Preface

The Philippines Quarterly Update provides an update on key economic developments and policies over the past three months. It also presents findings from recent World Bank work on the Philippines. It places them in a longer-term and global context, and assesses the implications of these developments and other changes in policy for the outlook for the Philippines. Its coverage ranges from the macro-economy to financial markets to indicators of human welfare and development. It is intended for a wide audience, including policy makers, business leaders, financial market participants, and the community of analysts and professionals engaged in the Philippines.

The Philippines Quarterly Update is a product of the World Bank’s Philippines Poverty Reduction and Economic Management (PREM) team. It was prepared by Eric Le Borgne (Senior Country Economist and task team leader), Sheryll Namingit, and Marianne Juco, under the general guidance of Ulrich Lächler (Lead Economist). Special Focus contributors include Fabrizio Bresciani for the section on food prices in the Philippines, Eric Le Borgne for the section on fiscal risks, and Soonhwa Yi for the section on exports of services. Annalyn Sevilla contributed to the 2011 budget analysis. Comments from the International Monetary Fund are gratefully acknowledged. The findings, interpretations, and conclusions expressed in this Update are those of World Bank staff and do not necessarily reflect the views of the Executive Board of The World Bank or the governments they represent.


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Executive Summary

Following a slowdown during the global financial crisis in 2009, the Philippine economy roared back in 2010, with GDP growth rates not seen in over 30 years. On the demand side, private consumption, investment, and net exports were the main drivers of growth. On the supply side, industry and services propelled the economy. The external position continued to strengthen, thanks to a consistently strong current account and, more recently, by improvements in the capital and financial account. Dollar remittances grew progressively faster throughout 2010. Labor market conditions improved, but unemployment remains high, contributing to strong OFW deployment. Growth is expected to normalize around its potential output in 2011 as the technical and temporary factors that generated record growth in 2010 disappear.

In spite of the remarkable rebound, growth continues to bypass the poor. The latest official poverty data confirm a lack of poverty reduction response to economic growth in the Philippines. Even though real GDP growth averaged 5.4 percent during 2003-06 and 4.3 percent during 2006-09, or well above population growth, the poverty incidence rose from 24.9 percent of the population in 2003 to 26.4 percent in 2006, and inched up further to 26.5 percent in 2009. Such an inelastic poverty response suggests that the gains from growth have eluded the bottom quarter of the population. SWS surveys in 2010 paint a broadly similar picture. A bright spot amidst these generally depressing poverty numbers, is that they point to some distributional improvement within the ranks of the poor as the poverty gap began to decline between 2006 and 2009. The rapid expansion of the 4Ps conditional cash transfer program may have contributed to this improvement and its recent scale-up in the 2011 budget bodes well for the fight against poverty.

In contrast to many countries in the region, food price inflation has been muted so far in the Philippines and is expected to remain moderate in 2011, though the distribution of risks is tilted to the upside (Special Focus #1). In the short-term, a return of a 2008-style food crisis in the Philippines seems unlikely, thanks to recent strong domestic palay production, good planting projections, record stockpiles of rice, and domestic retail prices significantly above international prices. For now, international rice prices remain stable. Food prices are nonetheless expected to rise moderately. Risk factors that could worsen this outlook include severe weather events that would disrupt domestic food supply and further sharp rises in international oil prices.

Monetary policy is projected to tighten gradually in the second half of 2011, as demand pressures currently are limited and inflation expectations remain within the BSP target band. Overall, the BSP is expected to continue to maintain an accommodative policy—real interest rates have been negative since April 2009. Despite a gradual policy tightening, we project inflation to move towards the upper band of the BSP’s target band in 2011 (any global food and fuel supply shocks would push inflation beyond the upper band). Bucking the trend towards capital controls elsewhere, the BSP successfully intervened in the foreign exchange market in late 2010 (using its forward book) to smooth what it deemed as excessive volatility in the Peso.

