

PHILIPPINES ECONOMIC UPDATE

October 2017

Preserving Consistency and Policy Commitment

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PRESERVING CONSISTENCY AND POLICY COMMITMENT

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PREFACE

The *Philippines Economic Update* (PEU) summarizes key economic and social developments, important policy changes, and the evolution of external conditions over the past six months. It also presents recent World Bank findings, situating them in the context of the country's long-term development trends and assessing their implications for the country's medium-term economic outlook. The PEU covers issues ranging from macroeconomic management and financial-market dynamics to the complex challenges of poverty reduction and social development. It is intended to serve the needs of a wide audience, including policymakers, business leaders, private firms and investors, and analysts and professionals engaged in the social and economic development of the Philippines.

The PEU is a biannual publication of the World Bank's Macroeconomics and Fiscal Management Global Practice (MFM), prepared in partnership with the Poverty & Equity, Finance & Markets, and Social Protection & Labor Global Practices (GPs). Birgit Hansl (Lead Economist and Program Leader) and Ndiame Diop (Practice Manager for the MFM GP) guided the preparation of this edition. The team consisted of Kevin Chua (Economist) and Kevin Cruz (Research Analyst) from the MFM GP, Pablo Ariel Acosta (Senior Economist) from the Social Protection & Labor GP, Griselda Santos (Senior Financial Sector Specialist) from the Finance & Markets GP, Gabriel Demombynes (Program Leader), Xubei Luo (Senior Economist), and Sharon Faye Alariao Piza (Economist) from the Poverty & Equity GP. The report was edited by Oscar Parlback (Consultant), and the graphic designer was Robert Waiharo (Consultant). Peer reviewers were Jasmin Chakeri (Program Leader, LCC1C) and Yutaka Yoshino (Program Leader, AFCE1). Logistics and publication support were provided by Maria Consuelo Sy (Program Assistant). The Manila External Communications Team, consisting of David Llorito (Communications Officer) and Justine Letargo (Online Communications Officer), prepared the media release, dissemination plan, and web-based multimedia presentation.

The team would like to thank Mara Warwick (Country Director for the Philippines) for her advice and support. The report benefited from the recommendations and feedback of various stakeholders in the World Bank as well as from the government, the business community, labor associations, academic institutions, and civil society. The team is very grateful for their contributions and perspectives. The findings, interpretations, and conclusions expressed in the PEU are those of the World Bank and do not necessarily reflect the views of the World Bank's executive board or any national government. This report went to press on October 3, 2017.

If you wish to be included in the email distribution list for the PEU and related publications, please contact Maria Consuelo Sy (msy@worldbank.org). For questions and comments regarding the content of this publication, please contact Birgit Hansl (bhansl@worldbank.org). Questions from the media should be addressed to David Llorito (dllorito@worldbank.org).

For more information about the World Bank and its activities in the Philippines, please visit www.worldbank.org/ph.

EXECUTIVE SUMMARY

The Philippine economy continues to perform well relative to its regional peers. The Philippines grew faster in the first half of 2017 than Indonesia, Thailand, Malaysia, and Vietnam but slower than China. Following strong growth in the immediate two quarters after the new administration assumed office in July 2016, the economy had a slower start in the first half of 2017. The country's economic growth rate fell gradually from 7.0 and 6.8 percent in the first and second half of 2016, respectively, to 6.4 percent in the first half of 2017. Private consumption resumed its position as the main engine of economic growth in the first half of 2017, and a rebound in exports contributed to growth. Despite an improving external environment and continued accommodative monetary and fiscal policies, both government and capital formation growth slowed in the first half of 2017, partly due to a slowdown in public spending and investments that were initiated during the 2016 election period.

Fiscal and monetary policies remain supportive of growth. In the first half of 2017, the government continued to pursue an expansionary fiscal policy which led to significantly higher expenditures while the government missed its revenue target. As a result, the fiscal deficit widened from 1.7 percent of GDP in the first half of 2016 to 2.1 percent of GDP in the first half of 2017. Higher expenditures are in line with the government's push to advance the country's investment agenda and are planned to be financed through a gradual expansion of the revenue base, which is at the heart of the priority tax reform. Meanwhile, the central bank has maintained its key policy rate at 3.0 percent since June of last year. Inflation climbed to an average of 3.1 percent in the first half of 2017 and was in part driven by higher food prices, which disproportionately affect poor households. Inflationary pressures also continue due to the pass-through effect of the depreciating Philippine peso and rising demand-side pressures, as the economy is operating near

capacity. Higher inflation started to not only dampen consumer and business sentiments, but likely contributed to consumption and investment growth moderating.

Although external demand picked up, output growth is slowing and sentiments are weakening. A favorable external environment helped to increase exports from 10.4 percent, year-on-year, in the first half of 2016 to 20.0 percent, year-on-year, in the first half of 2017, which was the fastest half-year growth since the second half of 2010. However, manufacturing activity slowed in the first half of 2017, and manufacturing output contracted in July for the first time since June 2015. At the same time, business confidence declined to its lowest level in three years. Consumer sentiments, which reached record highs in the first half of 2017, have also recently moderated. Rising concerns among businesses and consumers go beyond a weaker peso and higher inflation. They extend to the conflict in Mindanao, limited income increases, and the fact that unemployment increased from a historic low of 4.7 percent in 2016 to 5.6 percent in July 2017.

The Philippines' medium-term growth trajectory remains positive. The economy is projected to expand at a slower rate in 2017 compared to 2016, and the growth rate will likely end up at the lower end of the government's target of 6.5-7.5 percent of GDP. The World Bank projects the Philippine growth rate at 6.6 percent of GDP in 2017 and 6.7 percent of GDP in 2018 and 2019. Exports are expected to increase to the country's main trading partner, while imports are estimated to remain elevated due to high demand for intermediate and capital goods. Steady consumption growth is projected to continue to provide the main base for growth, sustained by an increase in remittances, an expansion of credit, and improved income levels. Higher capital outlays and construction activities are expected to boost investment growth as the government speeds up the implementation of its

infrastructure program. Slower economic growth may reduce the pace of poverty reduction, but the poverty rate is expected to fall as the economy continues its structural transformation.

Risks to the outlook are increasing. The ongoing U.S. Federal Reserve rate hikes could lead to a further depreciation of the peso and continued capital outflows from the Philippines. Moreover, rising protectionism in some advanced economies increases the risk of lower levels of remittances and foreign trade. The government made significant progress in building a pipeline for the planned infrastructure program, however, slow implementation of the infrastructure investment plan could pose a risk to growth. There is a need to improve the management of public finances and preserve fiscal sustainability when government infrastructure spending increases, including improving revenue administration and collection. Despite these risks, the administration is in a strong position, as macroeconomic fundamentals remain intact. However, both the fiscal and monetary space to address risks can quickly diminish and limit the government's ability to mitigate those risks.

Policymakers need to confront downside risks while fostering long-term growth. The short-term risks to the country's outlook include increased trade protectionism, the possibility of financial market disruptions, and elevated economic policy uncertainty. In the longer term, weaker growth potential remains the main risk. Consistency in the government's policies to achieve stable inflation, fiscal stability, and security will help

preserve consumer and business confidence. For the Filipino consumer, it will be important that inflation remains at moderate levels. This will warrant careful inflation management by the central bank authorities to anchor expectations. As long as it is consistent with medium-term fiscal sustainability, an expansionary fiscal policy could support short-term growth. The successful and timely implementation of the government's fiscal program, including its ambitious infrastructure plan and efforts to generate more revenue, would signal a strong commitment to the government's policy priorities. Key issues, such as mining regulations and regional development in Mindanao, will require policy certainty to preserve both external and domestic confidence in the Philippine economy.

Implementing structural policies that support investment and trade will be critical to boost productivity and long-term growth. These policies would require the government's commitment to reforms that promote competition in key sectors, secure property rights, lessen regulatory complexities, and improve doing business in the country. Longer-term policy priorities also include training and job search programs and other measures to support workers most affected by sectoral shifts in employment and share the dividends of growth and gains from globalization more widely. Sustained investment in human capital development and in sectors that create quality employment are also needed to safeguard the country's progress on delivering inclusiveness.

PART I:

RECENT ECONOMIC AND POLICY DEVELOPMENTS

The Philippine economy continues to perform well relative to its regional peers. Following strong growth in the immediate two quarters after the new administration took over in July 2016, the economy had a slower start in the first half of 2017. Capital formation growth eased to 9.7 percent, year-on-year, in the first half of 2017, compared to its rally of 30.9 percent, year-on-year, in the first half of 2016 when rapid economic expansion was spurred by a stimulus from election-related spending and investment. Positive consumer sentiment, coupled with robust remittance growth, boosted domestic consumption. A favorable external environment pushed export growth from 10.4 percent, year-on-year, in the first half of 2016 to 20.0 percent, year-on-year, in the first half of 2017. The services sector remained the principal engine of growth, and the agriculture sector recovered strongly as farm output benefitted from favorable weather conditions. Fiscal and monetary policies remained supportive of growth. The government executed its programmed budget in the first half of 2017 despite lower revenues, and the central bank kept its policy rate steady despite climbing inflation. The Philippine peso continued to weaken in the first half of 2017, impacted by the Federal Reserve's rate hikes. The balance of payments turned into deficit in the first half of 2017, driven by higher capital outflows. Sustained economic growth increases the likelihood that poverty reduction has continued.



1.1 Growth: Consistent Performance

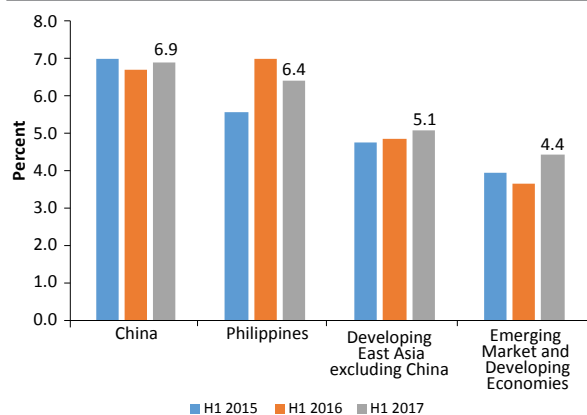
The Philippine economy had slow start in the first half of 2017. Consumer demand remained consistently robust while capital formation growth decelerated, and net exports rebounded alongside improving external demand.

1. The Philippines remained a consistent growth performer in the East Asia region, although growth moderated in the first half of 2017 (Figure 1 and Figure 2). The Philippines grew in the first half of 2017 faster than Indonesia, Thailand, Malaysia, and Vietnam but slower than China. Following strong growth in the immediate months after the new administration assumed office in July 2016, the economy had a slow start in the first half of 2017. The GDP growth rate fell from 7.0 and 6.8 percent, year-on-year, in the first and second half of 2016, respectively, to 6.4 percent, year-on-year, in the first half of 2017. Both the growth in government consumption and capital formation weakened significantly on an annual basis, partly due to the slowdown in the large election-related spending and investments initiated in the first half of 2016. Private consumption resumed its position as the main engine of economic growth, and a rebound in exports contributed to growth. However,

consumption and investment growth slowed in the first half of 2017 compared to the second half of 2016 despite an improvement in the external environment and continued accommodative monetary and fiscal policies.

2. Firming global economic activity improved the country's net exports performance.¹ The economic recovery in both advanced economies as well as in emerging markets and developing economies² led to a strong boost in the demand for the Philippines' main export commodities (Box 1). Exports increased from 10.4 percent, year-on-year, in the first half of 2016 to 20.0 percent, year-on-year, in the first half of 2017, which was the fastest half-year growth since the second half of 2010. Electronics components, especially semiconductors, which comprise half of the country's total exports of goods, expanded significantly.³ Meanwhile, import growth moderated from 23.2 percent, year-on-year,

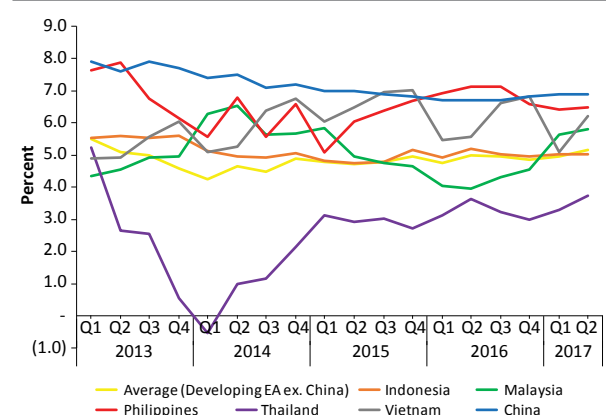
Figure 1: The Philippine economy continues to perform well compared to its regional peers...



Source: World Bank staff calculations

Note: Countries in Developing East Asia excluding China are the Philippines, Indonesia, Malaysia, Thailand and Vietnam.

Figure 2: ...which has been sustained over the past five years



Source: World Bank staff calculations

Note: Countries in Developing East Asia excluding China are the Philippines, Indonesia, Malaysia, Thailand and Vietnam.

¹ The discussion of net exports in this section assesses values at constant 2000 prices. This differs from the discussion in the balance of payments section, where net exports are assessed based on values at current prices.

² Emerging market and developing economies (EMDEs) includes all those that are not classified as advanced economies. Please refer to World Bank (2017b) for a list of all advanced economies.

³ Exports of electronics components increased by 25.7 percent, year-on-year, in the first half of 2017, up from 8.7 percent in the previous year. This was fueled by the growth of semiconductor exports, which expanded by 24.2 percent, year-on-year, over the same period.

in the first half of 2016 to 18.6 percent, year-on-year, in the first half of 2017. A 25.8 percent year-on-year increase in the imports of intermediary electronic goods, particularly electronics components and semiconductors which grew by 36.2 percent, drove the growth in imports in the first half of 2017.

Box 1 The global economic recovery solidified in the first half of 2017

Global activity is firming broadly as international trade is picking up. Global economic growth firmed in the first six months of 2017 and contributed to an improvement in confidence worldwide, and industrial activities recovered, as global trade picked up after two years of slow growth. Output gaps are narrowing and inflation rates are converging with central bank targets, as the modest recovery in major advanced economies continues. The demand for imports has also strengthened, further contributing to the recovery in global trade. Meanwhile, obstacles to growth among commodity exporters in emerging-market and developing economies are gradually diminishing, while activity in commodity importers remains generally robust. Given the improved confidence and less policy tightening in some commodity-exporting countries, domestic demand is leading the global economic upturn.

Advanced economies experienced solid economic performance in the beginning of 2017, with investments and exports regaining momentum after subdued growth in 2016. Private consumption decelerated somewhat in early 2017 despite improvements in labor markets. In the United States, a deceleration in consumer spending temporarily held back market activity, but it was partly offset by an increase in private investment. In the Euro Area, manufacturing activity and the exports of goods have been lifted by strengthening global trade and investment at a time when the unemployment rate fell to 9.5 percent in the first quarter of 2017, about 2.5 percentage points below its peak in 2013. Economic growth also accelerated in Japan, supported by an increase in exports, investments, and capital spending.

As international conditions improved, growth in emerging markets and developing economies accelerated in 2017 after reaching a post-crisis low of 3.5 percent in 2016. Following years of near stagnating growth, a gradual recovery in commodity-exporting countries is supported by firming commodity prices, recovering industrial activity, stabilizing investments, and improving confidence. This recovery is broad-based, impacting nearly 70 percent of commodity exporters in 2017. For commodity importers, economic growth continues to be robust, supported by accommodative policies aimed at increasing domestic demand and a recovery in global trade which is bolstering export growth.

Returns on assets in emerging markets and developing economies posted solid gains throughout the first half of 2017 but started to fall in July. Global financing conditions continue to be primarily driven by shifting expectations about monetary policy in the United States and the Euro Area. U.S. long-term yields decreased throughout much of the second quarter of 2017, reflecting disappointing inflation outcomes and diminished expectations of substantial fiscal stimulus. However, yields shifted upward in June 2017, reflecting the renewed pace of monetary policy normalization. As a result, capital flows and bond funds in emerging markets and developing economies registered net outflows in July – the first time in 2017. Moreover, currencies have suffered from tightening, especially for higher-risk and commodity exporters.

Source: World Bank (2017b), (2017d) and (2017e)

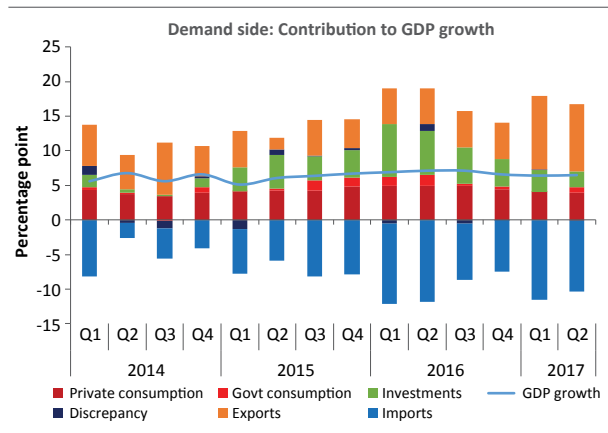
3. Private consumption remained the main engine of economic growth, although it weakened in the first half of 2017. Household consumption growth decreased from 7.3 percent, year-on-year, in the first half of 2016 to 5.8 percent in the first half of 2017. However, it remained in line with the average annual growth of 5.7 percent during 2010-2016. Consumption growth was supported by an accommodative monetary policy stance which kept the key policy rates low. The low interest rate environment led to a sustained increase in consumer loans, which together with remittances from overseas Filipinos expanded by 5.5 percent, year-on-year, in the first six months of 2017, further boosting household purchasing power. Moreover, the overall consumer confidence index of Filipinos registered record-high levels during the first half of 2017 and only weakened recently (Box 2). However, inflation levels increased from an average of 1.3 percent in the first half of 2016 to 3.1 percent in the first six months of 2017.

4. Growth in capital formation dropped sharply in the first half of 2017 following unusually strong investment growth during the election year. Fixed capital formation growth decelerated from 29.3 percent, year-on-year, in the first half of 2016 to 12.1 percent in the first half of 2017 (Figure 3). Investment growth in

durable equipment moderated to 13.2 percent, year-on-year, in the first half of 2017, compared to 41.3 percent, year-on-year, in the first half of 2016. Moreover, the construction sector grew by 8.8 percent, year-on-year, in the first six months of 2017, considerably slower than the 16.7 percent, year-on-year, recorded in the first half of 2016. Similarly, public construction grew by only 9.0 percent, year-on-year, in the first half of 2017, down from 34.9 percent during the same period in the previous year. This marked slowdown in investment growth was in part due to the high base in the first half of 2016 when large election-related spending significantly boosted capital spending.⁴ Furthermore, the slowdown in capital formation was a result of the slow start in the implementation of the government’s infrastructure program in the first half of 2017.

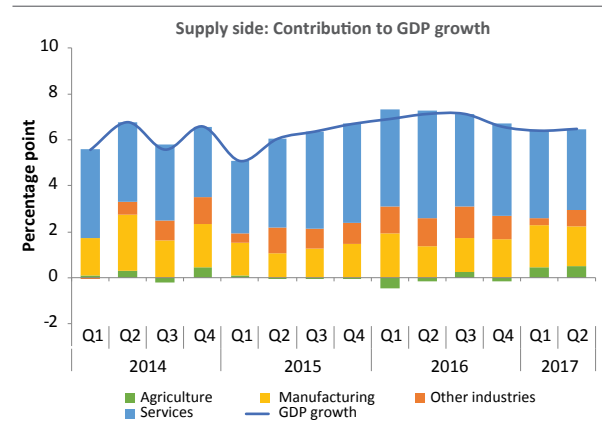
5. On the production side, the services sector remains the principal contributor to economic growth in the Philippines, although growth in both the services and industry sectors slowed significantly in the first half of 2017 (Figure 4). The services sector, which constitutes 60 percent of the country’s output, contributed 3.7 percentage points to overall growth in the first six months of 2017. The sector grew by 6.4 percent, year-on-year, in the first half of 2017, compared to 7.9 percent, year-on-year, during the first half of 2016.

Figure 3: Economic growth moderated in the first half of 2017



Source: PSA

Figure 4: The services sector remained the principal growth engine



Source: PSA

Note: Other industries are mining and quarrying, construction, and electricity, gas and water.

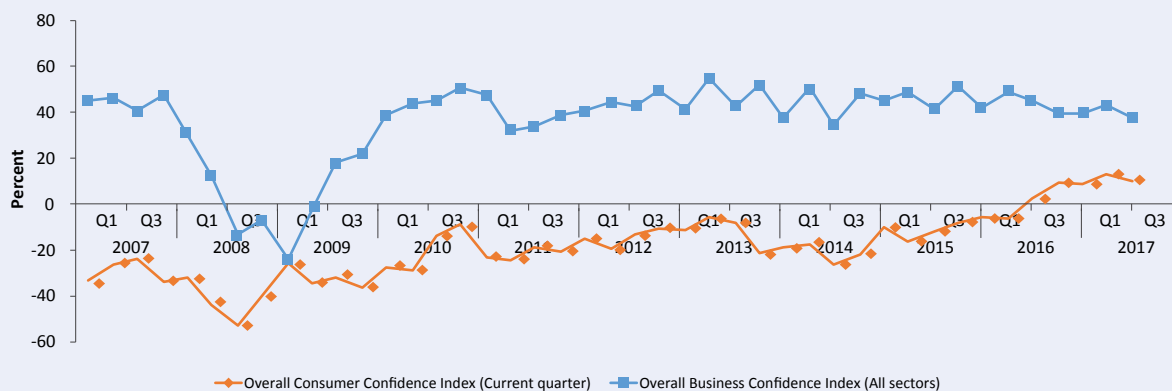
⁴ Pre-election investment frontloading played a key role in the strong expansion of capital formation in the first half of 2016. The stimulus from election-related spending led to an acceleration in the growth of fixed capital formation from 13.5 percent, year-on-year, in the first half of 2015 to 29.3 percent in the same period in 2016.

Box 2 Confidence in the Philippine economy

Even though the confidence of the Philippine business community improved as the economy grew over recent years, consumer optimism has been lagging. The government's commitment to macroeconomic stability and good governance helped accelerate economic growth and earned the country international recognition.⁵ For the private sector, this prolonged period of improved macroeconomic management has translated into a persistent trend of positive business sentiments⁶ since 2007.⁷ However, there has been a long-term negative trend in the *Bangko Sentral ng Pilipinas'* overall consumer confidence index since the consumer expectations survey launched in 2007. The fact that past high economic growth rates did not quickly translate into more inclusive growth might have contributed to a delay in improving consumer confidence.⁸

Consumer confidence surveys registered a positive value for the first time in the third quarter of 2016 but has since weakened. Even though consumer sentiments reached record highs in the first half of 2017, they have recently moderated but remain above 2016 levels.⁹ The gradual improvement in consumer sentiments was based on perceived positive prospects for the economy, improvements in household incomes due to a healthy job market, and government social protection programs (Figure 5).¹⁰ In particular, perceived improvements in peace and order fueled higher consumer confidence among Filipinos.^{11,12} However, recent data from the third quarter 2017 Consumer Expectations Survey show that consumer confidence is demonstrating signs of renewed weakness, similar to that of recent business confidence indicators. The overall

Figure 5: The Philippine economy benefits from strong consumer and business sentiments



Source: *Bangko Sentral ng Pilipinas*

⁵ The country is now rated at investment grade by the three major credit rating agencies, Standard & Poor's Global Ratings, Moody's Investors Service, and Fitch Ratings.

⁶ Business confidence is measured through the *Bangko Sentral ng Pilipinas'* overall business confidence index. The index is calculated as the percentage of firms that answered in the affirmative minus the percentage of firms that answered in the negative in a given indicator. A positive confidence index indicates a favorable view. For more information, see: http://www.bsp.gov.ph/publications/regular_business.asp.

⁷ The only significant dip in business confidence occurred during the 2007-2008 global financial crisis.

⁸ Consumer confidence is measured through the *Bangko Sentral ng Pilipinas'* overall consumer confidence index. This index is computed as the percentage of households that answered in the affirmative less the percentage of households that answered in the negative in a given indicator. A positive confidence index indicates a favorable view. For more information, see: http://www.bsp.gov.ph/publications/regular_consumer.asp.

⁹ By the second quarter of 2017, the overall consumer confidence index reached 13.1, a record high for the Philippines, and was the fourth consecutive quarter wherein the overall consumer outlook was positive.

¹⁰ Record high levels of consumer confidence were also observed in the three component indicators of consumer confidence in the second quarter of 2017: i) confidence in the country's economic condition, ii) confidence in the family's financial situation, and iii) confidence in family income.

