominal GDP used for 2009 is based on WB forecast

1/ 1999-onwards were based on BPM5 concept; 2009 is as of February (based on NSO definition)

2/ 1996-1998 were based on the old BOP concept; 1999-onwards were based on BPM5 concept

3/ 2008 is based on BSP definition while the rest are WB definition

4/ Based on Government's definition; 2009 is as of March

5/ 2009 is as of January

6/ 1984-1999 based on old monetary survey; 2007-onwards based on Depository Corporations Survey

7/ 2008 is as of September

8/ Solo basis; 2008 is as of June

9/ Inclusive of IBL; 2008 is as of September