The Aquino government’s steadfast focus on efficient spending reigned in the initially spiraling 2010 budget deficit and has set the stage for a moderate degree of fiscal consolidation in 2011. A sharp fiscal tightening took place in the second half of 2010, thanks to spending restraints in the face of modest revenue improvements. In 2011, fiscal consolidation will be mostly driven by structural improvements—the first improvement in the structural balance in five years—as the 2011 budget kick starts important reforms in spending efficiency and transparency. Now that the global recession is largely behind us, a faster unwinding of the fiscal stimulus would have the advantage of lower peso appreciation pressures, less risk of overheating the economy and creating inflationary pressures, more fiscal space, and higher resiliency to shocks for the economy.

Among its first actions in office, the Aquino government carried out a comprehensive assessment of fiscal risks and published a Fiscal Risk Statement (FRS)—(Special Focus #2). Experience reveals that FRs can yield important benefits, including lower and better-managed risks, improved policies, and lower financing costs. Historically, the Philippines has been exposed to considerable fiscal risks, in part reflecting important weaknesses in public financial management and resulting in large fiscal costs. While fiscal risks have abated, they still remain sizeable in the Philippines. To improve its risk management, the government is pursuing a program of institutional capacity building.
Recent Economic and Policy Developments

Output and Demand

1. The Philippine economy re-ignited in the last quarter of 2010, pushing annual GDP growth to rates not seen in over 30 years. After a brief softening of activity in the third quarter of 2010—in which GDP contracted by 0.8 percent quarter-on-quarter, based on seasonally adjusted (q/qsa), the Philippines economy posted a robust growth performance in the fourth quarter with GDP expanding 3 percent q/qsa (7.1 percent year-on-year). This resulted in a 2010 annual growth rate of 7.3 percent, the highest since 1976, and in sharp contrast with the 1.1 growth rate of 2009. Importantly, GDP per capita grew by a strong 5.3 percent in 2010, against a contraction of 0.9 percent in 2009 and growth of 0.1 percent on average during the 1980s and 1990s against 6.5 percent in the region during these same decades (Figure 1 and World Bank, 2010, Philippines: Fostering More Inclusive Growth). The growth performance of the Philippines was also strong in regional comparison (Figure 2).

2. On the demand side, private consumption, investment, and net exports were the main drivers of growth. Private consumption expanded briskly in Q4 2010 (especially food and beverages), contributing 5.7 percentage points to the 7.1 percent GDP growth. For the second quarter in a row government consumption subtracted from growth as the new administration tightened spending to contain the overall deficit and effectively started to unwind the fiscal stimulus (see fiscal section for details)—Figure 3. Improving investor confidence led to strong private investment in both Q4 and 2010 as a whole. Durable equipment grew by double-digit rates in 2010 and 26 percent in Q4, in part due to strong car sales, air transportation equipment, telecommunication equipment and other specialized industrial machineries. Private construction grew by 19 percent in 2010, more than offsetting the fall in public construction. As a result, total investment, as a ratio of GDP, rebounded from the trough reached in 2009, though it still remains low by regional standards (the ratio increased from 14.6 percent of GDP in 2009 to 15.6 percent of GDP in 2010). The rebound in net exports also contributed about 1.3 percentage point to full year growth although growth peaked in the third quarter.

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1 Q3 growth has been revised downward to -0.8 percent q/qsa against -0.5 percent q/qsa initially.
3. On the supply side, the economy was propelled by two relatively balanced engines: industry and services (Figure 4). After spearheading the strong recovery in the first half of 2010, industrial growth moderated in the second half due to the deceleration of manufacturing (mainly food), mining and the contraction of public construction. The services sector has expanded more evenly through the year. Trade, finance, private services and, to a lesser extent, real estate were the top contributor to sector growth. Following four quarters of decline—due to weather-related shocks such as typhoons Ondoy and Pepeng and the El Niño phenomenon—agriculture expanded thanks to a strong palay (rice) season and contributed 1.1 percentage points to overall GDP growth in Q4.