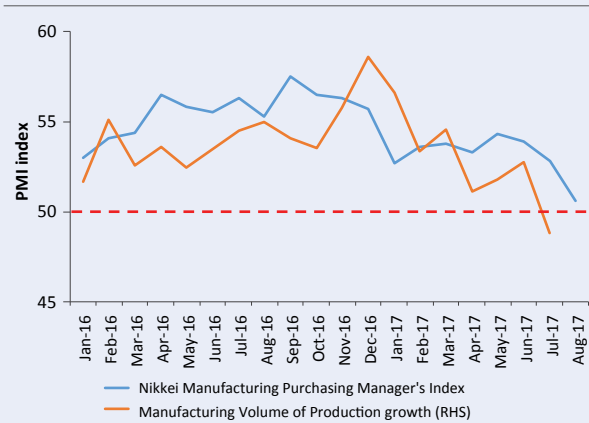
¹¹ The survey covering the second quarter of 2017 was conducted from April 1 to 12, 2017, which was before the Marawi events and the declaration of Martial Law in Mindanao. However, the recent conflict in Marawi City was among the factors cited in both the consumer and business expectations surveys as among the reasons for the weakening in overall confidence.

¹² These were consistently the main reasons for overall positive consumer sentiment based on the Consumer Expectations Survey from the third quarter of 2016 to the second quarter of 2017.

consumer confidence index fell slightly from 13.1 percent in the second quarter of 2017 to 10.2 percent in the third quarter of 2017 due to concerns over higher inflation and unemployment and limited increases in income. Concerns over the conflict in Mindanao have likely also dampened overall consumer sentiment.

There has been a recent weakening of business confidence (Figure 6). Based on the third quarter 2017 results of the business expectations survey, overall business confidence declined from 37.9 percent in the third quarter to 43.0 percent in the second quarter, the lowest level in three years.¹³ The weak peso, higher inflation, and the ongoing conflict in Mindanao contributed to diminished business confidence. The Nikkei Manufacturing Purchasing Manager's Index (PMI)¹⁴, which appears to be a reasonable predictor of the Philippines' main output indicators, remained in expansion territory in the first eight months of 2017. However, it has weakened since May 2017 in line with the worsening of business sentiment since the beginning of the third quarter of 2017.^{15,16} Manufacturing output also weakened in the first half of 2017 and contracted in July.

Figure 6: Recent weakening in business confidence translated in weaker manufacturing growth



Source: Markit Economics, PSA

6. Growth in wholesale and retail trade and real estate remained the principal growth drivers in the services sector. The expansion in the industry sector also moderated in the first half of 2017 to 6.8 percent, year-on-year, compared to 8.4 percent, year-on-year, in the first half of 2016, as growth in the construction sector slowed due to a combination of base effects from the previous year and the slow start to the government's public infrastructure program in the first quarter of 2017. The manufacturing subsector continued to drive growth in industry, with annual growth remaining at over 7 percent in the first half of 2017.¹⁷ However, overall manufacturing output weakened and contracted in July. Meanwhile, the three other industry subsectors all posted weaker

performance in the first half of 2017 compared the same period in 2016, including the mining sector, which contracted by 1.2 percent, year-on-year, during the first half of 2017, a reversal from the 2.7 percent growth registered during the first six months of 2016 (Box 3).

7. The country's agricultural sector expanded during the first half of 2017. The sector grew at an annual rate of 5.6 percent, reversing a contraction of 3.2 percent recorded during the same period in the previous year. A low base year and more favorable conditions for farm output, as the effects of the El Niño phenomenon largely dissipated, contributed to the recovery in agriculture.

¹³ See: http://www.bsp.gov.ph/downloads/Publications/2017/BES_2qtr2017.pdf

¹⁴ Nikkei launched the Philippines' Purchasing Manager's Index data on September 1, 2016. Data was collected at the beginning of January 2016.

¹⁵ A reading of above 50 for the Nikkei Manufacturing PMI indicates economic expansion, while a reading below 50 points to a contraction.

¹⁶ Likewise, the Philippine Institute of Supply Managers, which releases its own PMI data for a broader set of sectors, including manufacturing, services, and wholesale and retail trade, mirrors the overall trend seen in the Nikkei Manufacturing PMI, suggesting an expansion of output from firms in these sectors. Data from the PISM PMI was accessed through the central bank's selected economic and financial indicators: <http://www.bsp.gov.ph/statistics/keystat/sefi.pdf>.

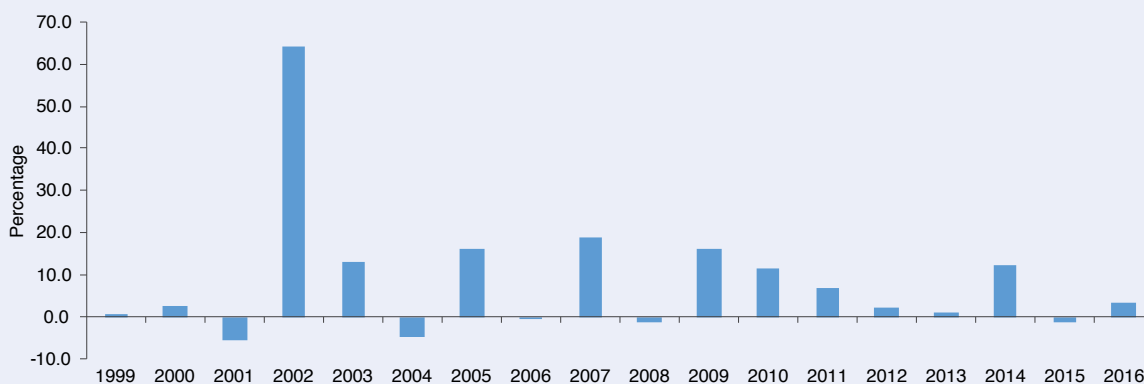
¹⁷ Mines and Geoscience Bureau website; Ocampo and Arguelles (2017).

Box 3 Regulation and investments in the mining industry

The Philippines is the fifth most mineral-rich country in the world for gold, nickel, copper, and chromite. It has an estimated US\$840.0 billion worth of untapped mineral resources, and about 9 million hectares of land have a high mineral potential. The metal and non-metal deposits in the Philippines are estimated at 21.5 billion and 19.3 billion metric tons, respectively.¹⁸

In recent years, changes in government regulations and policy uncertainties have limited foreign investment in the mining industry. Despite the 1995 Philippine Mining Act, which opened up the country's mining sector to 100 percent foreign ownership, foreign direct investment in the mining industry remain subdued (Figure 8). As a result, growth in the sector has been uneven with occasional periods of contraction (Figure 7). Government efforts to improve the mining industry face the difficult task of attracting new investments while protecting the environment and communities. In 2012, Executive Order no. 79 was enacted to reform the Mining Act by establishing mineral reservations¹⁹, expanding areas closed to mining operations, creating a Mining Industry Coordinating Council to help enforce mining laws, and imposing a moratorium on new mineral permits until legislation can be enacted to rationalize existing revenue sharing schemes. However, legislation has yet to be introduced in Congress, and the moratorium is still in place five years later.

Figure 7: Annual real growth of the mining and quarrying sector



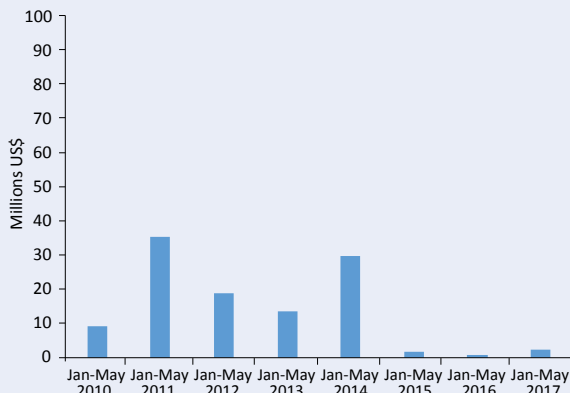
Source: PSA

Mining is increasingly financed by domestic sources. Domestic corporate lending in the industry increased steadily since June 2014, and it surpasses foreign direct investment by a wide margin (Figure 9). Outstanding domestic credit grew on average 31.3 percent annually between June 2010 and June 2017. Based on data from five major mining companies, capital expenditures and debt refinancing constitute the bulk of outstanding credit for major industry players in the long term, while short-term debt for working capital requirements makes up a smaller portion.²⁰

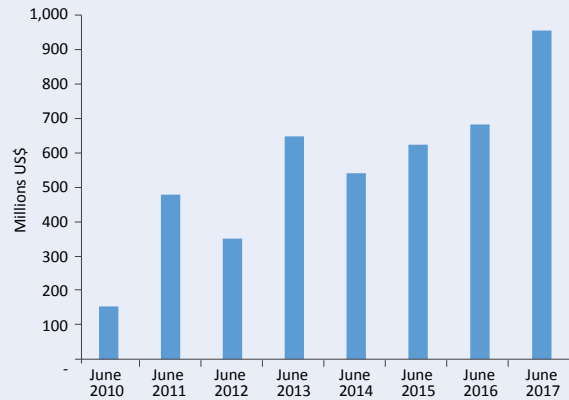
There is uncertainty in the policy environment surrounding the mining industry. In the first half of 2017, the former environment secretary ordered the closure of 23 of the Philippines' 41 mines, the cancellation of 75 mining contracts in watershed areas, and banned prospective open-pit mines. In addition, the 2012 moratorium on new mining permits under the Executive

¹⁸ Mineral reservations are identified by the government as potential and future mining areas with known strategic mineral reserves and resources for the development of strategic industries. Please see Executive Order No 79 for a full description.

¹⁹ Growth in the construction sector dropped from 13.8 percent, year-on-year, in the first half of 2016 to 7.4 percent in the first half of 2017. Its contribution to growth in the industry sector declined from 29 to 20 percent during the same period.

Figure 8: Net foreign direct investment in the mining and quarrying sector

Source: BSP

Figure 9: Loans outstanding in the mining and quarrying sector

Source: BSP

Order no. 79 has yet to be lifted, and mining firms that were suspended still await the review of their appeals. This uncertainty is a challenge for investors who seek policy consistency and make business decisions based on an analysis of risks and potential returns. There are discussions in Congress about new legislation dealing with responsible mining practices, mining taxation, and revenue-sharing schemes. The push towards responsible mining should address concerns over the environmental and social impacts of mining. The most cited negative environmental impacts involve land and water contamination, such as the 1996 contamination of the Boac river from a tailing dam failure, and destruction of forest, farmlands, corals reefs, and deep rifts due to mining pollution. Social impact concerns include the relinquishment of ancestral domains of indigenous people and reports of intimidation.

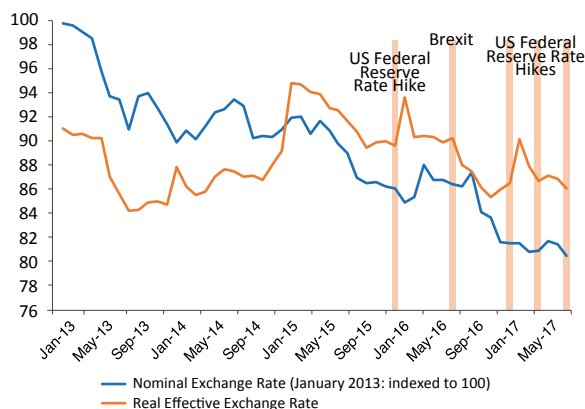
1.2 The Exchange Rate and The External Sector: Weakening Balance of Payments

While the Philippines' current account deficit remained stable, the peso was impacted by the Federal Reserve's rate hikes and continued to weaken, and the country's balance of payments turned into deficit because of increasing capital outflows.

8. The Philippine peso further depreciated in the first half of 2017. In nominal terms, the peso depreciated by 6.5 percent, year-on-year, from an average of Php46.88 per USD in the first half of 2016 to an average of Php49.93 per USD in the first half of 2017 (Figure 10). Moreover, the real effective exchange rate depreciated from 3.2 percent, year-on-year, in the first half of 2016 to 3.7 percent, year-on-year, in the first half of 2017. The real depreciation of the peso has been larger compared to other regional currencies (Box 4). There were two episodes of a marked

depreciation of the peso's nominal exchange rate in the first half of 2017. It depreciated 0.9 percent, month-on-month, in February and 1.2 percent, month-on-month, in June. In both instances, the expectations of and actual U.S. Federal Reserve rate hikes led to capital outflows from the Philippines.²¹ In addition, strong imports raised the demand for the U.S. dollar and weakened the peso. In July, the central bank reportedly intervened to temper excessive volatility in the foreign-exchange market. As a result, gross international reserves slipped from US\$85.5

²⁰ Credit information came from disclosed figures in the companies' annual reports. The select companies include Nickel Asia Corporation, Atlas Consolidated Mining and Development Corporation, Semirara Mining and Power Corporation, Philex Mining Corporation, and Lepanto Consolidated Mining Company.

Figure 10: The real effective exchange rate continued to weaken in the first half of 2017

Source: BSP

Note: Decrease denotes depreciation

billion in July 2016 to US\$81.3 and US\$80.8 billion in June and July 2017, respectively. At its current level, the reserves cover 8.6 months' worth of goods imports, payments of services, and primary income. It is also equivalent to 5.5 times the country's short-term external debt based on original maturity and 3.7 times based on residual maturity.

9. The current account deficit slightly moderated in the first half of 2017. It registered a US\$233.6 million (0.2 percent of GDP) deficit in the first half of 2017, slightly lower than the 0.3 percent of GDP deficit recorded in the first half of 2016 (US\$423.9 million). The current account was

Box 4 Opportunities and challenges of a weaker currency

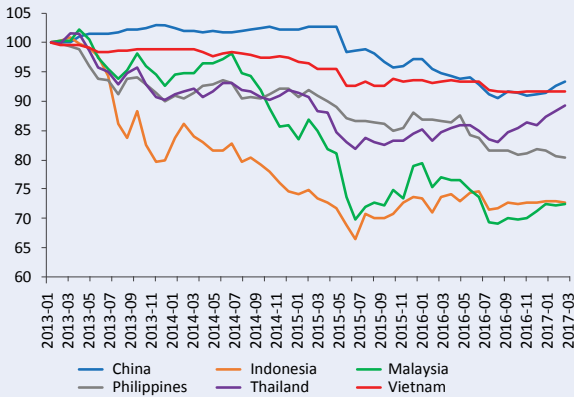
In line with other regional currencies, the Philippine peso has steadily weakened since January 2013. The Philippine peso slid in nominal terms from Php40.00 per USD in 2013 to Php50.58 per USD in July 2017. Its performance in the past four years is comparable with other regional currencies and performed slightly better than the Malaysian ringgit and Indonesian rupiah (Figure 11). However, the peso was the weakest performer in the region during the first six months of 2017, and it dropped to a fresh 11-year low in August at a time when other regional currencies had gained strength.

The depreciation of the country's real effective exchange rate creates a relative price advantage that the Philippines can explore. The real effective peso exchange rate depreciated at a moderate pace of 3.1 percent, year-on-year, in first half of 2017, which made it the worst regional performer with the exception of China's yuan (Figure 12). The depreciation of the peso has made it relatively cheaper to produce and export Philippine goods, improving the country's export competitiveness in the region. This could help explain the country's strong export performance over the past six months, as firms with established export products and sufficient production capacity to increase output in the short term were in a position to immediately take advantage of the price advantage. However, initial investments might be required for companies to take advantage of opportunities in more competitive markets.

Global developments, such as the ongoing U.S. policy rate normalization and Brexit, have contributed to the depreciation of the peso. The anticipation of U.S. Federal Reserve rate increases and uncertainty surrounding Brexit caused capital outflows from emerging markets in the Asia-Pacific region, as investors moved funds to safer markets and U.S. assets regained attractiveness. In the Philippines, the stock exchange endured stock sell-offs in the last quarter of 2016 (US\$357.0 million in September and US\$383.0 million in November 2016) and in February 2017 that brought volatility in the foreign-exchange market and the continued deterioration of the peso. Since then, stocks in the Philippines have rebounded in line with top performing major stock indices in the region, and the country's stock market reached a record-high of 8,321 in September 2017. However, the peso exchange rate has remained at relative low levels, with the market expecting further depreciation.

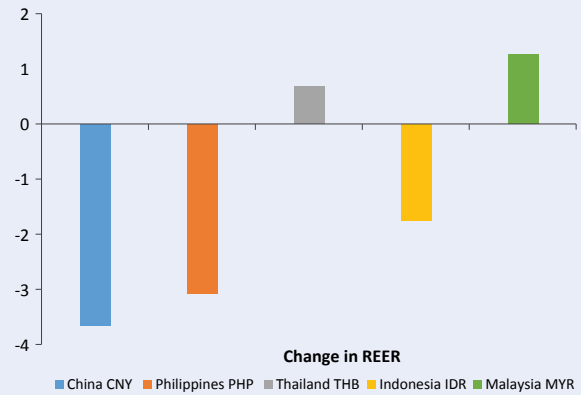
²¹ As of August 2017, the U.S. Federal Reserve has raised the interest rate twice for the year: on March 16 and June 15.

Figure 11: Regional currencies in nominal terms have generally depreciated since 2013



Source: EAP Update October 2017
 Note: Decrease denotes depreciation.

Figure 12: Change in the real effective exchange rate from January 2017 to June 2017 (percent)



Source: WB staff calculation

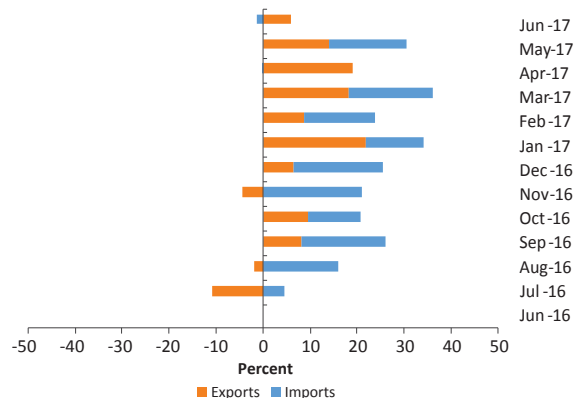
Preserving confidence in the economy will be important, as widening current- and fiscal-account deficits and the continuing depreciation of the peso weigh heavily on investor sentiments.

There are concerns over the anticipated current account deficit in 2017, the first in 14 years, and the ambitious public infrastructure investment plan that is expected to lead to a budget deficit of 3.0 percent of GDP over the next five years. There is a risk of overheating the economy if investments in new production capacity do not keep pace with demand, which could result in a higher inflation rate and a further weakening of the peso. Although the public infrastructure investment plan is consistent with the country’s development needs and will require greater capital formation and capital imports for some time, it will also need to be carefully managed to mitigate risks.

stable in the first year of the new administration.²² The trade balance continued to widen from 11.8 percent of GDP (US\$18.2 billion) in the first half of 2016 to 12.9 percent of GDP (US\$19.4 billion) in the first half of 2017. However, the growth of the trade deficit slowed, from 82.1 percent, year-on-year, in the first half of 2016 to 11.9 percent, year-on-year, in the first half of 2017 (Box 5). Exports grew at an annual rate of 14.6 percent, year-on-year, in the first half of 2017, compared to a 6.3 percent year-on-year contraction in the first half of 2016. Import growth continued to grow but at a slower rate of 10.1 percent in the first six months of 2017, compared to 21.8 percent in the first half of 2016 (Figure 13).²³ Services exports weakened in the first half of 2017, including export revenues from business process outsourcing (BPO) services. The growth in personal remittances remained robust at 5.5

percent annually and reached US\$15.4 billion in the first half of 2017, compared to 4.4 percent, year-on-year, in the first half of 2016 (Box 6).

Figure 13: Exports growth rebounded while import growth remained strong



Source: PSA

²² The current account deficit stood at US\$530.0 million (0.3 percent of GDP) in the second half of 2016.

²³ The discussion of net exports in this section assesses values at current prices. This differs from the discussion of net exports in the growth section, where net exports assess values at constant 2000 prices.

Box 5 The trade balance in the Philippines

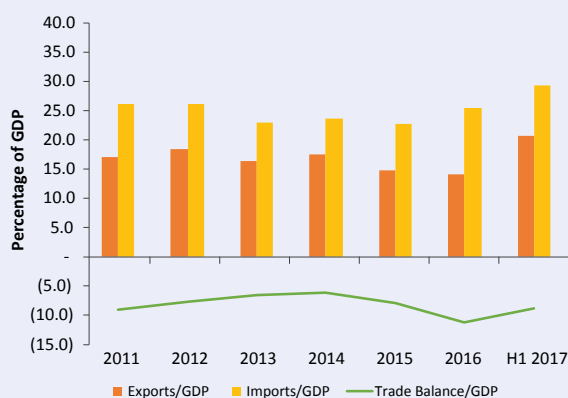
The Philippines’ trade balance has been in deficit for the past five years (Figure 14). Between 2011 and 2016, goods exports grew at an annual rate of 2.6 percent while merchandise imports grew at the faster annual rate of 5.7 percent. On average, the trade deficit was around 7.9 percent of GDP in 2011-2016 but rose to 8.7 percent of GDP in the first half of 2017.

Exports rebounded in early 2017 after two consecutive years of weak growth. Goods exports expanded by 14.6 percent, year-on-year, in the first six months of 2017, compared to a 6.3 percent, year-on-year, contraction in the same period in 2016. Leading the rebound was the exports of electronic products, including semiconductors and electronic data processing machines, which accounted for more than two-fifths of the growth, followed by the exports of forest, mineral, and petroleum products which constituted about a quarter of the growth. The exports of agriculture-based products and other manufactured goods also increased compared to last year’s contractions, in part due to the general improvement in the external environment. Yet given the slower growth of exports compared to imports, the continued adoption of policies to further improve the country’s export competitiveness remains important.

Even though the recent rise in imports exacerbated the trade deficit, a sizable share of the imports was capital goods. Capital goods, which used to constitute about a quarter of the total import bill during 2011-2015, have made up about a third of total imports since 2016 (Figure 15). Imports of capital goods grew at an average annual rate of 12.4 percent in 2011-2016. In the first half of 2017, they grew by 5.5 percent, year-on-year, driven by the imports of power generating and specialized machines, telecommunication equipment, and office and electronic data processing machines. Since capital goods are necessary inputs to build production capacity, their import growth is a welcome development to secure the country’s potential and future growth.

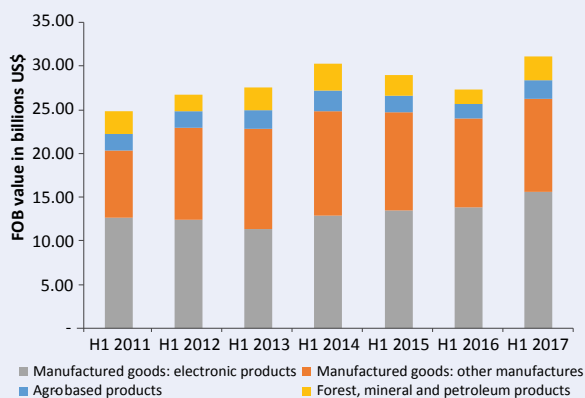
The imports of raw materials and intermediate goods have increased as they are key inputs in the production of Philippine exports. In 2011-2016, the imports of raw materials and intermediate goods grew at an annual rate of 4.6 percent. Moreover, they grew from 8.8 percent, year-on-year, in the first half of 2016 to 9.9 percent, year-on-year, in the first half of 2017. Materials for the manufacturing of electronic equipment constitute a key share among intermediate goods (23.1 percent) and are important for the country’s main exports of semiconductors and electronic products.

Figure 14: The trade balance has been in deficit for the past five years



Source: PSA

Figure 15: Capital goods covered roughly a third of the total import bill in H1 2016 and H1 2017



Source: PSA

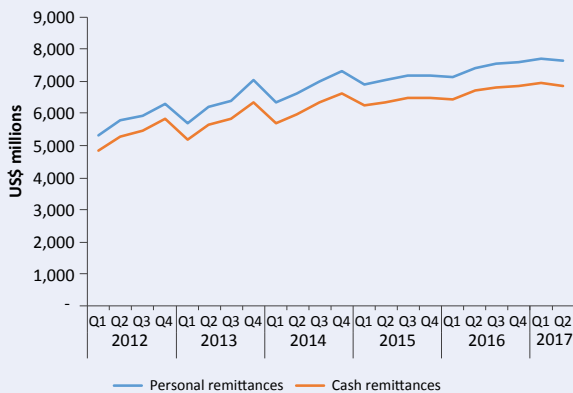
Consumer goods imports rose alongside increasing domestic incomes. As income levels rise in line with rising GDP levels, the propensity to consume imported goods is likely to continue to be strong. In 2011-2016, the imports of consumer goods grew at an annual rate of 15.5 percent, and they grew by 6.5 percent, year-on-year, in the first six months of 2017, largely as a result of an increase in imports of both non-durable goods, such as food items, and durable goods, such as passenger cars and home appliances. In the first half of 2017, 16.8 percent of total imports were consumer goods while about 38.6 percent were raw materials and intermediate goods.