Employment and Poverty

4. The labor market has improved thanks to robust growth but remains structurally weak. Despite the record growth performance in 2010, unemployment afflicted 7.1 percent of the labor force in October 2010, unchanged from October 2009 (Figure 6). Over the same period, underemployment even worsened to 19.6 percent from 19.4 percent. The weak posting of key labor market indicators, however, masks a cyclical improvement in employment prospects as 1.0 million jobs were created in the twelve months to October 2010 (Figure 5). This encouraged 1.1 million workers (new and previously discouraged ones) to join the labor force. The Philippines unemployment and underemployment rates remain high (Figure 6), especially in the regional context.
In spite of the remarkable rebound, growth continues to bypass many poor. The latest official poverty data confirm a disconcerting lack of poverty reduction response to economic growth in the Philippines. From 2003 to 2009, an additional 3.3 million citizens became poor in the Philippines (net basis), pushing the poverty headcount to 23.1 million. This increase nudged poverty incidence from 24.9 percent of the population in 2003 to 26.4 percent in 2006 and 26.5 percent in 2009 (Figure 8). Over 2003-06 and 2006-09, average real GDP growth reached 5.4 and 4.3 percent, respectively. As these growth rates imply a significant increase in real GDP per capita, it transpires that the distribution of the gains from growth have eluded the bottom fourth of the Filipino population. SWS surveys in 2010 paint a broadly similar conclusion (Figure 10). A bright spot amidst these generally depressing poverty numbers, is that they point to some distributional improvement within the rank of the poor: measures of the depth of poverty as well as the income distribution of the poor improved between 2006 and 2009 (Figure 9).

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1/ Income gap (IG): the average income shortfall (expressed in proportion to the poverty line) of families with income below the poverty threshold. Poverty gap (PG): total income shortfall (expressed in proportion to the poverty line) of families with income below the poverty threshold, divided by the total number of families. Both IG and PG are measures of the depth of poverty. Severity of poverty: the total of the squared income shortfall (expressed in proportion to the poverty line) of families with income below the poverty threshold, divided by the total number of families. It is a poverty measure which is sensitive to the income distribution among the poor—the worse this distribution is, the more severe poverty is (NSCB).

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Poverty incidence is the proportion of population whose annual per capita income falls below the annual per capita poverty threshold to the total number of population (NSCB).
Balance of Payments and External Debt

6. The country’s external position continued to strengthen thanks to a consistently strong current account and, lately, by the capital and financial account. The Q3 2010 overall balance of payments surplus grew to 7.2 percent of GDP, pushing the year-to-date surplus to 4.9 percent of GDP (one percentage point higher than in the same period in 2009)—Figure 11. The strong Q3 performance mainly stemmed from a continued steady performance on the current account (5.9 percent of GDP) and a boost in the capital and financial account (2.7 percent of GDP). The latter’s performance was due to the large repayments of loans by non-residents, net loan availments by local banks and private corporations and, to a lesser extent, net placements by non-residents of their currency and deposits in local banks. Direct and portfolio investment to the Philippines remained relatively muted compared to bank lending.

7. The strength of the balance of payments has given rise to a sharp buildup of reserves at the central bank; these now exceeds total external liabilities of the country. Net international reserves have steadily increased through the year but accelerated in the latter part of 2010 to reach $62.4 billion in December and then $63.6 billion in January 2011 (Figure 12). Combined with the central bank’s forward books, these foreign exchange reserves amount to an estimated 43 percent of GDP. These exceed the total external debt (public and private) of the Philippines, which stood at 31 percent as of September 2010 (Figure 13). Gross international reserves in January 2011 covered a comfortable 554 percent of the country’s short-term external debt by residual maturity.

8. The trade deficit narrowed sharply in 2010, to 3.3 percent of GDP, thanks to strong exports and muted imports. Merchandise exports grew by 41.3 percent y/y in Q3 2010 thanks to strong electronic exports. Exports have bounced beyond their pre-crisis levels but the recovery profile is broadly in line with that of key East Asian economies. Imports have not yet recovered to their pre-crisis levels though these contained large fuel and food components. Based on preliminary data, exports growth slowed down to 11.2 percent in November but bounced back to 25.3 percent in December, pushing the year-to-date growth to 34.3 percent. The rapid appreciation of the Peso against the US dollar by about 6.5 percent from July to early November 2010 may also have contributed to the slowdown in exports through its impact on price competitiveness (Figure 15). The movement in the Peso in 2010 was in line with other key currencies in the region so the price competitiveness impact should be limited in the short-term.

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1 BSP definition which differs from the World Bank definition due to (1) gross of branches and offshore banking units of foreign banks operating in the Philippines, which are treated as quasi-equity in view of nil and/or token amounts of permanently assigned capital required of these banks; (2) long-term loans of non-banks obtained without BSP approval which cannot be serviced using the foreign exchange resources of the Philippine banking system; and (3) long-term obligations under capital lease agreements.
9. Dollar remittance growth has gradually accelerated through November 2010; OFW deployment was also strong in 2010 (Figure 14). In nominal dollar terms, the pacing of remittance growth gradually increased from 5.9 percent in May (the slowest growth after typhoon-related remittance surge) to 10.5 percent in November 2010. With strong remittance growth in the last two months of the base year, growth slowed down to 8.1 percent in December pushing full year growth to 8.2 percent from 5.6 percent in 2009. Processed job orders for overseas foreign workers (OFWs) remain strong, growing by an estimated 15 percent in 2010 (POEA data). With the appreciation of the Peso, remittance in real Peso terms declined by 1.4 percent in 2010 in sharp contrast to the 9.6 percent increase of 2009; real peso remittances thereby continue to exhibit a marked counter-cyclical pattern.
Financial Markets

10. Notwithstanding the emerging markets sell-off of early 2011, improved fundamentals and resiliency have pushed the country’s spreads towards historical lows. The improved macroeconomic performance and outlook were strong enough to warrant a rating upgrade from Standard & Poor’s in November 2010, followed by an upgrade in the rating outlook by Moody’s in January 2011. Through 2010, sovereign spreads for Philippine bonds narrowed sharply to 159 basis points (bps) in end-2010 (spreads reached 544 bps in November 2008 from a low of 138 bps in May 2007). Likewise, yields for short-term maturities dropped significantly starting November, with the short-end of the yield curve tilting heavily downwards on account of a large buildup of liquidity (Figure 18). In January 2011, the Philippines has been able to issue at attractive rates on its global Peso bonds, an equivalent of $1.25 billion. The issuance took place a few days prior to the increase in risk aversion towards emerging markets bonds due to concerns about rising inflation.

11. The Philippine equity market posted a strong performance in 2010. Thanks to robust economic growth, favorable prospects and increased capital inflows finding its ways into equities from September to November 2010, the Philippine stock exchange index (PSEi) peaked at the 4,300 level (Figure 17). Net foreign purchase stood at P43 billion (0.5 percent of GDP from in September to October alone accounting for more three-fourths of the total net foreign purchases for the year. The strong rebound of the Philippine stock market which increased by 37.6 percent in 2010 compares well with its peers. The Thai and Indonesian equity markets grew by 40.6 and 46.1 percent in 2010, respectively.

Monetary Policy

12. Inflation remained muted throughout 2010 and finished at the bottom of the central bank’s target range (3.8 percent outturn against a 3.5-5 percent target range)—Figure 19. In early 2010, headline inflation was pulled up by some food prices (especially vegetables due to the fall-off from typhoons Ondoy and Pepeng), fuel and electricity prices hikes due to higher prices of oil in international market, and higher generation cost of electricity due to the El Niño phenomenon. High transport and communication services inflation also contributed to the increase but was constrained in the first half as fuel prices receded in August. Thanks to an appreciating Peso and declining electricity prices, inflation eased in the latter part of the year. Food inflation has decelerated late in 2010, in part, due to the base effect from Ondoy and Pepeng.