Box 6 Recent trends in remittances

Remittances to the Philippines continued to increase in the first six months of 2017, helped by the improving global economy and the continued strong deployment of overseas Filipinos. Personal remittances sent by overseas Filipinos expanded 5.5 percent, year-on-year, and reached US\$15.4 billion (10.2 percent of GDP) in the first half of 2017, outpacing the 4.4 percent, year-on-year, expansion registered during the same period in the previous year (Figure 16). Meanwhile, cash remittances increased by 4.7 percent, year-on-year, over the same period to reach US\$13.8 billion (9.2 percent of GDP), which is in line with the central bank’s projection of US\$28.0 billion for 2017. Preliminary data from the Philippine Overseas Employment Administration reveal that a total of 1.1 million Filipinos were deployed overseas, on track to surpass the 2.1 million overseas Filipinos recorded in 2016.

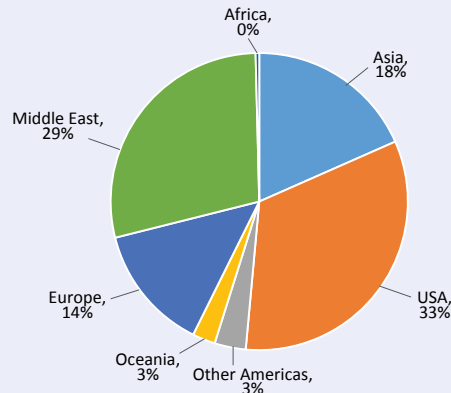
The source of remittances in the first half of 2017 broadly reflected the Filipino diaspora. Cash remittances from North and South America accounted for the largest share of remittance inflows (Figure 17), comprising 36.6 percent of total remittances, 90 percent of which were from the United States. The Middle East remained the second largest source of remittances, with a 28.3 percent share in the first half of 2017, followed by Asia (18.3 percent) and Europe (13.8 percent). These trends mirrored the distribution of around 9.2 million overseas Filipinos in 2016, with the United States accounting for the largest share of Filipino migrants at 39.5 percent (land-based), followed by the Middle East (24.8 percent), Asia and the Pacific (21.6 percent), and Europe (7.2 percent).²⁴

Figure 16: The Philippines benefited from robust remittances in the first half of 2017...



Source: BSP

Figure 17: ...reflecting the distribution of around 9.2 million Filipinos abroad



Source: BSP

²⁴ Source: Department of Foreign Affairs.

10. Increasing capital outflows led to the balance of payment swinging into deficit. The capital and financial accounts deteriorated in the first year of the new administration, from registering net inflows of US\$1.5 billion (1.0 percent of GDP) in the first half of 2016 to posting net outflows of US\$1.1 billion (0.7 percent of GDP) and US\$81.9 million (0.1 percent of GDP) in the second half of 2016 and the first half of 2017, respectively. This can be partially explained by the ongoing U.S. Federal Reserve rate tightening cycle and recovery in advanced economies which made foreign assets more attractive, leading to foreign equity outflows from the Philippines and a weakening of the country-specific investment sentiment. In the first half of 2017, there was a net outflow of US\$3.0 billion in portfolio investments, which was exacerbated by a net

outflow of US\$0.5 billion in other investments.²⁵ Foreign direct investments, which represent long-term investments, also moderated from registering US\$4.2 billion in net inflows during the first half of 2016 to a net inflow of US\$3.6 billion in the first six months of 2017. The deterioration in the capital and financial accounts overrode the modest improvement in the current account. As a result, the country's balance of payments remained in deficit for the entire first year of the new administration, registering a deficit of US\$705.7 million (0.5 percent of GDP) in the first half of 2017. This was a reversal of the US\$633.7 million (0.4 percent of GDP) surplus registered in the first half of 2016 but an improvement from the US\$1.1 billion (0.7 percent of GDP) deficit in the second half of 2016 (Table 1).

Table 1: Balance of payments, H1 2015 – H1 2017

	H1 2015		H2 2015		H1 2016		H2 2016		H1 2017	
	<i>In millions US\$ / In percentage of GDP</i>									
Current account	4,866	3.4	2,400	1.6	(424)	(0.3)	(530)	(0.3)	(234)	(0.2)
Goods	(9,528)	(6.7)	(13,781)	(9.2)	(17,349)	(11.8)	(18,199)	(11.5)	(19,420)	(12.9)
Services	2,076	1.5	3,379	2.3	3,465	2.4	3,579	2.3	4,640	3.1
Primary Income	851	0.6	1,006	0.7	1,337	0.9	1,239	0.8	1,700	1.1
Secondary Income	11,466	8.0	11,797	7.9	12,124	8.3	12,852	8.1	12,847	8.5
Capital and Financial accounts	(1,841)	(1.3)	(375)	(0.3)	1,511	1.0	(1,104)	(0.7)	(82)	(0.1)
Capital account	39	0.0	45	0.0	50	0.0	52	0.0	53	0.0
Financial account	1,880	1.3	420	0.3	(1,461)	(1.0)	1,156	0.7	135	0.1
Direct investment	119	0.1	(219)	(0.1)	(3,518)	(2.4)	(2,302)	(1.5)	(3,194)	(2.1)
Net acquisition of financial assets	2,102	1.5	3,437	2.3	666	0.5	1,447	0.9	404	0.3
Net incurrence of liabilities ^{1/}	1,983	1.4	3,656	2.4	4,184	2.9	3,749	2.4	3,598	2.4
Portfolio investment	3,110	2.2	2,361	1.6	2,326	1.6	(901)	(0.6)	3,031	2.0
Financial derivatives	(30)	(0.0)	35	0.0	57	0.0	(89)	(0.1)	(170)	(0.1)
Other investments	(1,319)	(0.9)	(1,757)	(1.2)	(325)	(0.2)	4,448	2.8	468	0.3
Net unclassified items^{2/}	(1,340)	(0.9)	(1,093)	(0.7)	(454)	(0.3)	581	0.4	(390)	(0.3)
Overall BOP position	1,684	1.2	933	0.6	634	0.4	(1,054)	(0.7)	(706)	(0.5)
<i>Memo:</i>										
Basic Balance	4,746	3.3	2,619	1.8	3,094	2.1	1,772	1.1	2,960	2.0

^{1/} Net incurrence of liabilities refers to net foreign direct investment to the Philippines.

^{2/} The term "Net unclassified items" is a balancing figure. There are two methods of computing the BOP position: the first approach uses the change in net international reserves due to transactions, while the second approach computes the sum balances of the current account, capital account less financial account. The two measures do not necessarily tally. The BSP uses the first approach to determine the overall BOP position.

²⁵ Other investment accounts consisted of domestic deposits in foreign banks and non-residents net loans from local banks.

1.3 Financial Markets and Monetary Policy: Inflation Peaked and Remains Sticky

Inflation peaked in April and remained at elevated levels. Monetary policy has remained accommodative to growth and domestic credit continues to expand. Finally, the financial system remains stable and well capitalized.

11. The inflation rate climbed to 3.4 percent in the first half of 2017 and has continued to hover around 3 percent since. The average headline inflation rate stood at 3.1 percent in the first eight months of 2017, up from an average of 1.5 percent in the same period last year. It has been steadily increasing since 2016, from a low of 0.9 percent, year-on-year, in February 2016 to a peak of 3.4 percent, year-on-year, in April of this year. However, it remained within the central bank's target range of 2-4 percent and decelerated in June 2017 to 2.8 percent before picking up again in August to 3.1 percent (Figure 18).

12. The price of food has been the main driver of the country's high inflation rate, as higher prices for staple food items caused about half of the initial average increase in the inflation rate. Rice prices also increased towards the second quarter of 2017 in line with the end of the main harvest season coupled with lower production in certain provinces because of pest infestation and floods (Box 7). At an annual increase of 4.3 percent, food prices reached a new high in April 2017. They declined between May and July only to climb back up to 3.7 percent in August due to the adverse effects of the recent typhoons. Throughout the first eight months of 2017, energy prices remained higher than in 2016, reflecting higher local electricity costs and elevated global crude oil prices. The core inflation rate accelerated to an average of 2.8 percent in the first eight months of 2017, up from 1.7 percent in the same period last year. This was partly the result of the pass-through effect of the two peso depreciation episodes. It peaked in April at 3.0 percent, eased back to 2.6 percent in June, before climbing back up to 3.0 percent in August. The central bank authorities have maintained the key policy rate at 3.0 percent since June 2016, as the inflation rate remained within the target range.

13. The Philippine financial market remained characterized by ample domestic liquidity and strong credit growth. In the first seven months of 2017, domestic liquidity growth remained robust at 12.3 percent, year-on-year (the same growth rate as in the first seven months of 2016), and averaged Php9.6 trillion. Credit growth, i.e. loans of commercial banks, net of reverse repurchase placements, grew from 17.7 percent, year-on-year, in the first seven months of 2016 to 19.7 percent, year-on-year, in the first seven months of 2017. Loans to firms, net of reverse repurchase placements, dominate the banks' loan portfolio and constitute 88.7 percent of the aggregate loan portfolio. They grew from an average of 16.7 percent, year-on-year, in the first seven months of 2016 to an average of 18.1 percent, year-on-year, in the first seven months of 2017. The credit expansion to businesses was primarily driven by lending to the real estate, electricity and gas, wholesale and retail trade, and manufacturing sectors (Figure 19). Loans to households grew from 17.4 percent, year-on-year, in the first seven months of 2016 to 23.6 percent, year-on-year, in the first seven months of 2017, with motor vehicle and salary loans constituting the bulk of new loans. Compared to neighboring countries, the Philippines' domestic credit-to-GDP ratio is low at 44.7 percent in 2016 (Figure 20).²⁶

14. The country's banking sector was stable and profitable in the first half of 2017. The financial system remained stable with nonperforming loans maintained at 2.0 percent of the total loan portfolio by end-July 2017, down from 2.2 percent at end-July 2016 (Figure 21). Banks maintained a strong capital adequacy ratio of 15.3 percent on average as of March 2017, well above the 10.0 percent regulatory minimum.²⁷ The banking system's profitability also remained stable with an average net interest

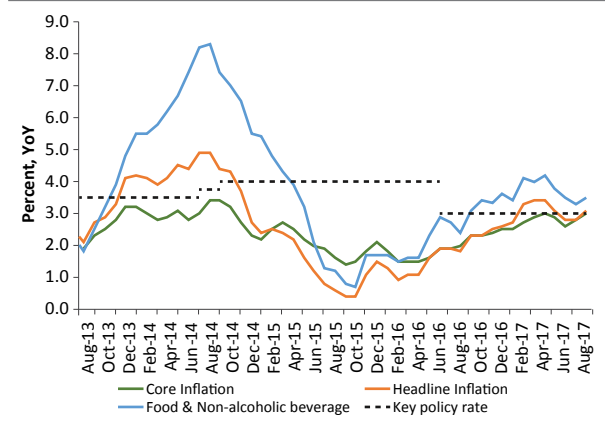
²⁶ The credit-to-GDP ratio was 124.1 percent in Malaysia, 156.0 percent in China, and 147.4 percent in Thailand in 2016. Source: World Development Indicators.

²⁷ As of March 2017, Universal and Commercial Bank capital adequacy ratio was 15.0 percent while thrift banks were at 16.9 percent. Both are way above the minimum ratio of capital-to-risk weight assets of 8.0 percent under Basel II and 10.5 percent under Basel III.

margin of 3.3 percent and net interest income at 73.8 percent of total income throughout the first half of 2017. The return on assets averaged 1.2 percent and the return on equity 9.9 percent over the first six months of 2017. Starting on July 1st, the appointment of a new central bank

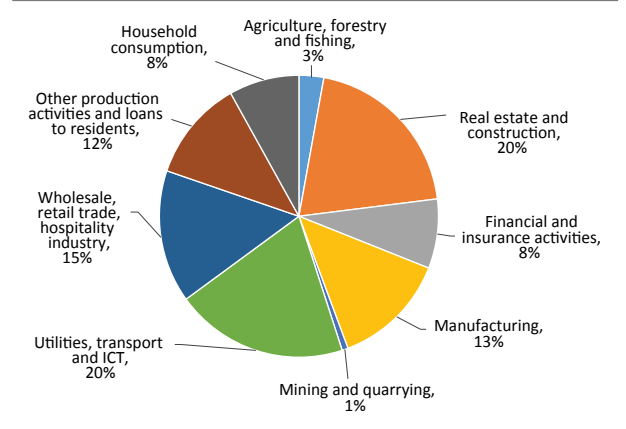
governor became effective after the term of the previous governor ran out. The newly appointed central bank governor promised a commitment to policy continuity and reaffirmed financial system stability and financial inclusion as top priorities for the central bank.

Figure 18: Inflation remained elevated at around 3 percent



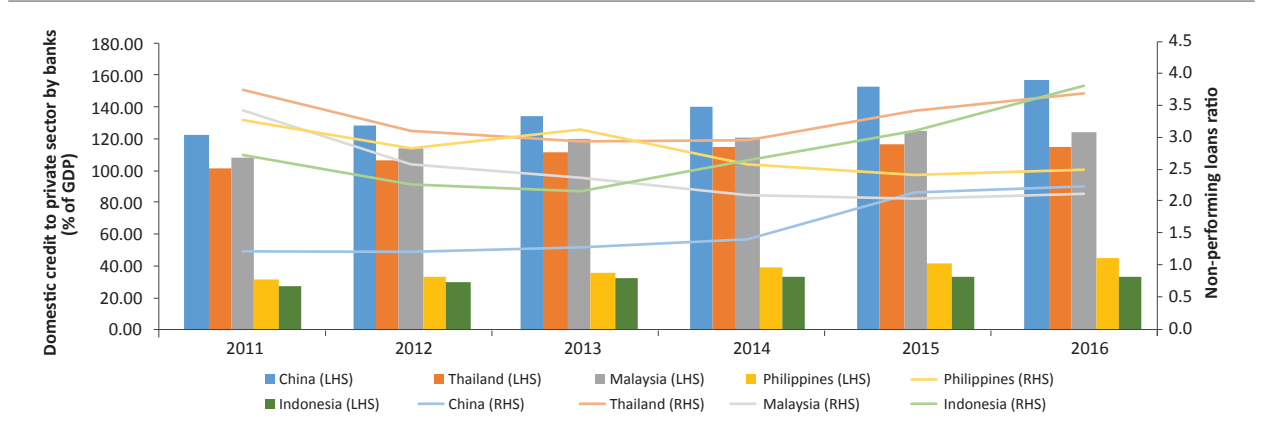
Source: BSP

Figure 19: The commercial loan portfolio is dominated by the real estate, utilities, transport and ICT sectors



Source: BSP

Figure 20: The credit-to-GDP remains low in the Philippines where the non-performing loans ratio is among the lowest in the region



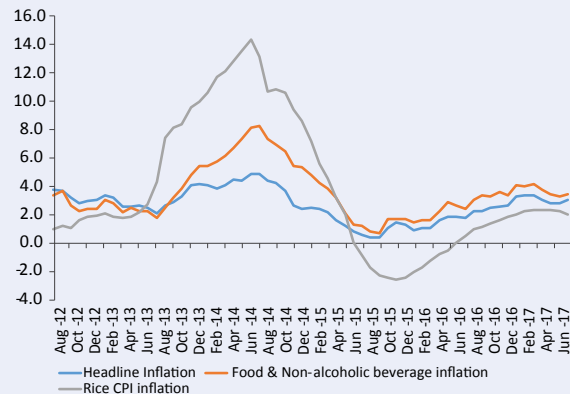
Source: World Development Indicators and <http://www.theglobaleconomy.com/compare-countries/> (Compilation of data from the World Bank, the United Nations, the International Monetary Fund, the U.S. Energy Information Administration, UNESCO, the World Economic Forum, etc.)

²⁸ The newly-appointed central bank governor took office in July. Having worked for the central bank for more than three decades, the governor is an advocate for structural reforms in the financial market, including tighter capital buffers, sound risk management, and the easing of foreign-exchange rules.

Box 7 Rice policies and food inflation

In the Philippines, fluctuations in the price of rice have a significant influence on food inflation (Figure 21). Rice is a staple food among Filipinos and covers about a quarter of the food in the Consumer Price Index (CPI) basket or 8.9 percent of the total CPI basket. As a result of the global rice crisis in 2008, Philippine rice prices rose by 35-40 percent in 2008-2009, and food inflation peaked at 17.3 percent in July 2008. Following the domestic rice shortage in 2013, the price of rice rose by 15-20 percent in 2013-2014, and food inflation peaked at 8.3 percent in August 2014. Historically, the negative impact of food inflation weighs more heavily on the poor. Poor households spend about 70 percent of their income on food, with 23 percent on rice, while families in the middle and upper classes spend only 30 percent of their income on food.²⁹

Figure 21: Rice inflation influences the level of food inflation



Source: PSA

Timely rice imports and responsive rice stock management are critical to smoothing rice prices.

Rice imports are largely controlled by the National Food Authority (NFA) which is mandated to maintain a 30-day stock during lean season and a 15-day stock at any given time.³⁰ However, restrictions on rice imports in recent years left the rice supply inadequate at times, and the mistiming of imports has caused a number of price hikes. For instance, domestic rice prices increased in 2014 because of importation lags, even as world rice prices fell.³¹ There have been improvements in rice stock management since 2015, in part through higher and timelier imports. Total imports reached 1.5 million tons in 2015 which supplemented local supply and managed to keep the rice price inflation at a low single digit.

The NFA's level of rice stocks has raised concerns over potential shortages and price hikes during the lean July-September season. The NFA is currently expediting its stock replenishment. In May, it shifted its import scheme from government-to-government procurement to government-to-private procurement³², allowing private foreign firms to participate in the bidding process, a move seen as more competitive and transparent. The bids for 250,000 metric tons of rice were awarded in July and will be delivered on a staggered basis from August to September. Meanwhile, the government has also approved private sector imports of 805,200 metric tons of rice in an auction that is expected to take place during the last quarter of 2017.

The Philippine government recently extended the quantitative restriction (QR) for rice imports for three more years until June 30, 2020. QRs on rice imports violate the agreement with the World Trade Organization that the government signed on January 1, 1995. However, as a transition rule, the World Trade Organization allowed the Philippines to impose a 10-year rice import QR system in 1995, which was extended four times in 2004, 2012, 2014, and 2017. The new administration's economic team actively promotes the lifting of rice import restrictions

²⁹ Lozada (2015).

³⁰ Private sector traders could apply for import permits and allowed to import rice, but they would be constrained by a collective limit of 805,000 metric tons per year and levied with 35 percent tariff rates.

³¹ World Bank (2015b).

³² This new scheme still allows foreign public sector entities to participate in the bidding process.

to attract more private sector participation. The Department of Agriculture, however, supports an extended grace period before the restrictions are removed to give farmers more time to adjust. The Philippines plans to offer trade concessions for several products for three more years in exchange for an extension of the QRs on rice imports.³³ Meanwhile, a bill has been filed in the Senate for the tariffication³⁴ of rice imports and the creation of a competitive enhancement fund that will benefit rice farmers.

In the long term, effective rice import and stock management needs to be complemented with improvements in agricultural productivity and logistics. Liberalizing rice imports and improving rice stock management are not the only tools for managing domestic rice prices. Only 6 to 7 percent of total global rice production is traded internationally.³⁵ As a result, the Philippines is likely to remain vulnerable to covariate shocks in regional exporting countries, such as Vietnam and Thailand. In the Philippines, the rice supply chain has high milling, drying, storage, and transportation costs, reflecting insufficient investments in roads and postharvest facilities as well as policy distortions. Increasing productivity and rice yields, including lowering the cost of transportation, would contribute to an improvement in the management of the country's rice prices. Key to improving agricultural productivity is addressing the binding constraints to Mindanao's agricultural sector, which contributes the largest share to the country's agricultural output. For a more detailed discussion, please refer to Part III: Unlocking Mindanao's Potential.

1.4 Fiscal Policy: Staying on an Expansionary Path

In the first half of 2017, the government's pursuit of an expansionary fiscal policy led to significantly higher levels of public expenditures while revenues fell short of their targets. As a result, the fiscal deficit increased to 2.1 percent of GDP.

15. A second consecutive year of expansionary fiscal policy led to a further increase in the fiscal deficit in the first half of 2017 (Figure 22 and Figure 23). The fiscal deficit increased in nominal terms by 28.4 percent, year-on-year, in the first six months of 2017, widening the fiscal gap from 1.7 percent of GDP in the first half of 2016 to 2.1 percent of GDP in the first half of 2017. However, the fiscal deficit in 2017 was smaller than the deficit of 3.1 percent of GDP recorded in the second half of 2016 when expenditures grew while revenues fell primarily due to seasonal factors. In order to finance the deficit, the government continued to rely on mainly domestic sources of financing. In the first half of the year, net domestic financing, which accounted for

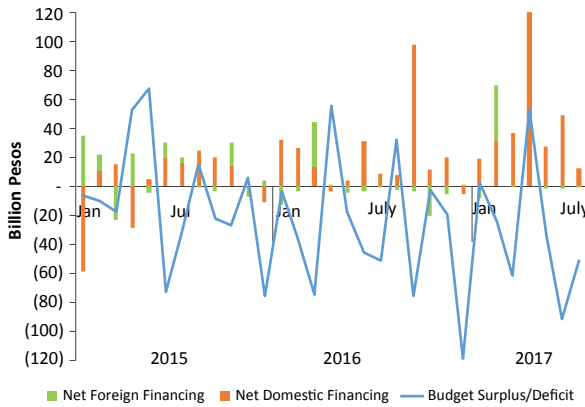
92.9 percent of total financing, expanded to Php365.7 billion, more than triple the amount of domestic financing registered in the first half of 2016. Moreover, net external financing nearly quadrupled from Php7.2 billion in the first half of 2016 to Php28.2 billion in the first half of 2017. This was a sharp reversal from the contraction of Php31.3 billion in foreign financing during the second half of 2016. Despite an increase in borrowing, the overall debt-to-GDP ratio did not worsen. It registered 42.5 percent of GDP in the first half of 2017, slightly down from 42.9 percent in the same period a year ago, as nominal GDP growth outpaced the growth in the government debt stock.

³³ The list of products for trade concessions has not yet been determined.

³⁴ Tariffication refers to the replacement of non-tariff barriers to trade, such as import quotas, with their estimated tariff equivalent.

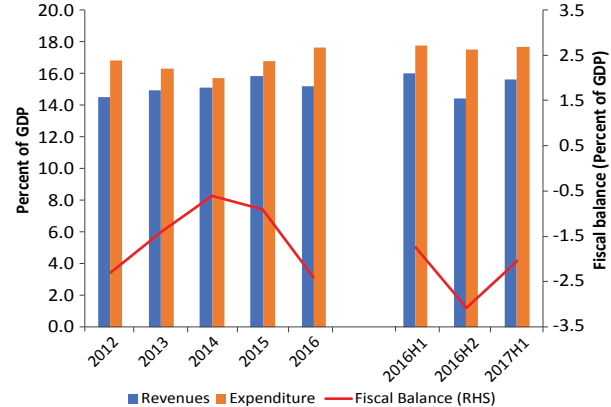
³⁵ World Bank (2017a).

Figure 22: The government's budget deficit reached 2.1 percent of GDP on the back of expansionary fiscal policy...



Source: Bureau of the Treasury (BTr)

Figure 23: ...as no new tax policy measures were introduced



Source: Bureau of the Treasury (BTr)

16. After a slow start to the year, the government has made significant progress in executing its programmed budget in recent months (Table 2). Actual government expenditures amounted to 99.6 percent of programmed spending in the first half of 2017. This constituted a significant increase compared to previous years when the government failed to execute its budget in a timely manner, leading to significant underspending. Government expenditures increased by 9.0 percent, year-on-year, in nominal terms in the first half of 2017 to reach 17.7 percent of GDP, which was the same level registered in the first half of 2016.³⁶ This was slightly higher compared to the second half of 2016 when expenditures reached 17.5 percent of GDP. Major expenditure items in both capital outlays and recurrent expenditures, such as personal services and subsidies to government corporations,³⁷ drove the increase in government spending in the first half of 2017. Spending on personal services grew nearly three times, from 4.4 percent, year-on-year, in the first half of

2016 to 13.1 percent, year-on-year, in the first half of 2017, propelled by an increase in salaries of government employees and uniformed personnel as well as hiring in key agencies, such as the Department of Education and the Department of Health.³⁸

17. Despite the government's infrastructure push, growth in capital outlays moderated in the first half of 2017. It slowed from 47.2 percent, year-on-year, in the first half of 2016 to 31.8 percent, year-on-year, in the second half of 2016 and 12.3 percent, year-on-year, in the first half of 2017. A similar moderation can be seen in infrastructure and other capital outlays, which grew by 8.8 percent, year-on-year, in the first half of 2017 compared to 52.4 and 35.5 percent, year-on-year, in the first and second half of 2016, respectively. Meanwhile, growth of capital transfers to local government units accelerated from 15.6 percent, year-on-year, in the first half of 2016 to 37.1 percent, year-on-year, in the first six months of 2017.³⁹

³⁶ The national government recorded total spending of 17.5 percent of GDP in the second half of 2016.