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4 Standard & Poor’s upgraded its foreign currency denominated debt credit rating from BB- to BB one notch higher from its previous rating citing the country’s improving external liquidity and growth prospects—this pushed the Philippines sovereign rating within two notches of investment grade status. Moody’s changed its rating outlook on the Philippines’ foreign and local currency bonds to positive from stable.

5 These are 25-year peso benchmark notes priced at 6.25 percent, representing a 23 percent discount from Treasury bond of comparable maturity.
13. Transportation and food price inflation became visible again in January 2011 (Figure 19). Inflation surprised on the upside in early 2011 as it jumped from 3.0 percent in December 2010 to 3.5 percent in January, against consensus forecast of 3.3 percent. Key inflation drivers in January were food prices—up from 2 percent in December to 3.1 percent—as well as transportation prices which increased from 3.2 percent in December to 4.4 percent in January. Core inflation remained stable at 3.3 percent. Within food prices, the post-Ondoy and Pepeng normalization of the price of vegetable was the main driver for the inflation uptick; rice price increases remained moderate, rising by only 1.5 percent compared to 3.9 percent in January 2010.

14. Despite record growth and closing output gaps, the BSP continues to maintain an accommodative policy as inflation expectations are anchored within its target band. In contrast from most central banks in the region, the Bangko Sentral ng Pilipinas (BSP) has not yet increased its key policy rates. The Philippines stands out from its regional peers in that both current and expected inflation (headline and core) remain well within its target zone. Despite rapidly closing gaps, positive shocks to inflation (and risks) stem mostly from the supply side, to which an inflation targeting central bank like the BSP is not expected to react vigorously unless these are expected to have second-round (demand-side) effects. Such a reaction function would also limit yield-seeking short-term capital inflows that could later become a destabilizing force. Real policy rates have been negative since April 2009 (Figure 20).

15. Bucking the trend towards capital controls, in late 2010 the BSP successfully intervened to smooth what it viewed as excessive volatility of the Peso. Aligned with its longstanding policy of smoothing rapid and pronounced exchange rate volatility the BSP introduced several measures to reduce strong movements in the peso. As capital inflows surged (from a low base) in September 2010, the BSP further liberalized its rules on foreign exchange transactions, especially regarding outflows. More significantly, the BSP also intervened forcefully in the foreign exchange (FX) swap market. By stopping to roll over part of its large FX swap book, the central bank effectively created an excess of peso/a shortage of dollar in the system which helped turn the currency. (The FX swap book of the BSP decreased from $23.3 billion in October 2010 to $17.8 billion in December 2010, the largest decrease since the global financial crisis—Figure 12).

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6 Following typhoons Ondoy and Pepeng, the flooding of several key road transport arteries towards Manila disrupted the vegetable supply chain and led to price spikes in late 2009.
7 Real policy rates are calculated as the key policy rates minus the one-year ahead consensus inflation expectations.
8 The most important of these measures was the doubling of the limit of dollar purchases to $60,000.
**Fiscal Policy**

16. The strong within-year fiscal tightening continued through November 2010 as spending restraints continued and despite limited revenue improvements (Table 2). When the Aquino government took office on July 1, 2010, a significant fiscal stimulus undertaken in the first-half of the year threatened to push the annual fiscal deficit significantly beyond the budgeted target. (The primary fiscal balance had deteriorated by 0.5 percentage points of GDP between H1 2010 and H1 2009 while the NG budget targeted an unchanged fiscal deficit of 3.9 percent of GDP between 2009 and 2010). Thanks to measures taken to improve expenditure efficiency and effectiveness—e.g., the zero-based budgeting; see September 2010 Philippines Quarterly Update for details— the Aquino government decisively controlled expenditures in the second half of 2010. In its first five months in office, the new government reduced total NG spending by 1 percentage point of GDP compared to 2009 spending. This spending slowdown more than offset the continued deterioration on the revenue front. While the tax effort improved by 0.1 percentage points of GDP on a year-on-year basis between H1 2010 and January-November 2010, non-tax collection decreased by 0.2 percentage points of GDP during the same period as lower interest rates impacted Treasury revenues. As a result, the overall fiscal deficit through November was tighter than budgeted (preliminary government estimates for the overall deficit—at 3.6 percent of GDP—indicate a continuation of the July-November trend).

17. Notwithstanding the carry-over impact of tax erosion measures, the tax effort marginally improved towards end-2010 (Table 2). Several tax eroding measures introduced during the course of 2009 and early 2010 had their partial or full year impact in 2010—see Alonzo (2011) for a comprehensive listing of all laws passed during the 14th Congress (June 30, 2007—June 30, 2010) that contained tax revenue eroding measures. In total 36 such laws were passed, or an average of one tax eroding law every month (excluding trade agreements). While the sharp rebound in economic activity should result in a cyclical increase in the tax effort—as large revenue sources such as corporate income taxes have a tax elasticity above one—no notable such increase took place in 2010. Despite renewed efforts by the Bureau of Internal Revenue to boost tax compliance, aside from a moderate increase in the tax effort in November 2010 (by 0.1 percentage points of GDP), the permanent tax eroding measures present an important drag on collection.

18. The steadfast focus during the second half of 2010 on priority and efficient spending significantly slowed down total public spending (Table 2). Personnel services, maintenance and other operating expenditures, tax expenditures, and capital outlays were the key categories where measures such as the zero-based budgeting approach generated the largest savings (compared to H1 2010 spending trends). As a result, primary (i.e., excluding interest payments) spending moved from being 0.3 percentage points of GDP higher than in 2009 as of June 2010, to being lower by 0.6 percentage points of GDP by November 2010. As some of the high rate of disbursement in H1 2010 reflected a desire to front-load spending, the slowdown in spending observed in H2 2010 does not entirely represent permanent savings. Tax expenditure is one example: large rice imports from the NFA took place in H1 2010 and resulted in high tax expenditure during that period. These imports proved sufficient for the rest of 2010 (and some of 2011) so that no associated tax expenditure took place. Yet, the underlying spending source—the NFA tax expenditure along with the large loss making activities of the NFA in general—remain broadly unchanged to date. Thanks to significant (and persistent over time) over-budgeting of interest payments along with low domestic interest rates during 2010, actual spending for this category consistently fell below budget throughout 2010.

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9 See, in particular, the Special Focus section on “The 2011 National Government Budget: Structural Reforms and Consolidation”.
10 While total NG expenditure was 0.2 percentage points of GDP higher in H1 2010 than in H1 2009, total spending from January to November 2010 had been reduced by 0.8 percentage points compared to the same period in 2009; a turnaround of 1 percentage points of GDP.
11 For example, corporate income tax reduction, PERA law, tourism incentives, implementation of the ASEAN Trade in Goods Agreement, of the Japan-Philippines Economic Partnership Agreement, tax incentives in Bataan and Aurora economic zones, abolition of DST on secondary trading stocks, and Real Estate and Investment Trust.
13 The slowdown in disbursement for personnel services is notable as salaries of government employees were increased in July 2010 as mandated by the salary standardization law (SSLIII).
Robust Growth, Stubborn Poverty