³⁷ Subsidies to government corporations, although relatively small compared to other expenditure items, increased by nearly 60 percent to fund the various programs of the NFA, the National Irrigation Administration, the Philippine Health Insurance Corporation, and the National Housing Authority.

³⁸ The increase in salaries of government employees was a part of the second tranche under the implementation of the adjustment of the compensation structure of government personnel under Executive Order No. 201 s. 2016. Meanwhile, the adjustment of combat pay and incentives for uniformed and military personnel is pursuant to Executive Order No. 3 s. 2016.

³⁹ The expansion in infrastructure and capital outlays was used to fund road construction, repair, and rehabilitation, and flood control projects under the Department of Public Works and Highways, as well as the purchase of big-ticket expenditure items under the modernization program of the Philippine military. Allotments and capital transfer to local government units were used to repair, rehabilitate, and improve local roads under the conditional matching grant of the Local Government Support Fund. Source: http://www.dbm.gov.ph/wp-content/uploads/DBCC/2017/Highlights%20of%20NG%20Disbursements_as%20of%20June%202017_for%20posting.pdf

Table 2: Actual and programmed expenditure of the Philippine government (H1 2015 – H1 2017)

	Level						Growth			
	H1 2015		H1 2016		H1 2017		H1 2016		H1 2017	
	Program	Actual	Program	Actual	Program	Actual	Program	Actual	Program	Actual
Current operating expenditures	997	869	1,049	923	1,013	1,001	5.2	6.1	-3.4	8.6
Personnel Services	384	325	396	339	402	383	3.2	4.4	1.4	13.1
Maintenance and other operating expenditures	210	179	237	217	216	208	12.9	20.8	-8.8	-3.9
Subsidy	65	44	39	37	27	58	-40.2	-16.8	-30.8	59.3
Allotment to Local Government Units	156	156	171	171	196	196	9.8	9.9	14.7	14.2
Interest Payments	172	156	194	154	164	159	13.3	-1.5	-15.9	3.1
Tax Expenditures	11	9	12	5	9	5	1.8	-41.8	-21.7	-11.3
Capital Outlays	246	200	329	295	311	331	33.4	47.2	-5.3	12.3
Infrastructure & other capital outlay	189	150	261	229	237	249	38.3	52.4	-9.3	8.8
Equity	2	0	10	9	2	3	431.6	2,733.3	-77.2	-62.4
Capital transfer to local government units	56	50	58	57	72	78	3.2	15.6	25.2	37.1
Net Lending	9	3	9	4	13	-1	-1.1	57.7	45.3	-131.7
Total	1,252	1,072	1,386	1,221	1,337	1,331	10.7	13.9	-3.5	9.0

18. Even though the government missed its revenue target, public revenue grew at a healthy rate in the first half of 2017. Revenue growth accelerated in nominal terms under the new administration, from 1.4 percent, year-on-year, in the first half of 2016 to 7.0 and 6.8 percent, year-on-year, in the second half of 2016 and the first six months of 2017, respectively (Table 3). However, revenue declined from 16.0 percent of GDP in the first half of 2016 to 15.6 percent of GDP in the first half of 2017, as non-tax revenue declined for the second consecutive year and GDP grew faster than revenues. In the first half of 2017, non-tax revenue declined in nominal terms by 9.0 percent to 1.4 percent of GDP, down from 1.7 percent of GDP in the first six months of 2016, as total income from the Bureau of Treasury fell by 17.2 percent, year-on-year. Moreover, tax revenue grew at a slower pace in nominal terms, from 10.1 percent, year-on-year, in the first half of 2016 to 8.8 percent, year-on-year, in the first six months of 2017, as no new tax policies

were enacted and the country's main revenue-generating agencies failed to meet their collection targets. The Bureau of Internal Revenue, which is responsible for around 80 percent of tax revenue, fell short of the government's target by 4.0 percent, and the Bureau of Customs, which is responsible for around 20 percent of tax revenue, missed its target by 3.0 percent. As a result, the country managed to collect 14.2 percent of GDP in the first six months of 2017, compared to 14.3 percent of GDP in the first half of 2016.

19. On May 31, 2017, the first package of the government's tax reform program successfully passed in the House of Representatives on its third and final reading. The current version of the bill estimates the revenue intake at Php119.4 billion (0.7 percent of GDP), compared Php157.2 billion (0.9 percent of GDP) in an earlier version of the bill. On September 21, 2017, the Senate of the Philippines filed its own version, SB No. 1592. Deliberations on SB 1592 are ongoing as of

⁴⁰ The BTr cites the decline of PHP9.2 billion in dividend collections from government-owned and controlled corporations in the first half of 2017 and reduced income generated from national government deposits as reasons for the decline in its income. Source: http://www.treasury.gov.ph/wp-content/uploads/2017/07/COR-Press-Release-June-2017-final_ed.pdf

⁴¹ Source: <http://www.philstar.com/business/2017/09/24/1741939/anti-corruption-tax-reform-measures-top-ledac-talks>

⁴² Source: <https://www.rappler.com/business/182876-tax-reform-bill-philippines-explainer-graphs>

Table 3: Philippine government fiscal position (H1 2016 – H1 2017)

	In billions PHP			Growth (percent)			Percent to GDP		
	H1 2016	H2 2016	H1 2017	H1 2016	H2 2016	H1 2017	H1 2016	H2 2016	H1 2017
Revenues	1,101	1,095	1,176	1.4	7.0	6.8	16.0	14.4	15.6
Tax Revenue	983	997	1,069	10.1	8.1	8.8	14.3	13.1	14.2
Non-tax Revenue	118	98	107	-38.8	-3.2	-9.0	1.7	1.3	1.4
Expenditures	1,221	1,328	1,331	13.9	14.6	9.0	17.7	17.5	17.7
Current operating expenditures	923	1,006	1,001	6.1	9.9	8.6	13.4	13.3	13.3
Personal Services	339	384	383	4.4	13.1	13.1	4.9	5.1	5.1
Maintenance and other operating expenditures	217	223	208	20.8	-0.7	-3.9	3.1	2.9	2.8
Subsidy	37	67	58	-16.8	95.9	59.3	0.5	0.9	0.8
Allotment to Local Government Units	171	172	196	9.9	10.0	14.2	2.5	2.3	2.6
Interest Payments	154	151	159	-1.5	-1.6	3.1	2.2	2.0	2.1
Tax Expenditures	5	10	5	-41.8	19.5	-11.3	0.1	0.1	0.1
Capital Outlays	295	311	331	47.2	31.8	12.3	4.3	4.1	4.4
Infrastructure & other capital outlay	229	264	249	52.4	35.5	8.8	3.3	3.5	3.3
Equity	9	3	3	2,733.3	700.0	-62.4	0.1	0.0	0.0
Capital transfer to local government units	57	44	78	15.6	7.9	37.1	0.8	0.6	1.0
Net Lending	4	17	-1	57.7	144.3	-131.7	0.1	0.2	0.0
Budget surplus/deficit	-120	-233	-154	-975.3	72.1	28.4	-1.7	-3.1	-2.1

the first week of October. Preliminary estimates by the Department of Finance reveal that SB 1592 would lower the revenue of an additional Php59.9 billion (around 0.3 percent of GDP), as the Senate version lowered the threshold for personal income tax exemption, reduced the value added tax exemptions by 36 lines compared to 70 in the DOF version of the bill, and restructured excise taxes on fuel, automobiles, and sugar-sweetened beverages. The Senate is proposing to pass Senate Bill 1592 on its third and final reading before the regular session ends in October. Differences between the versions in the Senate and the House of Representatives will then be settled in a bicameral conference, which the government hopes will conclude in November.

20. The government has submitted its proposed 2018 national budget of Php3.77 trillion to Congress, with expenditure priorities

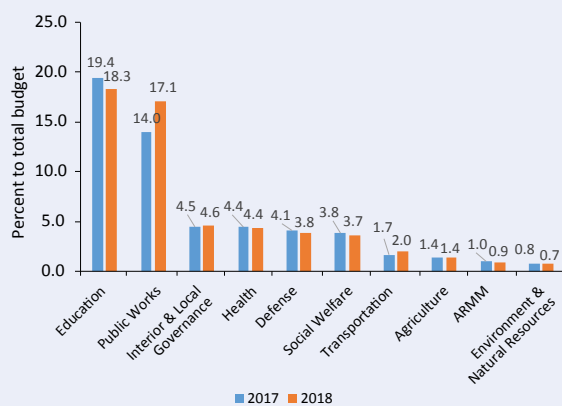
broadly in line with the 2017 budget. The president submitted the proposed 2018 national budget after the president's second State of the Nation Address on July 24, 2017. The budget is equivalent to 21.6 percent of GDP and is 12.4 percent larger than the 2017 budget of Php3.35 trillion. It focuses on the government's priorities of increasing investment in human capital and infrastructure (Box 8). The House of Representatives passed the proposed budget, House Bill No. 6215 or the General Appropriations Bill, on its third and final reading on September 26, 2017. The General Appropriations Bill was then forwarded to the Senate of the Philippines, where parallel deliberations are ongoing for its own version of the budget. Once the Senate of the Philippines passes its own version, differences between the lower house and upper house version will be settled through a bicameral conference.

Box 8 The proposed 2018 national budget

The 2018 national budget builds on the new administration’s development agenda as embodied in the 0-10 Point Socioeconomic Agenda, the Philippine Development Plan 2017-2022, and the Ambisyon Natin 2040. The proposed 2018 national budget of PhP3.77 trillion represents a 12.4 percent increase over the previous year’s PhP3.35 trillion budget and aims to reduce poverty and boost shared prosperity. Funding to social services, which would receive the largest share of the budget, is set to increase by 7.3 percent, year-on-year, to PhP1.45 trillion, as the government continues to prioritize the development of the country’s human resources through increased investments in education, health, and service delivery. Meanwhile, the proposed budget for the economic services sector is planned to expand by 25.0 percent to reach PhP1.2 trillion, anchored on the country’s continued push for strategic infrastructure development.

The proposed 2018 national budget prioritizes investment in both human and physical capital, maintaining the government’s key policy priorities from the previous year’s national budget (Figure 24). With a proposed allocation of PhP691.1 billion, funding to the education sector would increase by 6.4 percent compared to 2017, which would ensure that the sector remains the largest component of the national budget (18.3 percent of the total budget). Meanwhile, the government is planning to raise the budget for infrastructure by 27.8 percent, year-on-year, from PhP858.1 billion (5.3 percent of GDP) to PhP1.1 trillion (6.3 percent of GDP), with a focus on improving logistics connectivity by upgrading the country’s road, air, and sea transport networks. The significant rise in the proposed infrastructure budget is a part of the government’s *Build, Build, Build* program, where the government plans to invest approximately PhP8.1 trillion in strategic infrastructure development from 2017 to 2022.

Figure 24: The top recipients of the national budget (2017 & proposed 2018)



Source: Department of Budget and Management

Despite the expansionary nature of the new budget, the government remains committed to maintaining fiscal discipline. The recent transformation from a fiscal program under constant threat to one that is resilient underpins the country’s robust economic growth performance. Cognizant of the importance of prudent fiscal policy, the government has maintained a deficit target for the next five years but raised it from 2.7 percent of GDP in 2017 to 3.0 percent of GDP in 2018. Central to the government’s efforts to maintain fiscal discipline is its objective to improve the country’s tax policy and tax administration.⁴⁴ The government expects the implementation of the first package of tax reforms to begin in 2018, which is expected to boost tax revenue by PhP133.8 billion in its first year of implementation, increasing the government’s projected revenue effort from an estimated 15.2 percent of GDP in 2017 to 16.3 percent of GDP in 2018.

Source: Department of Budget and Management

⁴³ The education sector includes the Department of Education, the Commission on Higher Education, and state universities and colleges.

⁴⁴ A more detailed discussion on the government’s proposed tax reform program was discussed in the April 2017 and October 2016 editions of the *Philippines Economic Update*.

1.5 Employment and Poverty: Progress but with New Challenges

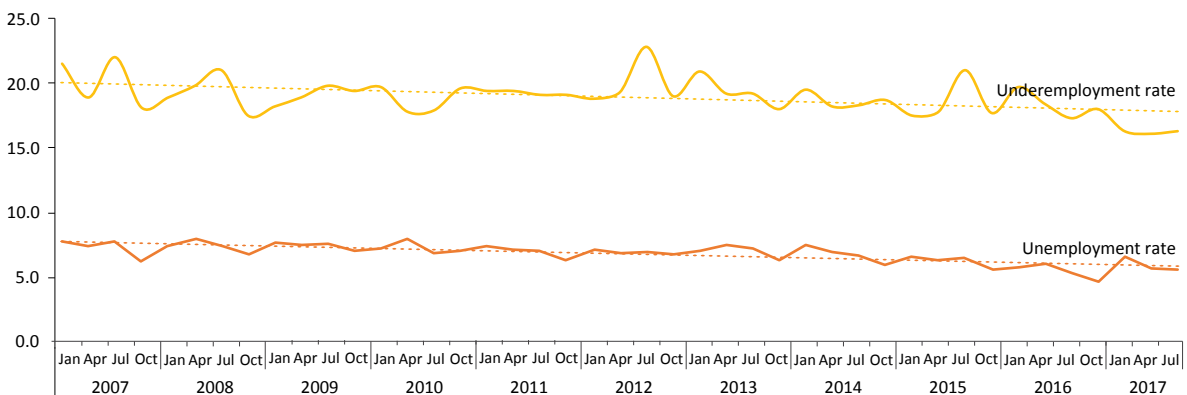
Unemployment levels increased in the first half of 2017, as many temporary jobs created during last year's election-related stimulus disappeared. Longer-term growth in wage jobs, particularly for households in the bottom 40 percent, and the shift of employment out of agriculture continue to drive the observed decline in poverty.

21. The country's employment rate is close to historic low levels, although it decreased slightly in the first half of 2017. The employment rate stood at 94.4 percent in July 2017, compared to 94.6 percent in July 2016. The employment rate peaked at 95.3 percent at end-2016 after a rapid but temporary creation of jobs occurred during the election year. The unemployment rate of 5.6 percent in July 2017 is an indication that the economy is close to full employment. While this is slightly higher than the historic low unemployment rate of 4.7 percent reached in 2016, it remains 1.3 percentage points below the average in 2007-2017 (Figure 25). Changes in unemployment were similar across regions. The unemployment rate in Metro Manila increased from 6.4 percent in 2016 to 7.9 percent in July 2017, marking an increase for the first time since 2013. Even though other regions also experienced an increase in the unemployment rate, there was still a declining trend over the past decade. Unemployment remains higher among men than women at 5.7 and 5.4 percent, respectively. Youth unemployment increased from 13.5 percent in

2016 to 15.3 percent in July 2017, but it has been gradually declining in the past decade. However, the underemployment rate⁴⁵ retreated from 17.3 percent in 2016 to a 10-year low of 16.1 percent in early 2017, before settling at 16.3 percent in July. Since the underemployed are more likely to work in the informal sector, the underemployment rate is an indicator that there is still a large prevalence of informal jobs in the Philippines.

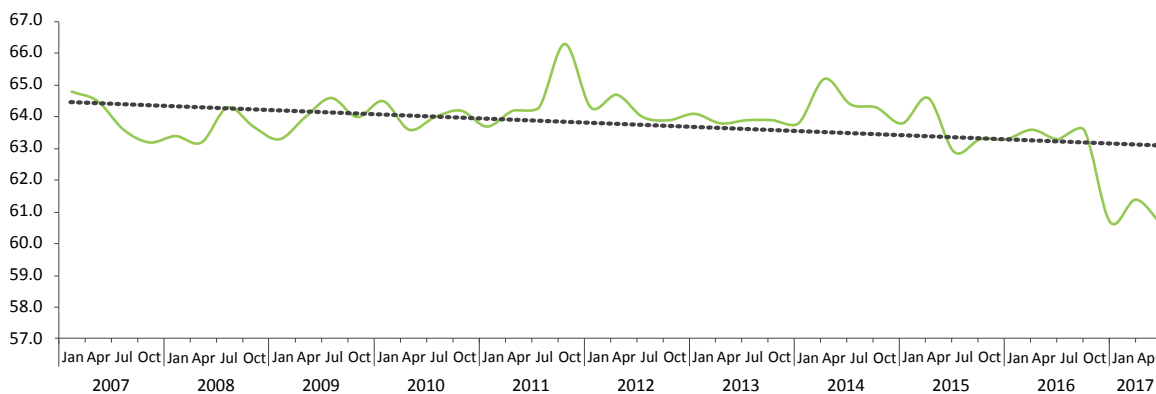
22. In the first half of 2017, the labor participation rate dropped and the number of new jobs created was lower compared to 2016. The labor force participation rate continued its downward trend and decreased from 63.3 percent in 2016 to 60.6 percent in July 2017 (Figure 26), the lowest rate observed in the past decade. The decline was slightly larger for women, falling from 49.0 percent in 2016 to 45.6 percent in July 2017, and women constitute 69.1 percent of the non-working labor force. The drop in the labor force participation rate reflects in part a slower pace in net job creation compared to a year ago. There were 1.9 million net jobs

Figure 25: Underemployment reached a 10-year low in April 2017



Source: Labor Force Survey, PSA

⁴⁵ The underemployed is defined by the Philippine Statistics Authority as employed persons who express the desire to have additional hours of work in their present job or an additional job, or have a new job with longer working hours.

Figure 26: The labor force participation rate declined in early 2017

Source: Labor Force Survey, PSA

created in the first half of 2016, compared to a net loss of 0.6 million jobs in the first half of 2017. The agriculture⁴⁶ and services⁴⁷ sectors lost 0.5 and 0.3 million jobs, respectively. In contrast, the industry sector generated 0.2 million jobs in the first half of 2017, 185,000 of which came from the construction industry. Manufacturing and construction have been driving employment growth in the industry, and the latter grew at an annual rate of 11.1 percent over the past decade.

23. Philippines' youth accounted for most of the drop in the country's labor force participation rate. The labor force participation rate among 15 to 24 year olds dropped from 42.1 percent in 2016 to 38.8 percent in July 2017. This is equivalent to a 0.7 million decline in the labor force. This may be attributed to the implementation of the K-12 program which commenced during the 2016-2017 school year. Based on enrollment records by the Department of Education, 1.5 million

students were admitted to grade 11 in June 2016, of which 1.45 million had finished grade 10.⁴⁸ Prior to the implementation of the senior high school program, a proportion of these students would have joined the labor market. There were also about 54,000 returning students who took advantage of the additional two years of free basic education.⁴⁹

24. Household incomes in the Philippines have increased over time as more people have transitioned into wage employment (Box 9). However, adjusting for inflation, wages have been largely flat over time, translating into only modest gains for those already in wage employment. Median wages grew by an annual rate of only 1.1 percent between 2007 and 2017, before picking up slightly to 1.6 percent in the first quarter of 2017. Until recently, public sector wages grew more rapidly than their private sector counterparts (Figure 27).⁵⁰

⁴⁶ Employment in agriculture has been steadily declining. Its share in total employment fell to 25.2 percent in July 2017, a drop of 9.3 percentage points from a decade ago.

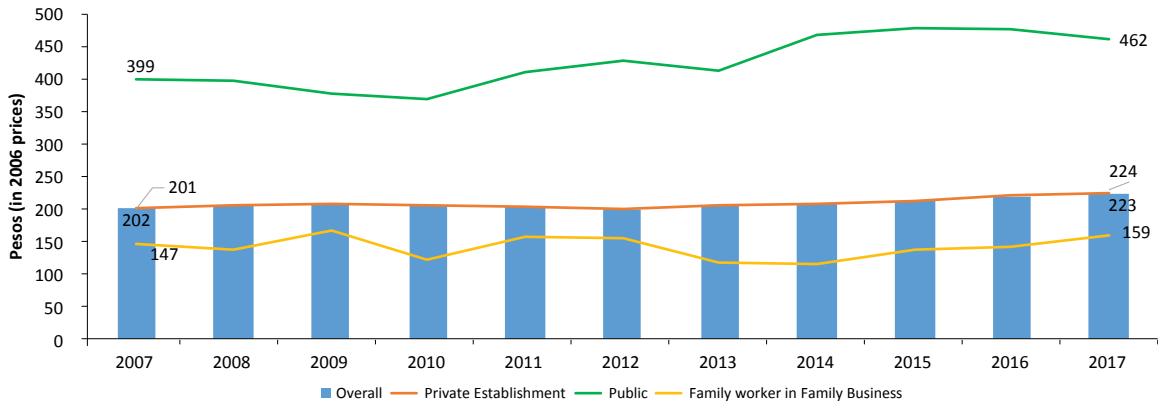
⁴⁷ The recent push for the Security of Tenure Bill (one of the priority bills endorsed by the Legislative-Executive Development Advisory Council) may have started to affect the hiring decisions of firms particularly in the services sector.

⁴⁸ This is equivalent to a high school graduate in the old curriculum. The Department of Education reported a 98 percent progression rate from grade 10 to grade 11.

⁴⁹ The boost in senior high school enrollment may have resulted from the senior high school voucher program, where almost half (about 0.7 million people) of grade 11 student beneficiaries enjoyed free tuitions in private high schools. This was an interim solution to the shortage of public schools.

⁵⁰ Two laws on the public sector salary standardization were implemented in the last 10 years. The first was Joint Resolution No. 4 by the Fourteenth Congress that authorized former President Gloria Macapagal-Arroyo to modify the compensation package for government, military, and uniformed personnel. The revised compensation took effect a year after it was signed in July 2008 for employees in national government offices and after eighteen months for employees in local government. The salary increase was implemented in equal tranches over four years. Another round of salary standardization through Executive Order No. 201 took effect in July 2016. This legislation ensured comparability of wages in government particularly management level positions with prevailing rates in the private sector. This new adjustment in wages will take effect in stages through 2019. Another important wage legislation is the Domestic Workers Act or Kasambahay Law, which regulates wages given to household employees and enforces the provision of social and other benefits. Wages of those working in private households have grown on average by 4.2 percent annually since the law was passed in January 2013.

Figure 27: Changes in real daily wages from 2007-2017



Source: Labor Force Survey, PSA

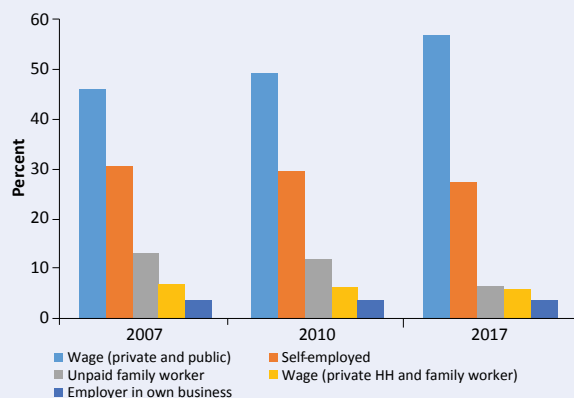
Between 2007 and 2017, median wages in the public sector grew by 1.6 percent, year-on-year, and there were significant increases in public sector wages between 2010 and 2015. However, wages in the public sector declined by 3 percent, year-on-year, in the first half of 2017. Private sector wages were mostly flat between 2007 and 2014, before starting to move upwards in the beginning of 2015. In the first half of 2017, wages in the private sector increased by 4.0 percent, year-on-year.

25. Higher wage income, particularly for households in the bottom 40 percent, constituted the main driver of recent poverty alleviation. The national poverty rate dropped from 25.2 percent in 2012 to 21.6 percent in 2015. Transfers from the government’s social programs, which increased from 0.1 percent in 2006 to 3.8 percent in 2015, have contributed to the faster pace of poverty reduction recent years.

Box 9 Increasing wage employment and household wage incomes

Wage employment is becoming more common in the Philippines, accounting for more than half of the country’s total workforce. In the first half of 2017, 57.1 percent of both public and private sector workers held wage jobs, up from 56.7 percent in the first half of 2016 (Figure 28). Public sector jobs constituted only 7.8 percent of wage jobs, and this share remained roughly constant in the past decade. As a result, the growing share of wage jobs is due to employment growth in the private sector. While the number of wage jobs has increased in the agricultural and services sectors, the industrial sector has seen the most rapid growth in wage employment. Industrial wage jobs grew by 63 percent between 2007 and 2017, from the 4.1 million wage jobs in 2007 to 6.7 million jobs in April 2017. There has also been a decline in the share of unpaid family workers to 6.7 percent of the total employed in April 2017. Moreover, the share of workers who are self-employed declined from 30.5 percent in April 2007 to 27.2 percent in April 2017.

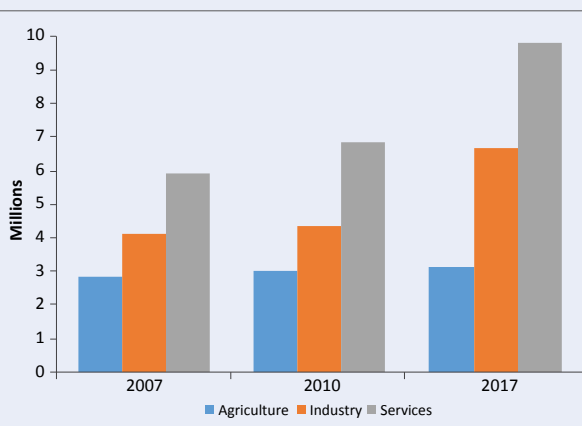
Figure 28: Distribution of type of worker



Source: Labor Force Survey April rounds, PSA

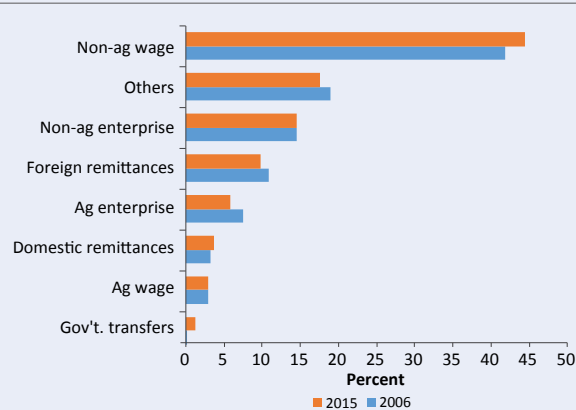
The share of wages in household income increased from 44.8 percent in 2006 to 47.4 percent in 2015 (Figure 29).⁵¹ The share of non-agricultural wages constituted the biggest change and increased from 41.9 percent in 2006 to 44.4 percent in 2015. The shift to non-agricultural wage income was particularly noticeable among households in the bottom 40 percent of the population. 27.5 percent of the income in these households came from non-agricultural wages in 2015, up from 21.3 percent in 2006 (Figure 30). This shift away from agricultural income has made domestic remittances more important for households in the bottom 40 percent, which constituted 8.5 percent of their income in 2015, up from 6.7 percent in 2006 (Figure 31).⁵²

Figure 29: Wage earners in private establishments by sector



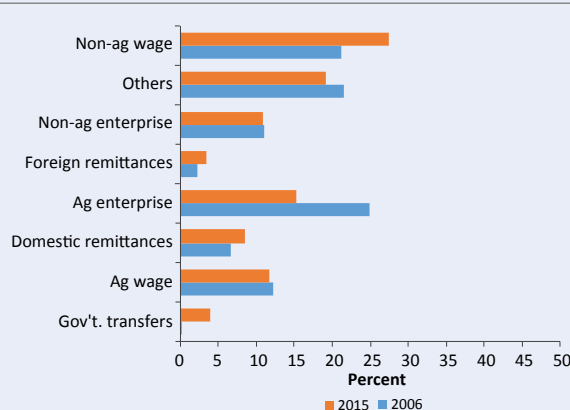
Source: Labor Force Survey April rounds, PSA

Figure 30: Household income sources of all households



Source: 2006 and 2015 Family Income and Expenditure Survey
 Note: Others include rental value of owner-occupied dwelling, pensions, other agriculture related sources

Figure 31: Household income sources of the bottom 40 percent



Source: 2006 and 2015 Family Income and Expenditure Survey
 Note: Others include rental value of owner-occupied dwelling, pensions, other agriculture related sources

⁵¹ 2015 Family Income and Expenditure Survey.

⁵² The share of income coming from agriculture enterprises for the bottom 40 percent fell sharply, from 25 percent in 2006 to 15.2 percent in 2015.

PART II:

OUTLOOK AND RISKS

The Philippine economy is projected to expand by 6.6 percent, year-on-year, in 2017, before growing by 6.7 percent, year-on-year, in 2018 and 2019. Investment growth has been moderating partly because of a slower than envisioned implementation of the government's infrastructure program, softening the growth prospects for 2017. However, the medium-term growth outlook remains positive, as stronger expected growth in the Philippines' main trading partners would lead to higher external demand. Imports are expected to remain elevated due to a high demand of intermediate and capital goods. As the public infrastructure program gains traction, capital outlays and construction activities are expected to rise. Consumption growth is expected to remain firm, contingent on sustained remittances and expanding credit to households. The local elections in 2019 will likely boost domestic activities as early as the second half of 2018. The rate of Filipinos living on less than US\$3.20-a-day is projected to decline to 22.9 percent in 2018. The pace of poverty reduction may drop slightly in the face of lower overall economic growth, but the poverty rate is expected to continue to fall as the economy continues its structural transformation. Short-term risks to the country outlook include increased trade protectionism, the possibility of financial market disruptions, and elevated economic policy uncertainty. Weaker potential growth remains the main long-term risk to the Philippines. An expansionary fiscal policy could help support growth in the short term as long as it is consistent with medium-term fiscal sustainability.



2.1 Growth Outlook

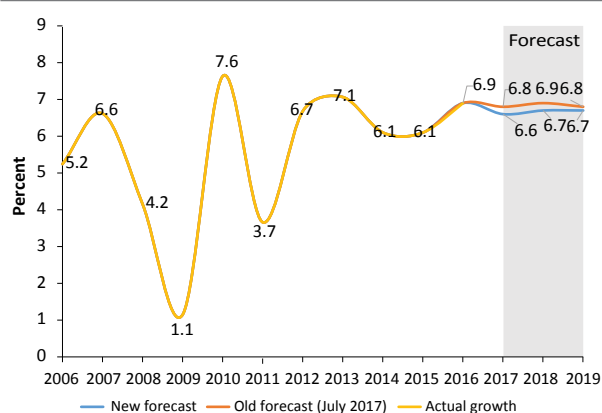
The economy is projected to grow at a slower pace in 2017 compared to 2016. Fiscal and monetary policies are likely to remain accommodative to growing the economy, and recovering exports and strong consumption growth are expected to boost economic growth. Higher investment growth could push the country's growth rate towards the upper end of the government's target of 6.5 to 7.5 percent of GDP, but this is contingent on whether or not the public infrastructure program gains full traction.

26. The Philippines' medium-term growth trajectory remains positive, but the growth rate for 2017 is likely to end up at the lower end of the government's target of 6.5-7.5 percent of GDP. The economy is projected to expand by 6.6 percent, year-on-year, in 2017 and 6.7 percent, year-on-year, in 2018 and 2019 (Figure 32). This projection reflects a downward revision from the 2017 and 2018 forecasts of 6.8 and 6.9 percent, respectively, in the July 2017 edition of the Philippines Monthly Economic Development. However, the growth outlook remains positive and exports are projected to grow at a robust rate as stronger growth is expected in the Philippines' main trading partners. Imports are expected to remain elevated due to high demand for intermediate and capital goods. Moreover, a steady consumption growth is projected to provide the main base for economic growth, sustained by an increase in remittances, an expansion of credit, and improved income levels. Higher capital outlays and construction activities

are expected to boost investment growth as the government speeds up the implementation of its infrastructure program. The local elections in 2019 will likely lead to increased domestic activities as early as the second half of 2018.

27. The growth in global trade is expected to rebound from a post crisis low of 2.5 percent in 2016 to 4.0 percent in 2017 despite rising trade policy uncertainty (Box 10). The recovery in global trade, which began in the second half of 2016, has been supported by stronger industrial activity. Since the slowdown in the growth of global investments was an important factor behind the deceleration of global goods trade, the increase in international investment flows may improve global trade in 2017.⁵³ Chinese exports have benefited from the recovery, resulting in increased demand for intermediate products across regional and global value chains, including the Philippines. Moreover, the trade in services, both globally and in the Philippines, demonstrated resilience throughout 2016, supported by robust global consumer spending, particularly in major advanced economies. The ongoing recovery in the goods trade may also boost services exports, which could benefit the Philippines as they are less volatile and procyclical than goods exports.⁵⁴

Figure 32: The growth trajectory is positive but lower than expected



Source: PSA, World Bank staff estimates

28. An improvement in the external environment is expected to benefit the Philippine economy. This constitutes one driving assumption behind the World Bank's projection. Global economic activity is projected to accelerate in 2017 and 2018 and firm in the medium term. The Philippines' main trading partners among advanced economies demonstrated solid

⁵³ Freund 2016; Boz et al. 2015; Bussiere et al. 2013; World Bank 2015a.

⁵⁴ Borchert and Mattoo 2009; Ariu 2016; World Bank 2016b.

economic performance in the beginning of 2017, resulting in increased demand for Philippine exports. Economic growth is expected to pick up in the United States and Japan and remain

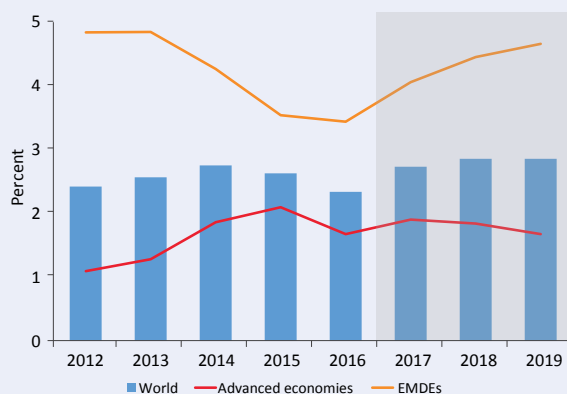
broadly stable in the Euro Area. Economic forecasts for several major economies have also been upgraded.⁵⁵

Box 10 The global economic outlook

Despite substantial policy uncertainty, global growth is projected to accelerate in 2017-2019. The rate of global economic growth is projected to increase from a post-crisis low of 2.4 percent, year-on-year, in 2016 to 2.7 and 2.9 percent, year-on-year, in 2017 and 2018-19, respectively (Table 4). The short-term outlook for advanced economies has generally improved due to firming business and investment activities despite elevated policy uncertainty in the United States and the Euro Area. In 2017, advanced economies are projected to grow by 1.9 percent, year-on-year, before moderating to 1.8 and 1.7 percent, year-on-year, in 2018 and 2019, respectively. In emerging-market and developing economies, annual growth is predicted to reach an average of 4.1 percent in 2017 and 4.6 percent in 2018-19 (Figure 33). Obstacles to growth for commodity exporters have diminished while activity in commodity importers continue to be robust.

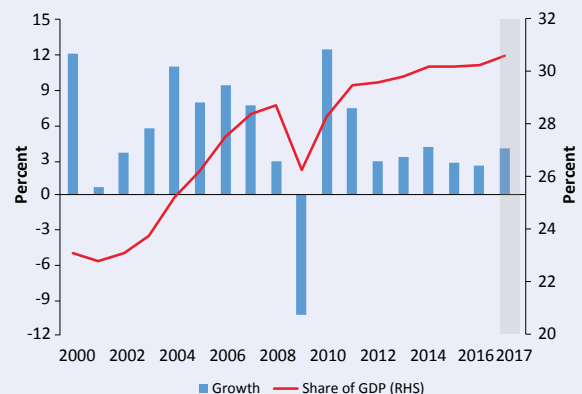
Global trade growth is expected to rebound in 2017. It is expected to rebound from 2.5 percent, year-on-year, in 2016 to 4.0 percent, year-on-year, in 2017, its fastest pace since 2010 (Figure 34). This growth is aligned with the global recovery in manufacturing activity and coincided with the bottoming out of global investments. It is supported by stronger import demand from major advanced economies, increased trade flows to and from China, and a diminished drag from weak import demand from commodity-exporting emerging-market and developing economies. Policy-induced infrastructure spending, specifically in China, will continue to support demand for industrial commodities, benefiting countries that export raw materials. The services trade will remain resilient and play a stabilizing role since it is less volatile and pro-cyclical than the goods trade. Nevertheless, trade growth will continue to be held back by structural impediments, such as maturing global value chains and a slower pace of trade liberalization.

Figure 33: Global growth is expected to strengthen in 2017-2019



Source: GEP June 2017

Figure 34: Global trade is expected to rebound in 2017



Source: GEP June 2017

⁵⁵ Collectively, advanced economies in the Euro Area are expected to grow by 1.7 percent in 2017, while Japan is projected to grow by 1.5 percent in 2017, 0.2 and 0.6 percentage points higher than their respective forecasts from the January round of the 2017 Global Economic Prospects.

There are downside risks to the global economic outlook. Risks such as trade protectionism and potential financial market disruptions dominate the outlook despite the possibility of more expansionary fiscal policies in advanced economies. A number of factors weigh on the long-term growth prospects of emerging-market and developing economies, including structural headwinds to global trade, worsening demographics, slowing productivity growth, and governance and institutional challenges. Moreover, even if the expected modest rebound in investment across emerging-market and developing economies materializes, slowing capital accumulation in recent years may already have reduced potential growth.

Over the long term, structural policies that support investment and trade are critical to boost productivity and potential growth. Emerging-market and developing economies will need to continue to pursue structural reforms to improve their long-term growth prospects, diversify their economies, and develop domestic as well as foreign markets. These include policies to improve the business climate, support investment in human and physical capital, and enhance regional and global trade integration. Central banks in advanced economies will gradually normalize monetary policy as inflation increases and economic slack diminishes. While the U.S. tightening cycle is well ahead of other major advanced economies, it is proceeding at a substantially slower pace than in the past.

Table 4: Real GDP growth rates, recent and projected

	2014	2015	2016e	2017p	2018p	2019p
World	2.8	2.7	2.4	2.7	2.9	2.9
Advanced economies	1.9	2.1	1.7	1.9	1.8	1.7
Emerging market and developing economies	4.3	3.6	3.5	4.1	4.5	4.7
Developing East Asia & Pacific	4.3	3.6	3.5	4.1	4.5	4.7
Philippines	6.1	6.1	6.9	6.6	6.7	6.7

Source: World Bank (2017b)

Note: Developing East Asia & Pacific includes Cambodia, China, Fiji, Indonesia, Lao PDR, Malaysia, Mongolia, Myanmar, Papua New Guinea, Philippines, Solomon Islands, Thailand, Timor-Leste, and Vietnam.

29. The fiscal policy assumption of the World Bank's projection is a continued expansionary path. However, purposeful budget execution will require addressing important implementation limitations. The delivery of large new infrastructure projects had been slow in the recent past. The government plans to primarily finance the development and implementation of infrastructure initiatives while contracting out operations and maintenance activities to the private sector. The implementation of the public infrastructure plan is expected to intensify over the next five years. To accomplish this, the government has proposed to increase the national budget in 2018 by 12.4 percent, year-on-year, to Php3.8 trillion, up from Php3.4 trillion in 2017 (Box 8). The proposed infrastructure budget is programmed to increase by 27.9 percent, year-on-year, to reach Php1.1 trillion or an

estimated 6.3 percent of GDP in 2018. Moreover, infrastructure spending for the next four years is set to increase by an average of 14.8 percent, year-on-year, to reach Php1.9 trillion or an estimated 7.4 percent of GDP in 2022. The government will need to ensure prudent spending, efficiency, and careful debt management if it is to deliver on its ambitious infrastructure targets.

30. The implementation of the government's investment program is expected to be slower than outlined in the medium-term budget proposal. In the first half of 2017, the government was able to execute its programmed budget, focusing on road repairs, irrigation projects, school construction, and military equipment. However, there was a slower than envisioned start in the implementation of large-scale public infrastructure projects, which are key to

the government's *Build, Build, Build* agenda. As a result, the projected spending increase in the World Bank forecast is lower than in the medium-term budget proposal, and the fiscal deficit is estimated at 2.4 and 2.5 percent of GDP in 2017 and 2018, respectively. Faster economic growth is projected to bring down the debt-to-GDP ratio from 41.8 percent in 2017 to 41.2 percent in 2018.⁵⁶ Going forward, long-standing implementation constraints are likely to impact the administration's investment plans.⁵⁷ The government needs to improve project planning and the implementation cycle to resolve bottlenecks in the project approval process and ensure that large expenditure increases translate into productive investments. Furthermore, a successful and timely passage of the administration's tax policy reform packages and the budget management reforms will be needed to guarantee sustainable financing of planned infrastructure investments.

31. Monetary policy is expected to remain accommodative, with the central bank's target average annual inflation rate remaining between 2 and 4 percent in the medium term. The inflation rate is projected to rise from an average of 1.8 percent in 2016 to 3.0 percent in 2017, before slowing to 2.6 percent in 2018 and settling at 2.8 percent in 2019. These projections are in line with those of the central bank which estimate the inflation rate to settle near the midpoint of the its target range of 3.0 percent +/- 1.0 percentage point in 2017 to 2019. After the headline inflation rate reached an average of 3.1 percent in the first eight months of 2017, high base effects are expected to temper inflation in the remaining four months of 2017. High base effects are also likely to spill over into 2018 and moderate inflation rates despite an anticipated rise in energy prices. The benchmark crude oil price is projected to recover from US\$42.8 per

barrel in 2016 to US\$52.0 and US\$54.0 per barrel in 2017 and 2018, respectively.⁵⁸ There may be a need to manage inflation expectations, as the public investment push is expected to spur domestic demand, leading to higher inflation in the second half of 2018 and into 2019. However, the central bank is expected to maintain its current policy stance as the projected inflation rates remain within its target range.

32. The Philippines' medium-term growth outlook is anticipated to be boosted by stronger growth in external demand. The growth in net exports is expected to recover in 2017, but import growth is projected to outpace export growth as an increase in infrastructure spending would raise the demand for intermediate and capital goods. Global trade growth is expected to rebound to 4.0 percent, year-on-year, in 2017, its fastest pace since 2010. An improvement in the external environment is expected to benefit Philippine exports, supported by stronger import demand from its major trading partners, such as China, the United States, Japan, and the European Union. BPO services are expected to drive services exports. Meanwhile, import growth is likely to strengthen as rising domestic incomes would lead to greater demand for imported consumer goods. The government's infrastructure investment push is also projected to lead to greater demand for capital goods.

33. The current account is expected to remain in deficit over medium term, partly owing to a larger trade deficit. The current account deficit is projected to grow from 0.2 percent of GDP in 2017 to 0.3 and 0.5 percent of GDP in 2018 and 2019, respectively. This is consistent with an expected increase in investments alongside the government's infrastructure investment push. The share of capital goods increased from about a quarter of total imports before 2016

⁵⁶ The government's planned budget deficits are 3.0 percent in 2017-2020. The debt-to-GDP forecast is 40.6 percent for 2017, 40.5 percent for 2018, and 39.8 percent for 2019.

⁵⁷ Procurement issues and implementation bottlenecks, which delay and complicate the administration's delivery of its public investment program, include bidding failures, legal challenges brought by losing parties, difficulties in securing permits, clearances and right-of-way issues, and contractors' non-compliance or submission delays of documentary requirements. See Fiscal Risks Statement 2017 (DBM).

⁵⁸ Meanwhile, international price for key food item particularly rice is expected to drop from US\$396/mt in 2016 to US\$385/mt in 2017 then rise to US\$389/mt in 2018. Price for wheat is also expected to drop from US\$167/mt to US\$150/mt in 2017 and US\$156/mt in 2018. World Bank commodities prices forecast, April 2017.

to a third in 2016. This is expected to rise even further in the coming years as the government's infrastructure investment plans gain traction. An increase in capital accumulation is expected to enhance the economy's production capacity and lay the foundation for future economic growth.

34. The Philippines' medium-term growth outlook depends on the country's level of investment growth. While the growth of private investments is projected to remain robust, the growth level will depend on the public investment program gaining traction and the government's ability to remove bottlenecks in the infrastructure project planning and implementation process. However, the implementation of the government's infrastructure program was slower than expected during the first half of 2017, contributing to moderate fixed capital-formation growth and a softening of growth prospects for the year. The World Bank's projection assumes a more gradual acceleration in the implementation of the public investment plan, which is expected to lead to 12.2 percent, year-on-year, growth of fixed capital formation in 2017. Gross fixed capital formation is projected to grow from 12.2 percent, year-on-year, in 2017 to 14.7 and 16.1 percent, year-on-year, in 2018 and 2019, respectively.

35. Following exceptional growth in 2016, private consumption growth is expected to moderate around its five-year average in the next couple of years. Household consumption is expected to grow only moderately from an

average of 5.9 percent annually between 2011 and 2015 to 6.0 percent in 2017, before rising to 6.1 and 6.3 percent in 2018 and 2019, respectively (Table 5). This follows a 7.0 percent, year-on-year, growth rate in 2016, which was spurred by election year stimulus spending. The Philippine economy has historically been consumption-driven, with household consumption representing roughly two-third of total expenditures, and consumption is expected to remain the main base of growth in the medium term. The prospect of strong consumption growth in the medium term is supported by a number of factors. First, income levels in the Philippines are gradually increasing as more people move into wage jobs and employment conditions improve. Second, the number of middle-income households, which have a higher propensity to consume, is gradually growing because of sustained economic growth and changing demographics. Finally, the flow of remittances appears to be resilient and is expected to remain around current levels in the coming years.

36. The services sector is projected to sustain its recent expansion and remain the main driver of output growth. The sector is projected to grow at 6.8 percent, year-on-year, in 2017 and 7.0 percent, year-on-year, in 2018-2019. An expanding economy, coupled with a rising middle-income class and strong remittance receipts from overseas Filipinos, is expected to drive strong demand for real estate properties and financial services. The finance and insurance

Table 5: Economic indicators for baseline projection

	2014	2015	2016e	2017p	2018p	2019p
Real GDP growth, at constant market prices	6.1	6.1	6.9	6.6	6.7	6.7
Private consumption	5.6	6.3	7.0	6.0	6.1	6.3
Government consumption	3.3	7.6	8.4	3.8	6.0	8.7
Gross fixed capital investment	7.2	16.9	25.2	12.2	14.7	16.1
Exports, goods and services	12.6	8.5	10.7	17.1	12.2	12.4
Imports, goods and services	9.9	14.6	18.5	17.0	14.3	15.5
Inflation (period average)	4.1	1.4	2.0	3.0	2.6	2.8
National government balance (% of GDP)	-0.6	-0.9	-2.4	-2.4	-2.5	-2.8
National government debt (% of GDP)	45.4	44.8	42.6	41.8	41.2	40.8
Current account balance	3.8	2.5	0.2	-0.2	-0.3	-0.5

Source: PSA, BSP, BTr, World Bank Staff estimates

subsector has also been the favorite destination of foreign direct investments, receiving 57.2 percent of net foreign direct investments in the first half of 2017, which is expected to boost services-sector growth in the medium term. Meanwhile, credit growth has been generous in the real estate and construction (20.1 percent of total domestic loans in the first seven months of 2017) and the wholesale and retail trade subsectors (15.2 percent), which is expected to continue. The information technology (IT) and BPO industries continue to enjoy strong growth prospects with revenues expected to increase from US\$22.9 billion in 2016 to US\$38.9 billion in 2022, overtaking remittances as a major source of dollar receipts.⁵⁹

37. Manufacturing activities are projected to remain robust in the short term, but investment is needed in the medium term to expand production capacity. The Volume of Production Index for manufacturing has sustained its growth since mid-2015 while the PMI remained in expansion territory in the first eight months of 2017 but has weakened since May (Box 2). Factory activities can likely be sustained in the short run, although capacity utilization inched up to 83.8 percent in July 2017, slightly up from 83.5 percent a year ago. Even though investment in durable equipment to support manufacturing is increasing, only a third of these investments have been for general and specialized machineries, leaving room for more investment. Efforts to create a more business-friendly environment, such as implementing business-friendly reforms, revisiting the negative investment list, reducing tariffs on key manufacturing inputs such as chemicals and

cements, improving the finance for micro, small and medium-sized enterprises, and enhancing market competition, would encourage higher investment levels and create more productive capacity and jobs.

38. Growth in the agriculture sector is projected to recover somewhat in the medium term, but the sector remains vulnerable to weather-related events. The sector is set to rebound with an expected 4.2 percent annual growth rate in 2017, primarily due to an improvement in weather conditions⁶⁰ and a low base in 2016. Agricultural growth in succeeding years is expected to moderate, as the Philippines has yet to address longstanding structural weaknesses in the agricultural sector, particularly in Mindanao.

39. Decades of underinvestment and a long history of policy distortions have depressed growth in agricultural productivity.⁶¹ These structural weaknesses are most apparent in Mindanao, the agricultural basket of the country, which produces more than a third of the Philippines' total agricultural output. Despite possessing a comparative advantage in agriculture,⁶² the Philippines has so far been unable to unlock the sector's full potential, as low agricultural productivity among smallholders reflects a number of well-known policy, investment, and institutional deficits, which tend to be magnified in Mindanao. As a result, implementing a successful regional development strategy for Mindanao is key to unlocking the potential of the country's agricultural sector and ensuring its transition into a sector marked by high productivity and low vulnerability.⁶³

⁵⁹ IT and Business Process Association of the Philippines (2016).

⁶⁰ Weather conditions in 2017 will generally be milder compared with conditions during the past two years. The state weather bureau reported that there was a bleak chance for the occurrence of rain-driving La Niña in 2017, while the El Niño phenomenon has already dissipated in mid-2016 after impacting the country from late 2015 to early-2016. The country will still be visited by seasonal typhoons that may impact farm outputs.

⁶¹ Examples include protectionist policies, such as the rice self-sufficiency policy, large subsidies for inputs, and distortions in institutions that prevent broad and secure access to land by small landholders.

⁶² Mindanao is blessed with good agro-climatic conditions, as most of its provinces lie below the typhoon belt and has rich natural resources, such as i) fertile soil and wide range of elevation suitable for a variety of crops, ii) large deposits of minerals such as gold, copper, and nickel, iii) extensive forests, albeit of secondary growth, and iv) vast marine wealth.

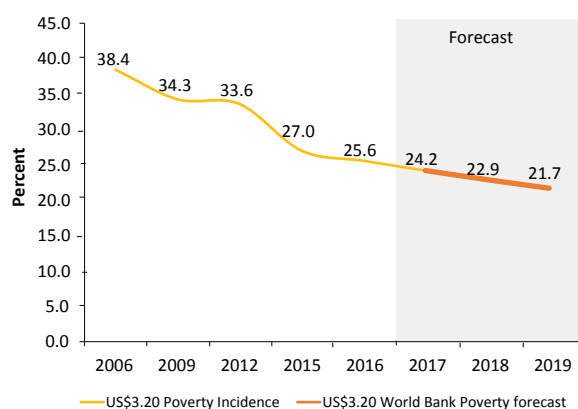
⁶³ For a more detailed discussion on the development challenges faced in Mindanao and how to unlock its potential, please refer to Part III: Unlocking Mindanao's Potential, which draws from the World Bank (2017c) Philippines Mindanao Jobs Report: A Strategy for Mindanao Regional Development.

2.2 Poverty and Shared Prosperity

Poverty reduction will likely continue as the country's growth outlook remains positive and inclusive growth policies are pursued.

40. Sustained economic growth increases the likelihood that poverty reduction has continued since 2015. The World Bank tracks poverty rates in the Philippines using an *international poverty line* which is equivalent to US\$3.20-a-day in purchasing power parity terms.⁶⁴ Using this measure, the poverty rate for the Philippines is projected to have dropped from 27.0 percent in 2015 to 24.2 percent in 2017, implying that around 1.0 million Filipinos exited poverty each year since 2015. The projection is based on the Philippines' growth forecast under the assumption that the responsiveness of the poverty rate to economic growth follows the observed historical average.⁶⁵ As economic growth remains robust in the short term, the poverty rate is projected to decline further to 22.9 percent in 2018 (Figure 35).

Figure 35: Actual and projected poverty rates using the US\$3.20-a-day poverty line



Source: PSA, World Bank staff estimates

41. Progress in the economy's structural transformation is expected to contribute to poverty alleviation. The share of agriculture in

total employment decreased from about 37.0 percent in 2006 to 25.2 percent in July 2017, while the share of the services sector rose from about 49.0 to 55.4 percent during the same period. The gradual transition of workers from agriculture to more productive sectors is expected to contribute to poverty reduction, as even lower-end industry and services jobs pay more than agriculture jobs.⁶⁶ Nevertheless, there is a need to improve the productivity of the agricultural sector which is only one sixth of the productivity of the industry sector. Agriculture is central for the country to achieve inclusive growth, as the sector employs a disproportionate share of the poor, and its output has a significant influence on food prices which heavily impacts the poor.

42. Government investment policies and a public commitment to the inclusive growth agenda are expected to have a decisive impact on poverty. The Philippine conditional cash transfer program (*Pantawid Pamilyang Pilipino*), which reaches one-fifth of the population, increases the income necessary for beneficiaries to afford basic needs and helped reduce the income gap of beneficiaries by up to 6.0 percentage points in 2015.⁶⁷ Improving the conditional cash transfer program and other social assistance programs would shore-up consumption among poor households and promote greater human capital accumulation to improve long-term economic prospects. Aside from social sector spending, the government is pursuing a large infrastructure agenda, which is expected to boost poverty reduction in the medium term by generating employment opportunities in the construction sector.

⁶⁴ This is the median of the national poverty lines among lower middle-income countries which is slightly higher than the Philippines' national poverty line.

⁶⁵ Specifically, it is assumed that the elasticity of GDP per capita with poverty reduction is equal to the average value observed over the period 2006-15.

⁶⁶ Philippines Poverty Assessment, forthcoming.

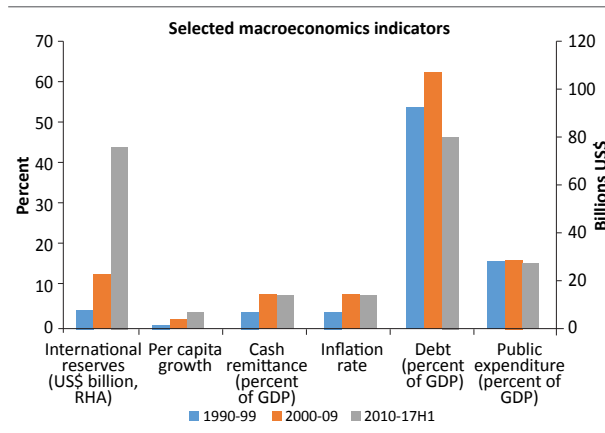
⁶⁷ Based on an assessment made on 2015 Family Income and Expenditure Survey data. More information in the Philippines Poverty Assessment, forthcoming.

2.3 Risks and Policy Challenges

Both external and domestic risks to the country outlook remain substantial and are increasing. Policymakers face the challenge of confronting downside risks while fostering long-term growth.

43. External risks remain prominent while domestic challenges are growing. The ongoing U.S. Federal Reserve rate hikes could result in new episodes of peso depreciation and capital outflows from the Philippines, increasing volatility in the foreign exchange market. Rising protectionism in some advanced economies also constitutes a risk that could impact the country through lower levels of remittances and trade. Domestic challenges include a slower than envisioned implementation of the government's infrastructure investment plan. As infrastructure spending increases, there is also a growing need to more prudently manage public finances and preserve fiscal sustainability, including improving the revenue administration and collection. Despite these risks, the administration is coming from a position of strength as macroeconomic fundamentals remain intact. However, both the fiscal and monetary space to address external and domestic risks can quickly diminish and limit the government's policy options to mitigate those risks (Figure 36).

Figure 36: Macroeconomic fundamentals remain intact



Source: BSP, PSA, World Bank staff estimates

44. Expectations of international interest rate tightening may lead to an acceleration of capital outflows and renewed volatility in the foreign exchange market. A faster-than-expected

normalization of policy rates in advanced economies constitutes the most significant external risk to the Philippines. A further increase in U.S. yields, driven by a sudden reassessment of U.S. monetary policy expectations, could lead to renewed tightening of financing conditions. The higher interest rate environment risks raising the country's borrowing costs at a time when the government is also considering sourcing foreign funds to finance its infrastructure program. Both expectations of and actual Federal Reserve interest rate hikes may lead to higher portfolio outflows from emerging markets, including the Philippines, as U.S. assets become more attractive. This will insert more volatility in the foreign exchange market and could lead to a further depreciation of the peso. In July, the central bank reportedly smoothed the volatile exchange rate market by using foreign-exchange reserves. A depreciating peso has the unwanted effect of an inflationary pass-through, as some major commodities, such as rice, wheat, animal feeds, and fertilizers, are partially imported.

45. Potential protectionism in some advanced economies raises concerns over a retreat from an open world economy, which could impact the Philippines through lower trade and remittances. Protectionist sentiments in the United States and elsewhere have not yet translated into actual policies that directly impact the Philippine economy. However, American protectionist measures can likely lead to lower levels of trade and remittances, especially since the United States is the primary source of remittance inflows to the Philippines, accounting for more than a third of cash remittances (Box 6). Meanwhile, a slowdown in global trade may directly or indirectly affect the Philippines' export of commodities, such as electronics and semiconductors, because of the country's linkages with the global value chain.

46. Passing reforms related to public financial management and the budget process are crucial to ensure the timely and successful implementation of the infrastructure agenda.

As the medium-term growth prospect hinges on the infrastructure investment program, failure to address implementation and delivery bottlenecks may result in lower infrastructure spending.⁶⁸ If constraints are successfully removed, growth could be potentially pushed towards the upper end of the government target of 6.5-7.5 percent. Progress is being made to fully use the programmed budget, but the government needs to ensure that recent achievements are sustained. House Bill 5590 or the Budget Reform Bill, which the administration hopes will pass before year end, aims to strengthen government accountability for the use of public funds through greater transparency and more efficient public financial management. The bill is expected to increase actual spending through new schemes that include a shift from obligation-to cash-based budgeting, shortening the validity of appropriations from two years to one, the introduction of an extended payment period, and the establishment of a unified accounts code structure. There are also plans to create an Office of Comptroller General, with internal auditing duties, under the Office of the President to speed up assessments and compliance.⁶⁹

47. The successful passage of the government's tax reform package will help to ensure the sustainability of the government's fiscal balance.

An expansionary fiscal policy in the medium term, including growing public sector wages, will continue to put pressure on public finances and overall fiscal health if the level of government revenues remains unchanged. The timely passage of the government's tax reform package is necessary to ensure the sustainability of the government's fiscal accounts in the medium term, which is a key component of the

country's solid macroeconomic fundamentals. The first package of the government's tax reform program was successfully passed in the House of Representatives on its third and final reading on May 31, 2017. The Senate of the Philippines is currently conducting its own set of deliberations on its own version of the bill, which is expected to last until October 2017. Should the first package of tax reforms pass before the end of the regular session of congress in 2017, implementation of the new tax policy is scheduled to start in 2018. The Department of Finance estimates an increase in revenue by Php119.4 billion (0.7 percent of GDP) in its first year of implementation, while preliminary estimates on the Senate version of the bill are estimated at least Php59.9 billion (0.3 percent of GDP), a downward revision from an earlier version of the bill which had estimated additional revenues of Php157.2 billion (0.9 percent of GDP).

48. Commitment to the government's policy goals of achieving stable inflation, fiscal stability, and security and rule of law will help preserve consumer and business confidence.

Maintaining positive consumer and business sentiments will support growth in both consumption and private investment, which are expected to be the primary growth drivers of the Philippine economy in the medium term. For Filipino consumers, it will be important that inflation remains at moderate levels. This will warrant careful inflation management by the central bank authorities to anchor expectations. There are a number of emerging key risks to inflation in the near term, stemming from exchange-rate volatility, the price effects of the government's tax reform policy, and demand-side pressures from an increase in infrastructure spending. The successful and timely implementation of the government's fiscal program, including its ambitious infrastructure plan and efforts to generate more revenue (including the passage of the first package of

⁶⁸ In previous years, ambitious increases in the government's budget resulted in underspending, as fundamental issues in budget execution were not addressed. Structural weaknesses within key departments and agencies, such as poor planning, weak program and project design, and procurement difficulties, prevented the government from fully executing its programmed budget. From 2011 to 2015, actual disbursements by the national government fell short by around 10 percent per year despite the ample fiscal space afforded to the national government (Monsod, 2016).

⁶⁹ See House Bill no. 5590, An Act to Reform the Budget Process by Enforcing Greater Accountability in Public Financial Management (PFM), Promoting Fiscal Sustainability, Strengthening Congress' Power of the Purse, Instituting an Integrated PFM System, and Increasing Budget Transparency and Participation, and for Other Purposes.

the tax reform program), would signal a strong commitment to the government's policy priorities. Key issues facing the country, such as mining regulations (Box 3), the government's response to the ongoing conflict in Marawi City (Box 11), and regional development in Mindanao, will require policy certainty to preserve both external and domestic confidence in the Philippine economy.

49. Policymakers face the challenge of confronting downside risks while fostering long-term growth. The short-term risks to the country outlook include increased trade protectionism, the possibility of financial market disruptions, and elevated economic policy uncertainty. In the longer term, weaker potential growth remains the main risk. An expansionary fiscal policy could support short-term growth as long as it is consistent with medium-term fiscal sustainability. Securing monetary and fiscal space to deal with

potential risks should also be a policy priority. Continued macroeconomic improvements in the Philippines provide a window of opportunity to address underlying vulnerabilities and long-term structural issues. Over the longer term, structural policies that support investment and trade are critical to boost productivity and economic growth. This will require the government's commitment to reforms that promote competition in key sectors, secure property rights, lessen regulatory complexities, and improve doing business in the country. Other long-term policy priorities include training and job-search programs and other measures to support workers most affected by sectoral shifts in employment and share the dividends of growth and gains from globalization more widely. Sustained investment in human capital development and in sectors that create quality employment are needed to safeguard the country's progress on delivering inclusiveness.

Box 11 The Marawi city crisis

Marawi City, a relatively small city in the Autonomous Region in Muslim Mindanao (ARMM), is an important economic and cultural hub in the region. Although Mindanao is an important part of the Philippine economy, Marawi City and the province of Lanao del Sur make up a relatively small share of Mindanao's formal economy. The ARMM region, which Lanao del Sur is a part of, constitutes only 0.7 percent of the Philippines' GDP and 4.8 percent of Mindanao's GDP. Meanwhile, Marawi City is the least economically vibrant city in Mindanao.⁷⁰ It ranks last in terms of taxes on business income among the 33 cities in Mindanao, as taxes on business revenue amounted to only Php0.5 million or 0.01 percent of business tax revenue among cities in Mindanao. Given the limited scope of Marawi City's economy, it has a small direct impact on the Philippines' formal economy. However, the city still plays an important role in the region as the economic hub of Lanao del Sur and as a cultural hub in Mindanao. It is strategically located in the region due to its proximity to Lake Lanao, as a center of trade and commercial activities to nearby towns and municipalities, and hosts the Agus 1 and Agus 2 hydro-power plants. Marawi City and Lanao del Sur are also important gateways to the provinces and cities of the Northern Mindanao region, providing an important link to the transport and flow of goods throughout Mindanao.

Although the direct impact of this conflict on the country's formal economy may be limited, the social development impact on the citizens of Marawi and nearby areas is more severe. Mindanao has some of the highest poverty rates in the entire Philippines, especially in conflict-affected areas, and the province of Lanao del Sur had the highest poverty incidence among provinces in the Philippines at 71.9 percent in 2015. Marawi City itself had a poverty incidence of around 60 percent in 2012. The ongoing conflict has resulted in the displacement of nearly 400,000 citizens from Marawi⁷¹ and caused significant damage to local infrastructure, agricultural

⁷⁰ Measured by using total business tax revenue in 2016 as proxy for city income. Source: Bureau of Local Government Finance.

⁷¹ Source: <http://www.gmanetwork.com/news/news/nation/616565/marawi-fighting-displaces-nearly-400-000/story/>

resources, and other sources of livelihood for its citizens and nearby towns. In the short term, the continued timely response by the government is needed to ensure that those displaced receive appropriate humanitarian assistance, as internally displaced persons are vulnerable to various health risks. Over the medium term, careful coordination among various government agencies is required to ensure the rehabilitation of Marawi City is successful once the conflict is resolved.

In addition, the Marawi conflict brings uncertainty to the completion of the peace process that is expected to end the almost five-decade violent conflict which large parts of Mindanao has suffered. The region's history of widespread conflict has led to weak economic growth, low job creation, anemic poverty reduction, and a massive displacement of the population. But the Marawi City crisis has different characteristics than the previous conflict. First, it points to a convergence of different terrorist groups. Second, the scale of the disruption is different, with armed terrorist forces occupying an entire city which led to a complete evacuation. Finally, it has potential spillover effects into neighboring areas and brings uncertainty to the completion of the Mindanao peace process, which is likely to adversely affect national consumer and business sentiments.

PART III:

UNLOCKING MINDANAO'S POTENTIAL⁷²

Economic progress in the Philippines will depend on the success of economic development in Mindanao, as it is hard to see how the country can achieve sustained and inclusive growth without progress in this region. Like the rest of the Philippines, the central policy challenge for Mindanao is how to accelerate inclusive growth—the type that creates more and better jobs and reduces poverty. But this is more difficult in Mindanao than in Luzon or the Visayas because of longstanding armed conflict in the region. Although progress has been made in making growth more inclusive, Mindanao still trails the rest of the Philippines in terms of shared prosperity. This is compounded by the weakness of the Mindanao economy, resulting from decades of not only armed conflict but also a narrow growth strategy. This special focus note, which is based on the main findings of the World Bank's Philippines Mindanao Jobs Report, proposes a comprehensive strategy for unlocking Mindanao's potential, including interventions in the region that will support sustainable peace and development and job creation. The strategy is built on three main components that aim to (1) raise agricultural productivity and improve farm-to-market connectivity; (2) boost human development; and (3) address drivers of conflict and fragility and strengthen institutions in ARMM and conflict-affected areas.



⁷² This special focus note was prepared by Birgit Hansl. The analysis is based on a World Bank Report (2017): *Mindanao Jobs Report - A Strategy of Mindanao Regional Development* with contributions from a large team of World Bank staff based in various GPs and experts from the Philippines, in particular Mindanao.

3.1 Introduction

50. Boosting economic development in Mindanao is essential for the economic progress of the entire Philippines. 37 percent of the country's poor population lives in Mindanao, although the region only represents about 25 percent of the country's population. As a result, reducing poverty in Mindanao will be key to reducing it nationally. Moreover, increasing agricultural production in Mindanao could reduce food and input prices nationally, improve public welfare, and heighten the competitiveness of the Philippines' agricultural sector since the region is considered the country's agricultural food basket (Box 12). Achieving successful economic development in Mindanao will be a major test of the country's ability to achieve its long-term vision of rapid, sustained, and more inclusive growth.

51. Resolving the conflicts in Mindanao rests on addressing the root causes of conflict and providing jobs and economic opportunities as alternatives to violence. There are both economic and political drivers of the conflicts, and attaining a just and lasting peace will require political solutions to address the causes of conflict, such as injustice, weak governance, land conflicts, and discrimination. The peace agreements that have been signed in the past have not been enough to put all of Mindanao on a path to inclusive growth. Peace can only be secured by addressing the sources of conflict and creating jobs and economic opportunities. Fostering economic development is necessary to stabilize the region, as jobs can provide opportunities to those who have not previously experienced the benefits of economic growth.

52. This special focus note is based on the World Bank's *Philippines Mindanao Jobs Report*⁷³ which followed an inclusive approach of engaging with a broad-based group of stakeholders. The goal of the report was to generate ownership among Mindanawons through consultations that were guided by mostly local technical experts.

The report is also unique in that it deals with all of Mindanao and looked for ways to grow the entire regional economy, as most previous research has focused on only conflict-affected areas or specific economic sectors. Conflict and non-conflict areas in Mindanao are closely interconnected through economic trade routes. Because non-conflict areas and cities serve as consolidation stations for produce from conflict areas, developments in the latter have profound implications for the rest of Mindanao and vice versa. Mindanao's jobs challenge can only be effectively addressed if the development strategy seamlessly connects conflict and lagging regions to growth poles so that all of Mindanao can benefit. Addressing constraints in any area will therefore improve economic activity and job creation throughout Mindanao.

53. Jobs and economic opportunities are central to stabilize the region and achieve peace. Conflict affects nearly 60 percent of all Mindanao's local government units. Breaking the cycle of insecurity and reducing the risk of its recurrence will require a virtuous spiral of restoring confidence in collective action and transforming institutions so they can provide sustainable security, justice, and jobs.⁷⁴ Jobs offer a stake in society to groups that might otherwise receive more respect and recognition from engaging in armed violence rather than lawful activities.

54. The World Bank is proposing a strategy for regional development with concrete policy recommendations. The three main components aim to (1) raise agricultural productivity and improve farm-to-market connectivity; (2) boost human development; and (3) address drivers of conflict and fragility and strengthen institutions in ARMM and conflict-affected areas. The World Bank engagement in Mindanao will be based on this strategy. Policy recommendations are made in four separate categories: (i) increasing agricultural productivity by improving extension and irrigation services along with price reforms to realize Mindanao's agriculture potential;

⁷³ World Bank (2017c). See: <http://documents.worldbank.org/curated/en/395661498616337079/Philippines-Mindanao-jobs-report-a-strategy-for-Mindanao-regional-development>

⁷⁴ World Bank 2011.

(ii) building up logistics and transport connectivity by improving road networks and the efficiency of shipping services to reduce trade costs; (iii) improving the supply of reliable power and the speed, affordability, and quality of information and communications technology (ICT) services

by fostering competition; and (iv) supporting private investment by addressing the growing skills gap and the high regulatory burden for businesses and improving financial inclusion and land governance.

3.2 The Development Challenge in Mindanao

55. Achieving rapid and sustainable growth in Mindanao constitutes a difficult challenge.

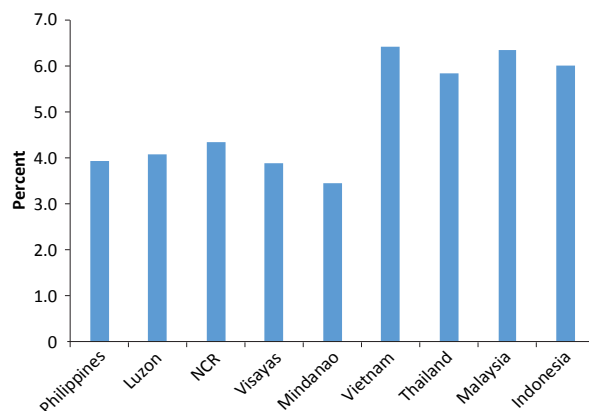
In the region, productivity in agriculture is low except for a few export crops, manufacturing is constrained by weak infrastructure, and a low-productive and low-skilled services sector has become the catch basin for excess agriculture workers who cannot find jobs in the cities. Lack of competition in key sectors, insecure property rights, complex regulations, severe underinvestment in infrastructure, education, and health, and weak institutions have led to an anomalous growth pattern for Mindanao, resulting in low-quality jobs for the majority of its population and substantial emigration of many of its talented people. Decades-long conflict has caused untold human suffering and severely constrained economic growth in conflict-affected areas (about 60 percent of Mindanao's cities and municipalities are directly affected by conflict) while reducing confidence and discouraging investment throughout Mindanao.

Slow Economic Growth

56. Mindanao has fallen behind the rest of the Philippines. Even though its per capita income was once similar to Luzon's and triple that of the Visayas, Mindanao's growth rate is now far below those of these two island groups. The region's GDP increased by 3.4 percent annually between 1975 and 2014, compared to 4.1 percent in Luzon, translating into a 30 percent higher growth rate for Luzon (Figure 37). By 2014, Mindanao's per capita GDP was only about half that of Luzon's. Compared to neighboring countries with a similar comparative advantage in agriculture,

Mindanao was as rich as Thailand and richer than both Indonesia and Vietnam until 1980. In 2014, per capita GDP in Mindanao was 30 percent of Thailand's, 50 percent of Indonesia's, and 87 percent of Vietnam's. Moreover, the ability of economic growth to generate employment has declined steadily in the region. Between 1975 and 1996, employment only grew between 1.04 and 1.72 percent for every 1 percent Mindanao's economy grew. The elasticity in the region also fell to 0.43 between 1997 and 2008 and to 0.31 between 2009 and 2014, suggesting that higher growth in recent years did not create a commensurate number of jobs.

Figure 37: Average annual GDP growth in Mindanao, the rest of the Philippines, and neighboring countries, 1975–2014, percent



Source: World Bank, World Development Indicators database

57. Slow growth in Mindanao since the late 1970s reflects limited technological progress.

From 1978 to 2014,⁷⁶ the contribution of physical and human capital to Mindanao's growth was comparable to that of Luzon, but growth in output

⁷⁵ This is the earliest available year with regional GDP data.

⁷⁶ 1977 is the earliest year all data were available. Two years are needed to measure initial capital formation, and 2014 data are the most recent available.

per worker was minimal and the contribution of total factor productivity⁷⁷ was negative (Table 6). Conflict is probably the cause for Mindanao's negative total factor productivity contribution, which tends to undermine institutions, the rule of law, and incentives to innovate and grow. The number of conflict-related deaths and incidences of negative total factor productivity from 1986 to 2004 are positively correlated.⁷⁸

58. However, Mindanao's economic performance has recently started to improve. From 2010 to 2014, the region's annual growth rate averaged 6.1 percent of GDP, on a par with Luzon and the Visayas. Key cities in Mindanao, like Davao and Cagayan de Oro, are the region's new engines of growth. Similar to the rest of the country, Mindanao's growth trajectory reflects the increase in investments over the past six years. It also reflects public policies, such as the partial liberalization of the cabotage regime, and resources, such as a tripling of the infrastructure budget, devoted to growing Mindanao's economy and improving investor confidence.

The Labor Force: Opportunity and Challenge

59. There is a considerable and rising demand for quality jobs that can raise real income and lift people out of poverty. In 2014, some 2.4 million Mindanawons were either unemployed

(about 460,000) or underemployed (1.9 million).⁷⁹ Moreover, Mindanao's relatively young population means that an expected 392,000 workers will enter the labor force each year between 2016 and 2022, totaling 5.2 million by 2022. For the region to benefit from the availability of its young workers, which is an enormous potential resource that can boost growth, it will require productive jobs that pay decent wages. Also, enabling workers to transition from the informal sector, which currently represents 70 percent of employment in Mindanao, to formal sector jobs could improve their welfare and increase productivity.

60. The sources of Mindanao's economic growth have not generated enough high-quality jobs. Unlike in Luzon and the Visayas,⁸⁰ which have more diversified, innovative, and labor-intensive economic structures (e.g., higher-value exports, such as electronics and furniture) and fast-growing formal services (e.g., IT-BPO), Mindanao's growth was driven by plantation crops (e.g., rubber, abaca, banana, and pineapple) and forestry, mining, and heavy manufacturing (e.g., steel) supported by an import substitution program.⁸¹ These capital-intensive sectors required little local processing, resulting in little local reinvestment of profits and low local multiplier effects. Furthermore, infrastructure funds have not focused on building the intra-Mindanao logistics network, which has discouraged intra-

Table 6: Growth decomposition, 1978 to 2014

	Growth input per worker	Contribution to growth		
		Physical capital	Human capital	TFP
Philippines	0.90	0.14	0.29	0.46
Luzon	0.84	0.11	0.29	0.45
Visayas	1.76	0.67	0.34	0.74
Mindanao	0.08	0.13	0.26	-0.31

Sources: PSA, Bureau of Labor and Employment Statistics (BLES), and World Bank staff calculations.

Notes: Cumulative growth from 1978-2014 is calculated similar to the method utilized by Bosworth-Collins (2003).

⁷⁷ Total factor productivity is the residual of growth after accounting for the contributions of capital and labor, adjusted for educational attainment. On average, statistical errors should equal zero so that the negative residual likely reflects a lack of technological and institutional change.

⁷⁸ Sufficient data are available only for these years.

⁷⁹ About one in five Mindanao workers would like to work more, but many jobs are only temporary or part-time.

⁸⁰ The rapid growth in the Visayas is also explained by large investments in the Leyte province under Ferdinand Marcos, whose wife, Imelda, comes from there.

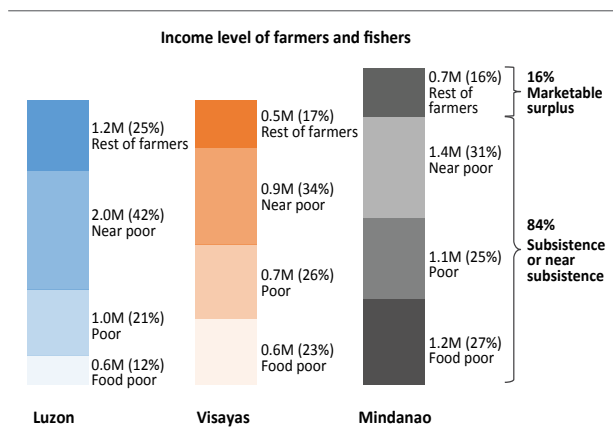
⁸¹ Between the 1950s and 1980s, an import substitution policy was implemented to support local manufacturing. In Mindanao, Iligan City was a center of heavy manufacturing (e.g., steel production).

regional trade. Instead, funds have been used to connect the region's plantations to its cities and ultimately to Manila and Cebu. While Mindanao's growth sectors did contribute to high GDP per capita between the 1960s and the 1980s, they did little to create jobs or reduce poverty. This growth pattern concentrated power and wealth, which entrenched deep inequalities and ultimately contributed to the region's conflicts, as few benefits reached the Muslim population and indigenous peoples.

High Incidence of Poverty

61. The poverty rate is higher in Mindanao than in Luzon and the Visayas. According to the 2015 Family Income and Expenditure Survey, 36 percent of the population of Mindanao lived below the poverty line, compared to 13.1 percent in Luzon and 28 percent in the Visayas. Poverty is particularly high in rural Mindanao. In 2012, there were 1.2 million food-poor farmers and fisherfolk (27 percent of the total) and 1.1 million (25 percent) living between the food and poverty thresholds. Another 1.4 million (31 percent) lived close to the absolute poverty line (20 percent above), making them highly vulnerable to fall

Figure 38: Poverty and vulnerability, farmers and fisherfolk in Mindanao, 2012, percent

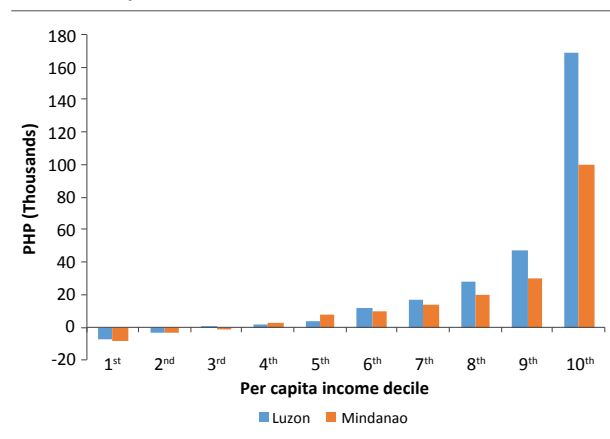


Source: FIES-LFS 2012

back into poverty. As a result, a total of 3.7 million farmers and fisherfolk lived in or near poverty, leaving only 0.7 million (16 percent) famers and fisherfolk with regular marketable surplus to generate savings for the next planting season (Figure 38 and Figure 39). In part, the high poverty rate reflects unequal economic and political power. When one person or firm controls the land, labor, credit, and product markets, or any combination thereof,⁸³ that person can drive farmers to subsistence by exploiting interlocking markets or even blocking access to markets.⁸⁴ Consultations and research undertaken for this study suggest that these practices thrive in Mindanao and lock some farmers and fisherfolk into a vicious spiral of poverty and indebtedness.

62. Poverty is highest in conflict-affected areas. At 59 percent, ARMM has the highest poverty incidence among cities and municipalities in Mindanao, which was 18 percentage points higher compared to the region as a whole in 2012.⁸⁵ Municipal poverty incidence deteriorated in ARMM between 2003 and 2012 and is correlated with the incidence of *rido*, inter-clan feuds.

Figure 39: Average savings of farmers and fisherfolk households by economic decile, Luzon and Mindanao, 2012



Source: FIES-LFS 2012

⁸² Based on the 2012 FIES. In 2012, the average annual per capita food poverty line in Mindanao was Php13,453 and the poverty line was Php19,291, both slightly higher (1.4 percent) than that of Luzon despite Mindanao being less developed. People falling below the provincial per capita food thresholds are considered food-poor, while those with per capita income equal to or above the provincial per capita food thresholds but below the provincial per capita poverty thresholds are considered poor. Those with per capita income equal to or above the per capita poverty thresholds but below the 50th population percentile (agricultural workers tend to have lower income) are considered near-poor.

⁸³ For instance, in a Mindanao town, the *datu* (local chieftain) can control local politics, own the only rural bank, and have a monopoly of security services and wide influence over labor and land allocation.

⁸⁴ For more discussion, see Binswanger, Deininger, and Feder (1993).

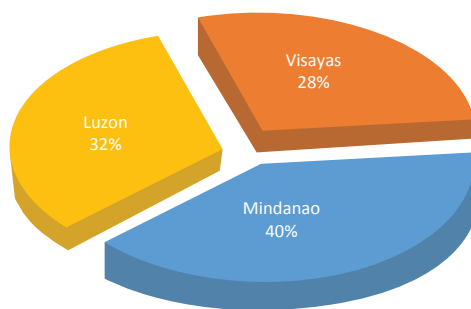
⁸⁵ Small area estimates of poverty were used to determine municipal and city level poverty incidence in the Philippines. The latest available data from the Philippines Statistics Authority was in 2012.

63. Poverty among workers is higher in Mindanao than elsewhere in the country. Thirty four percent of workers in the region live below the poverty line, compared to 12 percent in Luzon in 2012. The incidence of in-work poverty is highest among less educated and less skilled workers, especially for those who hold temporary or involuntary part-time jobs. The self-employed are more likely to be poor than wage earners, and self-employment often reflects a lack of opportunity rather than an entrepreneurial drive. Underemployment, not temporary unemployment, is the main reason for in-work poverty. The key to reducing in-work poverty in Mindanao is to provide better education and skills training and increase productive job opportunities by making the investment climate more attractive.

Mindanao's Agriculture

64. Mindanao is the agriculture center of the Philippines, producing diverse crops and livestock, including many high-value commodities. It contributes 40 percent of the country's agricultural products (Figure 40), with significant shares of rubber, cacao, coffee, coconut (small farms), bananas and oil palm (mid-sized farms), and pineapple (large farms) (Figure 41). The top three Philippine exports are

Figure 40: Regional production as share of total agricultural production in the Philippines, 2014, percent



Source: PSA

Note: Data for fisheries uses 2012 as base and the growth rate of the AFF sector to project 2014 share of production.

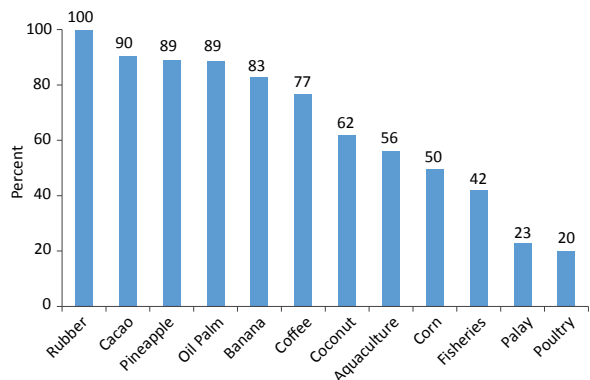
coconuts (38 percent of world export volume in 2014), bananas (33 percent in 2014), and pineapples (28 percent in 2014).⁸⁶

65. Since most workers in Mindanao rely directly on agriculture, transforming the sector could be significant for generating jobs. In 2012, the agriculture and agricultural produce value chain accounted for 60 percent of Mindanao's value added and 57 percent of its employment.⁸⁷

66. Mindanao's agriculture sector is dominated by smallholder farming. About 60 percent of farms in Mindanao cover less than 2 hectares (smallholders) and another 33 percent are 2 to 5 hectares (mid-size farmers). Mindanao also has a large proportion of landless agricultural workers—estimated at over a million or about a third of all farm workers.

67. Despite the promise of agriculture, many Mindanawons end up in low-paying services jobs in urban areas. Limited job creation in agriculture has had economy-wide implications. Because of slow agricultural growth, millions of workers have joined the informal services sector where jobs are of low-pay, low-skill, and of low-productivity. Services generates 44 percent of Mindanao's economic output, but half of these

Figure 41: Crops produced in Mindanao as a share of total production, 2014, percent



Source: PSA

⁸⁶ Export volume estimates are based on the WITS database.

⁸⁷ Of which 30 percent came from the farm (crops/livestock), fishery, and forestry sectors (primary sector) and the balance (30 percent) from various industrial and services sectors that add value to farm produce.

jobs are informal, such as in petty retail trade, public transportation, and personal services. Also, many workers who escaped unproductive agricultural jobs in depressed rural and conflict-affected areas are struggling to find better-paying jobs in urban areas.

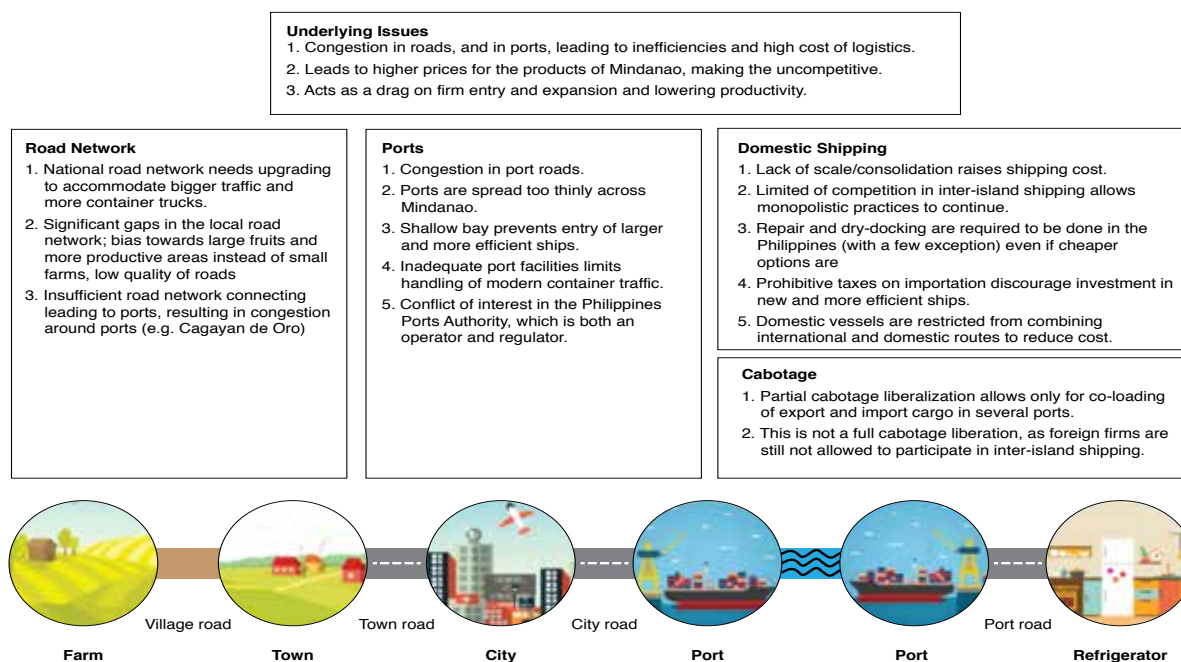
68. Poor public policies, investment deficits, and institutional shortcomings constitute current constraints to realizing the transformative potential of the agricultural sector. Some of the drivers and causes of the poor performance in the sector are insecure and disputed property rights, ineffective farmer organizations, fragmented agricultural research and tenuous research-extension linkages, limited access to and low quality of agricultural services, and continued weaknesses in the devolution of services to local government units. There are also problematic gaps in rural infrastructure, especially farm-to-market roads and irrigation systems, and access to capital is a continuing problem. Finally, there is an extensive unfinished agenda of complementary reforms, primarily relating to agricultural price and trade-policy distortions.

Improving Logistics and Transport Connectivity

69. Lowering logistics costs would significantly benefit Mindanao's agriculture value chains.⁸⁸

An efficient logistics system is essential if Mindanao's potential of becoming a global supplier of basic and value-added produce is to be realized. Ensuring a seamless logistics network from farm to markets will entail (1) connecting farms to towns by investing in village roads; (2) connecting towns to ports by investing in major roads; (3) promoting competition in the domestic shipping industry; (4) liberalizing cabotage; (5) modernizing the major ports; and (6) streamlining export and import procedures. Because the logistics chain is only as good as its weakest link, partial reforms will not lead to lower prices and better service. For instance, reforming domestic shipping and cabotage without modernizing ports and improving roads will not lower shipping cost; shipping lines will not upgrade to larger ships to increase scale if the movement of cargo will still be delayed on the road and at the port.

Figure 42: Farm-to-market logistics issues in Mindanao



⁸⁸ The Philippines Mindanao Jobs Report discusses the domestic and foreign markets for Mindanao's agricultural products. In particular, unlocking the agricultural sector in Mindanao and addressing logistics and connectivity issues will strengthen the contribution of Mindanao's agricultural output to the nation's food security, particularly increasing rice and maize supply to the other island regions. In addition, there opportunity to expand the production of exportable agriculture products: aquatic, coffee, and coconut products. Here the challenge will be mainly to more closely link farmers with enterprises.

70. Improving transport connectivity from farm to market would have numerous positive effects on economic development. Without a well-developed transportation network, farmers must deal with higher input costs and lower prices for their produce. Because there are few marketing options, farmers' lack of bargaining power further reduces prices. Poor-quality roads may also limit access to extension services and lower the quality of produce that reach their destinations because of the multiple transport modes needed to reach markets, from animal-drawn carts to trucks. As a result, poor transportation options reduce the opportunities for farmers to diversify into higher-value perishable crops and invest in productivity or quality-enhancing improvements. Also, a large portion of produce is wasted because it is not possible or economically feasible to transport it without access to quality roads.⁸⁹ Improved connectivity would also benefit rural societies by facilitating the access to social services and encouraging higher school attendance. In the Philippines, road investment complemented by investments in education has had a significant direct and indirect impact on the welfare of the poor.⁹⁰ Agro-enterprises in areas with limited connectivity have higher costs for collecting produce, higher physical and product quality losses, and greater difficulties in achieving the scale required for the efficient use of processing facilities. Consumers relying on these producers are confronted by higher food prices, reduced scope for dietary diversity and good nutrition, and increased exposure to food safety risks.

Improving Power and ICT Infrastructure

71. Daily power outages, together with logistics problems and armed conflict, are a huge cost to businesses and cited as a top binding constraint for investing in Mindanao. Scheduled power outages due to insufficient generation averaged three hours a day in major cities in 2015. Occasional unscheduled shutdowns and maintenance of power plants can add up to four hours,⁹¹ and transmission repairs due to bombings can take weeks.⁹² Besides disrupting work, power outages and fluctuations can damage machinery and equipment. The total cost for three months of power outages during the peak of the 2013 Mindanao power crisis amounted to an estimated Php600 million for businesses in Zamboanga City,⁹³ and the cost was estimated at Php42 billion (0.3 percent of Philippine GDP) for power outages in Davao City in 2015.⁹⁴

72. Efficient and affordable Internet service has the potential to transform Mindanao in the same way it transformed Manila. Davao has emerged as Mindanao's IT-BPO hub⁹⁵ and Cagayan de Oro has been identified as a potential destination. In 2015, there were 104 firms involved with IT-BPO in Davao and Cagayan de Oro, employing a total of 35,389 workers. Other major cities, such as General Santos and Iligan, are marketing themselves to attract technology firms. Yet Internet speeds in Mindanao are much lower than in the rest of the country and significantly lower than in Metro Manila.⁹⁶ In cities throughout Mindanao, average Internet speeds range from 141 kbps in Marawi⁹⁷ to 2.4 mbps

⁸⁹ For example, coconut water is dumped to lighten the coconuts carried by horses or people in Mindanao. In Sulu, because of poor roads and the high cost of shipping, many fruits are left to rot on farms despite high urban demand (e.g., mangosteens).

⁹⁰ For an extensive discussion, see Balisacan and Pernia 2002.

⁹¹ For example, in early 2016, a seven-day corrective maintenance of a unit of the Therma South coal-fired plant in Davao City led to daily brownouts lasting three to four hours (Lacorte 2016).

⁹² For example, the November 2015 bombing of transmission lines in Marawi City shut out power from the Agus-1 and Agus-2 hydroelectric power plants for more than two weeks (Manar 2015).

⁹³ This is double the amount of business taxes paid by Zamboanga businesses in 2014. A major hospital spends an additional Php600,000 a month on generators (<http://www.zamboangachamber.com/home/articles/172--the-cost-and-effect-of-the-power-crisis-on-businesses-and-residents-of-zamboanga-city>).

⁹⁴ The Chamber of Commerce estimates the hourly cost of power outages at Php80 million, as reported in the Inquirer article by de Quiros (2016). The cost for 2015 assumes two hours of power outages a day x 260 work days x Php80 million = Php41.6 billion.

⁹⁵ The 2015 Tholons top 100 outsourcing destinations in the world ranked Davao 69th among 100 cities. Davao is also in the 10 "next wave" cities for the IT-BPO industry. This recognition has already helped it attract a number of large IT-BPO firms.

⁹⁶ In the absence of official data, a third-party website (www.testmy.net) was used to record Internet speeds. Individual speed-test results from each city are averaged. This method depends on the plan of each user who conducted the speed test. The plans are assumed to be fairly similar.

⁹⁷ Residents of Marawi have to go some 38 km to Iligan to send large files.

in Cagayan de Oro, compared to 3.6 mbps in Makati.⁹⁸ It appears that Davao users have to pay about 1.5 times more to get the same speed as in Makati, and Marawi users have to pay 26 times more. A dedicated line can cost up to Php20,000 per month for each additional 1 mbps of speed, compared to Php700 for a residential line with no speed guarantee.

Supporting Private Investment: Skills Development, Easing of the Regulatory Burden, Better Access to Finance, and Improving Land Management

73. Despite heavy demand, skills shortages are slowing the expansion of the IT-BPO industry. The Davao ICT council estimated about 5,000 job vacancies in 2015, but the industry could not fill them even though 20,000 students graduate from college⁹⁹ in Davao City and surrounding provinces every year.¹⁰⁰ Most applicants in Davao are rejected for lack of both soft¹⁰¹ and technical skills.¹⁰² This results in a supply gap of 70 percent in Davao's ICT sector and 40 percent in Davao's BPO industry.¹⁰³ This is less of a problem in Cagayan de Oro because its industry is much smaller. A shortage of engineers is also affecting manufacturing, construction, and utility firms in Mindanao.¹⁰⁴ The construction sector is hard-pressed to find civil, electrical, design, planning, and contract engineers. Moreover, the manufacturing sector is seeking mechanical, chemical, and industrial engineers. Business chambers confirm a lack of engineers in Mindanao, as the few engineering graduates tend to leave Mindanao for jobs in Manila or overseas. As leading cities in

Mindanao transform into manufacturing and high-skill services economies, skills will become even more important. The major causes of these skills shortages are too little investment in basic education, inadequate training programs, and the migration of skilled workers.

74. As in the Philippines in general, cities in Mindanao tend to perform worse on Doing Business indicators than other East Asian cities. For instance, the two best performers in Mindanao, General Santos and Davao, ranked 124th and 125th, respectively, among 151 economies (Quezon City was 128th) for starting a business (Singapore was 1st, Thailand 59th, and Malaysia 71st). A number of reasons explain the high cost of starting and maintaining a business. First, many government agencies at both the national and the local levels are involved in starting a business, and several private sector providers (e.g., bookstores, banks, etc.) are also involved, but there is lack of coordination. Second, one-stop shops and process automation are limited, especially in Mindanao where Internet service is slow. Third, several steps, such as securing an import permit and getting Securities and Exchange Commission (SEC) approval, take several days because processing is done in Manila or in a regional center (e.g., SEC registration of Iligan firms is done in Cagayan de Oro, which is 90 km away). Finally, most agencies have yet to shift from annual renewals of licenses to less frequent renewals, such as every three years for low-risk businesses.

⁹⁸ Source: www.testmy.net. 2012 is the latest data.

⁹⁹ Since 2010, the average number of graduates in the Davao Region (Region XI) is around 20,000 (CHED Higher Education Facts and Figures: <http://www.ched.gov.ph/central/page/ched-statistics>).

¹⁰⁰ High attrition rates are also a problem. A study by IBPAP and TeamAsia (2014) estimates the attrition rate of IT-BPO firms at 15 percent. In addition, about 18 percent of employees leave the industry as a whole each year (IBPAP).

¹⁰¹ Soft skills include critical thinking, communication, and teamwork. Results of the Global Competitiveness Assessment Tool, an industry-benchmarked assessment system used by BPO companies, show that the average scores of most schools are below the industry benchmark range. In particular, schools score below the range in learning ability, English language proficiency, perceptual speed and accuracy, and behavioral skills. On basic skills, 60 percent of test takers score below the 30th percentile. On behavioral skills, 70 percent of test takers score that low.

¹⁰² For more information, see DOST-ICTO and IBPAP (2014).

¹⁰³ Estimates from Carillo (2013).

¹⁰⁴ For more information, see the Department of Labor and Employment (DoLE), 2010.

75. Mindanao's economy constitutes 15 percent of the national GDP but receives only 3 percent of total credit granted in the country. Eighty seven percent of credit granted by banks in the Philippines is concentrated in the national capital region. Mindanao's low share of credit compared to its contribution to GDP is similar to the situation in the Visayas and Luzon. Bank credit tends to be concentrated in metropolitan areas which are also centers of economic activity. This pattern is repeated in Mindanao, where Davao receives 27 percent of all credit in the region, and Davao, Cagayan de Oro, and General Santos together represent up to 52 percent of all credit in Mindanao. However, statistics on credit reported by banks may not fully reflect its geographical destination because many banks process loans, especially for large commercial borrowers, in their regional or main offices.

76. Residents in Mindanao are on average less likely to use financial services by banks and instead rely more on microfinance organizations and cooperatives. Forty three percent of Filipinos report having used a bank in Mindanao, including ATMs, compared to 57 percent in Luzon and 35 percent in the Visayas. In Mindanao, 36 percent of residents use microfinance organizations and 21 percent use cooperatives.¹⁰⁵ However, 34 percent of residents report using informal credit and 28 percent have some savings, which suggests a possible demand for formal financial services.

77. Agricultural businesses throughout the country have similar financing problems, but instability in Mindanao is an additional deterrent. There is high risk involved in providing finance to businesses in smallholder agriculture, especially when land rights are not secure. While changes in national policies could increase lending to the agricultural sector nationally, several specific policies could help

increase lending in the conflict-affected areas of Mindanao.

78. Financial inclusion and better access to financial services constitute one element of the broader development effort envisaged to lift economic performance in the ARMM. The National Strategy for Financial Inclusion, which was adopted in 2015, creates a framework for efforts to boost financial inclusion throughout the Philippines. A range of policy and regulatory actions, financial education, and consumer protection programs and advocacy initiatives can improve prospects for financial inclusion in ARMM. However, there is also a need for interventions specifically tailored to the region considering its specific challenges.

79. Inadequate land-use planning and zoning is impairing the quality of life in Mindanao's fast-growing cities. The region's city centers are becoming congested and polluted, and informal settlement enclaves are multiplying. Public administration is finding it hard to cope with the growing demand for services, and infrastructure investments and regulation of land use for housing, commerce, and industry is becoming more challenging to coordinate. While several of Mindanao's cities are beginning to proactively update their comprehensive land use plans, recent accelerated growth will require more regular updates than the five years mandated by the Local Government Code.

80. The registry of land transactions does not reflect reality. An estimated 10 to 20 percent of transactions are not registered mainly because of the high costs (formal and informal) of transferring¹⁰⁶ and registering a property. In 2011, the time and cost involved in registering a property in Mindanao's cities were the highest in the Philippines. Moreover, access to reliable and current information

¹⁰⁵ BSP National Financial Inclusion Baseline Survey, 2015.

¹⁰⁶ This was estimated by local registrars and assessors. The cost is driven by a number of taxes and fees: capital gains, transfer, and documentary stamp taxes, and registration and survey fees. Often, the magnitude of back taxes deters people from registering.

from the registry is costly. The Land Titling Computerization Project has ironically made accessing land records very expensive even for government offices fulfilling their mandates, and it has contributed to delays in registering new titles and transactions. The result is missing, outdated, inaccurate, and costly land

records that reduce incentives to develop land, hold back formalization, prevent small and medium-sized enterprises from accessing formal credit, slow infrastructure projects with right-of-way issues, and complicate community mortgage programs for buying land.

3.3 Economic Policies to Reduce Conflict

81. Though the long-standing armed conflicts affecting parts of Mindanao can only be resolved by political solutions, economic policies can help reduce conflict. Dealing with historical injustices and recognizing cultural minorities is essential for peace and reconciliation. However, the government's peace and development roadmap sets out ways to also overcome the drivers of conflict. This section offers a series of recommendations to tackle these drivers as a complement to a political solution.

82. Violent conflict in Mindanao is complex and affects large areas. The state is engaged in peace processes with two groups: Moros fighting for self-determination and communists fighting for ideology and against poverty and inequality.¹⁰⁷ Violence can occur between political dynasties, communities (e.g., Moros versus indigenous peoples, Christians, or other Moros), and clans, and with criminal, terrorist, kidnap-for-ransom, and other armed groups. Of Mindanao's six regions, conflict is most prevalent in the ARMM, the Zamboanga Peninsula Region, and the Caraga Region.

Almost 60 percent of Mindanao's 455 cities and municipalities and 13.6 million people (62 percent of the population) are directly affected by conflict.¹⁰⁸ In conflict areas, farmers often produce at subsistence levels and businesses remain small to escape being noticed.¹⁰⁹ About 63 percent of the people in areas affected by conflict live below the poverty line,¹¹¹ and ARMM has the highest poverty incidence among Mindanao's regions. The provinces that became part of the ARMM decades ago were once the richest region of Mindanao but are now the poorest.

83. Land disputes result in conflict.¹¹² Two factors explain the prominence of land disputes among Moros and indigenous people: (i) the legacy of resettlement and land programs from the 1900s to the 1980s¹¹³ and (ii) magnified effects of overlapping legal frameworks for land. The first largely affects the Moro people and the second the indigenous people. Dispossession of the original inhabitants of Mindanao came in four waves: (1) from the end of Spanish rule in 1898 to the end of the Philippine Commonwealth in 1946; (2) the early years of

¹⁰⁷ Some groups, however, are little more than extortionists fronting as a communist insurgency.

¹⁰⁸ Sources include the Bangsamoro Conflict Monitoring System (BCMS), supplemented by field consultations and research.

¹⁰⁹ Fear of kidnapping or extortion keeps businesses small and capital mobile. Most produce is sent to processing centers outside of ARMM to places like Davao, Cebu, and Zamboanga. In 2015, there were only 13 large companies registered in mainland ARMM; they were engaged in agricultural planting and processing, or biomass energy production (data provided by the ARMM Regional Board of Investments; a large establishment is defined as one that employs at least 200 persons).

¹¹⁰ World Bank staff estimates based on the BCMS, census of population and housing, and small area estimates of poverty.

¹¹¹ Growth in the Caraga and Davao regions has been higher than in the ARMM due to less intense conflict, a more predictable conflict environment, and a mining boom.

¹¹² This section draws largely from the World Bank and International Organization for Migration (2017). It also draws from LGI (2016). Floradema Eleazar is the main author under the guidance of Thea Hilhorst.

¹¹³ Unlike the Spanish and American colonization of the Philippines, the "colonization" of Mindanao by Manila was fairly recent, and there are people still alive who speak of how their land was taken from them.

the third republic from 1946 to the late 1960s; (3) the martial law years from the 1970s to the mid-1980s; and (4) the comprehensive agrarian years from the late 1980s to the present. Each was characterized by a policy instrument driven by the political and economic agenda of the central government. The magnified effects of overlapping legal frameworks grew from Mindanao's unique socio-geology that creates multiple rights over the same plot of land. The Philippines has eight separate land laws, with significant overlap and no clear rules of precedence, that are the responsibility of five offices in four agencies, often without coordination.¹¹⁴ The situation is exacerbated by unique socio-geological features that disproportionately impact indigenous people.

84. Land dispossession and conflict are aggravated by policies and developments that have disregarded traditional institutions based on communal ownership of land. Among them are (1) poor land administration and management that results in the approval of conflicting and multiple rights over the same plots (all with legal anchors, although not all are necessarily seen as fair); (2) cadastral surveys that cause conflict; (3) land dispute systems favoring “confrontational” judicial mechanisms that ignore customary approaches such as mediation by leaders; (4) excessive accumulation of land by the new political elite and commercial interests in mining and logging; and (5) displacement of people due to violent conflict and environmental factors. There is a strong case to be made to complement, or even trump, conventional solutions to land problems by solutions that address the core reason for grievances and are sympathetic to local customs.

85. Mass displacements have exacerbated the welfare impact of conflict. In August 2014,

there were almost a million internally displaced persons in Mindanao according to the United Nations High Commissioner for Refugees. Some 41 percent of the population in mainland ARMM and adjacent provinces have been displaced at least once, with many suffering far more often. Millions have migrated from Basulta and central Mindanao to safer areas in the Philippines and neighboring Sabah in Malaysia. The Malaysian government estimates that there were 470,000 Filipinos in Sabah in 2015. However, unofficial sources put this number at about a million, of which 25 percent were considered “stateless”, i.e., they did not have birth certificates or passports to prove their nationality, which reduces their access to jobs and services and increases their vulnerability to exploitation.

86. Violent conflict has had a major impact on growth and poverty levels throughout Mindanao. Concerns over security have depressed tourism and boosted the emigration of skilled workers. The reputational damage caused by insecurity has even reduced investment in areas relatively unaffected by violence. These areas also bear the fiscal burden of coping with displaced persons. On the other hand, more peaceful areas have benefited from opportunities to process agricultural produce from conflict-affected areas, where processing facilities are rare. Many skilled workers from conflict-affected areas have also migrated to other regions of Mindanao.

87. Economic policy can support the resolution of conflicts. The issues at the root of the conflicts, in particular a deep sense of injustice as a result of greatly unequal political and economic power and longstanding grievances over land dispossession, can only be resolved by a political settlement. It is clear, however, that poverty and economic hopelessness in conflict-affected areas help

¹¹⁴ These are the Public Land Act of 1936 (Commonwealth Act 141), Forestry Code of 1975 (Presidential Decree 705), Comprehensive Agrarian Reform Law of 1988 (Republic Act 6657), People's Small-Scale Mining Act of 1991 (RA 7076), Local Government Code of 1991 (RA 7160), National Integrated Protected Areas System Act of 1992 (RA 7586), Mining Act of 1995 (RA 7942), and Indigenous Peoples' Rights Act of 1997 (RA 8371). They are implemented by the Land Management Bureau and Forest Management Bureau in the DENR, Land Registration Authority in the Department of Justice (DOJ), the Department of Agrarian Reform (DAR), and the National Commission on Indigenous Peoples (NCIP).

perpetuate conflict, as individuals without land or work opportunities are driven to join armed groups to survive or seek social status. Discontent arising from social injustice and discrimination in the distribution of economic opportunities and development resources can also fuel violence. Thus, this report focuses on two major supports for peace: providing

alternative income sources and improving the delivery of basic services, particularly in areas that have been neglected. Although such policies cannot resolve conflicts on their own, they can facilitate peace by creating economic opportunities and demonstrating government effectiveness in improving welfare.

3.4 A Regional Development Strategy for Mindanao

88. Reducing poverty and delivering on the new Philippine Government Strategic Framework for Mindanao Peace and Development will demand a new form of engagement in Mindanao. The strategic framework recognizes that there are “two Mindanaos”: one that can be characterized as relatively stable and prosperous and another one that is suffering pervasive poverty, violent conflict, and poor governance. To address the goal of a peaceful, cohesive, secure, and inclusively developed Mindanao, the framework calls for five linked strategic outcomes: resilient communities built; effective governance promoted; inclusive economic growth and jobs ensured; security environment stabilized; and the consensus for peace strengthened.

89. The World Bank has created a strategy for regional development in Mindanao. This builds on a dialogue with the Philippine government and local stakeholders. The three main components are: (1) raise agricultural productivity and improve farm-to-market connectivity; (2) boost human development; and (3) address drivers of conflict and fragility while building up institutions in ARMM and other conflict-affected areas.

90. Mindanao's comparative advantage lies in agriculture, yet its full potential is not being realized mainly because productivity remains low. Agriculture and related services and industries account for 60 percent of Mindanao's GDP and 57 percent of its employment.

Mindanao accounts for 40 percent of the country's total agricultural output and 60 percent of all agricultural exports. However, only 16 percent of Mindanao farmers produce a marketable surplus, and more than half of farm households are poor. Also, rural underemployment is high, and many farmers are neither organized nor linked to value chains. With a few exceptions (e.g., bananas) the sector's once vibrant growth has stalled.

91. There is domestic and foreign market potential for Mindanao's agricultural products (Box 12). First, there is scope to supply more rice and maize to the other islands of the Philippines as food or feed ingredients. Although Mindanao accounts for a high proportion of national food production, it is only tenuously linked to the national market, limiting its contribution to national food security. This is a missed opportunity for both Mindanao and the country. There is also an emerging opportunity to cater to growing urban demand within Mindanao for higher-value perishable meat and vegetables. Realizing the domestic market potential will depend on addressing limited connectivity to give farmers better access to markets both within Mindanao and beyond. Finally, there is an opportunity to expand the production of exportable agriculture products: aquatic, coffee, and coconut products. This involves linking farmers more closely with enterprises, as it is primarily agribusinesses that have the opportunity to differentiate or diversify product lines.

92. Limited connectivity constitutes a major constraint for growing the agricultural sector.

Farmers are disconnected or misconnected with technical service providers, agro-enterprises, markets, and consumers, a problem that has multiple consequences (Table 7). Many roads are in bad condition or congested, resulting in rejected agricultural produce, especially perishable commodities like bananas and other fruits and vegetables. Beyond the lack of

adequate farm to market roads, there is a need to prioritize modernization efforts to relieve congestion on roads accessing ports for more connectivity beyond Mindanao. Moreover, Mindanao ports lack economies of scale: there are some 690 ports in the region, yet the top four ports handle only 17 percent of domestic cargo and 12 percent of foreign. Many ports are owned by private companies and are closed to smaller farmers.

Box 12 The market potential of agriculture in Mindanao

Mindanao is considered the agricultural basket of the Philippines, producing a diverse set of crops and serving both local and international markets. Of the three island regions, it accounts for the largest share of agricultural production and contributes significantly to national food security. For example, it produces about 50 percent of national corn production. Also, it produces most of the country's high-value crops: about 80 percent of bananas and coffee and over 60 percent of coconuts. In addition, Mindanao contributes a significant share of the country's key commodity contributions to total world export volume. Its bananas, pineapples, and coconuts comprise about a third of world export volumes.¹¹⁵ However, Mindanao's agricultural sector has not realized its potential.

A number of Mindanao's agricultural products could extend their shares in both domestic and international markets. An analysis of about two dozen value chains in Mindanao reveals that some products, such as coffee, aquatic products, seaweed, and coconut, appear to have considerable market potential, either for more effectively serving nearby urban centers or for expanding in markets abroad.

Ramping up coffee production in Mindanao could also address the demand for domestic consumption of currently imported coffee products. In recent years, domestic coffee consumption rose significantly to about 130,000 metric tons of coffee in 2015—more than double the consumption in 2007. Until the 1990s, the Philippines was a major exporter of coffee beans, but domestic production steadily fell following a sharp decline in prices. Today, green coffee is among the country's top 10 agricultural imports. For Mindanao, where about two-thirds of national coffee production takes place, there is a potential to expand to coffee processing, such as the production of instant coffee, given that 95 percent of all domestically consumed instant coffee is imported.

Aquatic products like milkfish, tilapia, and seaweed could serve wider domestic and international markets. According to the Food and Agriculture Organization, the Philippines ranks among the top 20 global producers of fish, crustaceans, and mollusks, accounting for about 1 percent of total global production; Mindanao contributes already nearly half of total domestic production. Domestically, milkfish and tilapia are central items in the Filipino diet, yet Mindanao's contribution to milkfish and tilapia production is about 15 and 7 percent, respectively.

¹¹⁵ Export volume estimates were generated using the World Integrated Trade Solution (WITS) database.

In terms of the aquatic export markets, seaweed has the most market potential for Mindanao.

The Philippines ranked 3rd globally in production of aquatic plants, with 5.7 percent of total world production in 2014. Mindanao accounts for more than half of total Filipino production and most of it takes place in the ARMM. Moreover, seaweed, as an aquatic export, is second only to tuna in terms of value, accounting for US\$202 million—about 20 percent of total export earnings for fisheries in 2015. There is heavy demand from international markets for seaweed, from which carrageenan is extracted for use as an additive, binder, and emulsifier in the food, pharmaceutical, beverage, and cosmetic industries.

The coconut industry represents a growth opportunity for Mindanao and a chance for its poorest farmers to establish linkages with enterprises.

The Philippines is the second largest producer of coconuts in the world. In 2015, coconuts accounted for about 40 percent of total export earnings and over 60 percent of those coconuts came from Mindanao. In recent years, international demand has outstripped supply because of the proliferation of coconut byproducts, such as virgin coconut oil, coco sugar, and copra. As a result, there is an opportunity to expand Mindanao's coconut-related agribusiness for both domestic and export markets.

Table 7: Effects of poor connectivity on farmers, agribusiness, and consumers

Farmers	Agribusiness	Consumers
Reduced terms of trade (higher input costs and lower produce prices)	Higher aggregate cost for produce	Higher food prices for both staples and non-staples foods
Reduced marketing options and less bargaining power	Higher physical and product quality losses	Reduced scope for dietary diversity and improved nutrition
Reduced incentives to invest in higher on-farm productivity	Difficulties in realizing scale benefits and utilizing processing capacity	Increased exposure to food safety risks
Minimal scope to diversify into higher-value perishable products	Inability to service national markets	
Dulled incentives for producing higher-quality products and frequent rejections	Reduced export competitiveness and profitability	

93. Customs procedures are a major bottleneck to trade facilitation, especially for agricultural products. On the Doing Business indicator for Trading Across Borders, the Philippines ranked 95th in 2016¹¹⁶, one rank lower than in 2015. The World Bank Logistics Performance Index ranks the country at 71st, down from 85th in 2014, with a ranking of 78th for Customs and Border Management, 31 points lower than in 2014.

94. Protracted land disputes and conflict have deterred investments in agriculture, slowing job creation and poverty reduction. Favorable climatic conditions, the presence of Lake Lanao and the Liguasan Marsh, and the impact of climate change elsewhere in the country have encouraged large firms based in Davao and Cagayan de Oro to extend their operations to Lanao del Sur and Maguindanao through contract-growing agreements with smallholders. However, a large majority of

¹¹⁶ World Bank, 2016a.

prospective investors are deterred by unclear and overlapping property rights, and even current investors are deterred from expanding their operations. Land disputes can easily turn into violent confrontation and inter-elite clashes, which can destroy inventory, delivery, and production schedules. In some cases, the potential for profit from large pineapple and banana farms has led elites to dispossess smallholders as they consolidate lands for contract growing.

95. The proposed strategy is designed to support Mindanao's comparative advantage and strengthen its linkages with the entire region. It identifies three priorities to unlock agriculture potential and streamline farm-to-market connectivity: 1) raise farm productivity, 2) develop the transport network, and 3) build up ports and improve customs (Figure 45).

96. Connectivity bottlenecks are compounded by skills deficits. Over 80 percent of Mindanao's farmers and fishermen are poor or near-poor, lacking scale and skills to compete. People with more education in Mindanao, especially in ARMM, see few prospects for wage gains. To maximize human development and productivity in Mindanao, weaknesses need to be addressed in both basic education and skills & employment development. The approach needs to especially target the youth in conflict-affected areas.

97. Resolving conflict in Mindanao rests on addressing the causes of conflict and providing jobs and economic opportunities as alternatives to violence. The proposed framework builds on the 2011 World Bank *World Development Report* on conflict, security, and development. Breaking the cycle of insecurity and reducing the risk of its recurrence require restoration of confidence in collective action and transforming institutions to provide a sustained level of security, justice, and jobs. "Restoring confidence" requires deliberate efforts by both state and private actors from the national to the community level in order to launch the initial stages of confidence-building and institutional transformation and secure early gains. "Transforming institutions" requires giving early priority to actions to reform the institutions responsible for citizen security, justice, and jobs.

98. Creating jobs is central to stabilize and normalize conflict areas. First, jobs address one of the root causes of conflict, which is a lack of employment opportunities that drives many, particularly combatants and out-of-school youth, to desperation. Without prospects for earning a decent income, the unemployed (especially the young) become pessimistic about the future. Second, when employment opportunities are available, recruitment by rebel or criminal elements promising better income becomes less attractive. Third, jobs give individuals a sense

Figure 45: How to unlock Mindanao's agriculture potential



of being part of the society as they share in its benefits. Finally, if individuals feel that they belong to the society, they will have a greater stake in its preservation and have more to lose, especially their jobs and goals of a better future, if conflict breaks out.

99. However, job creation will not be enough. Where the cause of conflict is not economic, such as the struggle for identity or self-rule, economic measures alone will not be enough to resolve the conflict. In Mindanao, peace and development will hinge on a political solution that can successfully address the causes of violence—injustice, inadequate governance, land dispossession, discrimination, and sociocultural marginalization. Inclusive job creation can support peace by providing equitable access to economic opportunity for all, even those in remote, conflict-affected communities.

100. Supporting the transformation of institutions will not be simple and cannot be done quickly. There will be no single “make or break” moment; it will take a series of self-reinforcing actions to restore confidence and gradually build effective institutions. Violence prevention and recovery is only possible if it is recognized that security, justice, and economic stresses are linked. As a result,

a specialized suite of programs is needed in fragile environments that combines elements of security, justice, institution building, and economic transformation. In addition to making agriculture more productive, improving farm-to-market connectivity, and promoting human development, it will be necessary to build up institutions in the ARMM and other conflict-affected areas and address the less obvious drivers of conflict and fragility. One aspect is to support resilient communities and responsive local governments. Another is to promote citizen security through supporting normalization processes and promote justice by addressing land conflicts.

101. The proposed strategy could have wide-ranging benefits to the Philippines. These range from nationwide improvements due to customs reform and the ability of subsistence farmers and day laborers in poor areas to access farm-to-market roads to youth enrolling in job-training programs. It will also transcend the divide between non-conflict and conflict-affected areas in Mindanao and support interventions to promote peace and socioeconomic development as well as longer-term economic development opportunities that would help reduce the risk of conflict in the future. The proposed strategy will guide the World Bank's engagement in Mindanao.

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ANNEX

Table A.1: Key economic indicators (2015 to 2019)

	2015	2016	2017	2018	2019
	Actual		Projected		
Growth and inflation	<i>(in percent of GDP, unless otherwise indicated)</i>				
Gross domestic product (percent change)	6.1	6.9	6.6	6.7	6.7
Inflation (period average)	1.4	1.8	3.0	2.6	2.8
Savings and investment					
Gross national savings	24.9	24.8	25.6	26.9	30.6
Gross domestic investment	22.0	24.6	25.8	27.2	31.1
Public sector					
National government balance (GFS basis) ^{1/}	-1.0	-2.5	-2.5	-2.6	-2.9
National government balance (gov't definition)	-0.9	-2.4	-2.4	-2.5	-2.8
Total revenue (government definition)	15.8	15.2	15.8	16.3	16.8
Total spending (government definition)	16.7	17.6	18.2	18.8	19.6
National government debt	44.8	42.0	41.8	41.2	40.8
Balance of payments					
Merchandise exports (percent change)	-13.3	0.6	12.5	9.8	9.9
Merchandise imports (percent change)	-1.0	16.6	17.3	17.8	18.4
Remittances (percent change of US\$ remittance)	4.6	4.9	5.3	5.5	5.5
Current account balance	2.9	0.2	-0.2	-0.3	-0.5
Foreign direct investment (billions of dollars)	5.7	7.9	7.5	7.7	8.1
Portfolio Investment (billions of dollars)	-0.6	0.4	0.5	0.7	0.8
International reserves					
Gross official reserves ^{2/} (billions of dollars)	80.7	81.1	80.5	80.7	81.2
Gross official reserves (months of imports) ^{3/}	10.1	9.2	8.6	8.6	9.0
External debt^{4/}	26.5	24.6	24.1	23.7	23.4

Sources: Government of the Philippines for historical and World Bank for projections

^{1/} Excludes privatization receipts and includes CB-BOL restructuring revenues and expenditures (in accordance with GFSM).

^{2/} Includes gold.

^{3/} Defined as the total of goods and services imports.

^{4/} Central Bank definition.

Table A.2: National government cash accounts (GDS basis) (2016-2018)

	2015	2017	2018
	Actual	Estimate	Budget
	<i>(in percent of GDP, unless otherwise indicated)</i>		
Revenue and grant	15.2	15.8	16.3
Tax revenue	13.7	13.8	15.3
Net income and profits	6.4	6.4	6.4
Excise tax	1.1	1.3	1.4
Sales taxes and licenses	2.3	2.4	2.5
Others	1.1	1.1	0.9
Collection from customs	2.7	2.8	3.6
Nontax revenue ^{1/}	1.5	1.9	1.0
Grant	0.0	0.0	0.0
Total expenditure	17.6	18.2	19.3
Current expenditures	13.2	13.3	13.4
Personnel services	5.2	5.2	5.13/
MOOE	2.9	3.1	3.2
Allotment to LGUs ^{2/}	2.4	2.4	2.4
Subsidies	0.5	0.5	0.7
Tax expenditures	0.0	0.0	0.0
Interest payment	2.1	2.3	2.0
Capital outlays	4.4	4.8	5.8
Net lending	0.1	0.1	0.1
Balance (GFS definition)	-2.5	-2.5	-2.6
Balance (GOP definition)	-2.4	-2.4	-2.5
Primary Balance (GFS)	-0.3	-0.1	-0.5
<i>Memorandum items</i>			
Privatization receipts (PHP billions)	0.7	2.0	2.0
Nominal GDP (PHP trillion)	14.5	15.9	17.5

Sources: Department of Finance, Bureau of Treasury, and Department of Budget and Management, and World Bank staff calculations

^{1/} Excludes privatization receipts (these are treated as financing items in accordance with GFSM).

^{2/} Allocation to local government units (LGUs) excludes capital transfers, which are included in capital outlays.

^{3/} Based on national government cash budget. On an obligation basis, personnel services make up 6.2 percent of GDP.

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