PROSPECTS

Output and Demand

19. **Growth is expected to normalize around its potential output in 2011 as the technical and temporary factors generating record growth in 2010 disappear.** While off from the 2010 record growth, the economy is projected to grow by a still robust 5.0 percent in 2011 (Table 1). Catalysts to the 2010 record growth—the rebuilding of inventories, the recovery of exports and manufacturing, accommodative monetary and fiscal policies, election spending—have run their course as production levels exceed pre-crisis peaks, the economy’s output gap is closing, and policy stimuli are gradually withdrawn. While consumption is expected to remain a robust and dependable contributor to overall GDP growth, investment in 2011 is expected to become an important contributor to growth as a more favorable investment climate emerges. Strong confidence outlook from both consumers and business supports this (Figure 21). Net exports are also projected to remain strong thanks to exports diversification and robust outlook for the electronics industry (Figure 22). On the supply-side, the services sector will remain the main-driver of growth followed by industrial production. Barring any major calamity this year, the agricultural sector should positively contribute to growth this year as the first three quarters of 2010 were negatively impacted by El Niño. For 2012, GDP growth is expected to expand by 5.4 percent as investment accelerates, in part thanks to the implementation of the priority PPP programs of the Aquino administration.

20. **Risks to our baseline growth are broadly balanced with upside risk on private investment and downside risk relates to external shocks, especially oil, and food prices.** Efforts to improve the investment climate, tackle corruption and weak governance, along with more credit-rating upgrades could boost investor confidence and attract more private investment. Better-than-expected global growth also bodes well for the economy and for GDP to reach government’s GDP growth target. Sectors with high-growth potential include the business process outsourcing and the tourism industry. Key downside risks pertain to international oil and food prices. Both such shocks would have a negative impact on the Philippines’ balance of payments though the 2008 experience reveal these would be manageable. These shocks would increase domestic inflation and slow economic activity down. The net impact on the budget would be positive in the case of an oil price shocks (higher tax revenue, especially from the VAT), while it would be negative for a food price shock though the extent of the impact should be more contained than in 2008 as the well targeted 4Ps conditional cash transfer would likely play a more central role to protect the poor than the inefficient National Food Authority’s rice subsidy program.14

14 The latter has a large off-budget component the impact of which translates in large contingent liabilities for the National Government—see Special Focus on fiscal risks below.
Employment and Poverty

21. Despite limited progress in tackling poverty, the scale up the social protection system in the 2011 budget would guarantee some safeguard to a large share of the poor. The problems underlying the weak inclusiveness of growth in the Philippines and stubbornly high poverty incidence are various and interact in complex ways. One approach to poverty alleviation is to create a modern social protection system that can efficiently target poor households and provide them with assistance that can contribute to helping them and their children reach out of poverty. The rationalization of several inefficient social protection programs and the reallocation and scaling up in the 2011 NG budget of resources towards the 4Ps conditional cash transfer program, have decisively pushed the scope and reach of social protection in the Philippines. At end-2011, the 4Ps/CCT program is indeed budgeted to cover 2.3 million poor households, or about 60 percent of poor households compared with 26 percent of poor households at end-2010 (based on the 2009 FIES poverty data).

22. The scale up of the 4Ps conditional cash transfer program bodes well for the fight against poverty in the Philippines. Recently released official poverty data from the 2009 FIES reveal that while poverty incidence has steadily increased from 2003 to 2009, key indicators measuring the depth of poverty point to an improvement in that dimension over that same period. One hypothesis for this latter improvement—which could be tested once the FIES 2009 dataset becomes available—is that the 4Ps/CCT program contributed to this outcome. The gradual scale up of the 4Ps program from its pilot phase in 2007 was designed so as to start coverage with the poorest of the poor and gradually expand to the next poorest households and municipalities. By end-2009 the 4Ps was already disbursing cash to 376,000 households, or 9.7 percent of poor households. This could be a sufficiently large share of the poor to have a noticeable impact on country wide poverty depth indicators. The 4Ps/CCT is also expected to improve human capital among the poor thanks to its education attendance and health requirements. Nevertheless, challenges in markedly reducing poverty remain in the Philippines (World Bank, 2010, op. cit.). Among these, and notwithstanding the welcome increased allocation in the 2011 budget, is insufficient spending in priority sectors like health and education which also contribute to the challenge in generating inclusive growth.

23. Despite the favorable economic outlook, the formal labor market is projected to improve only marginally as it suffers from several structural problems. Both unemployment and underemployment have a large structural component in the Philippines. Over the recent cycle, the lowest level reached for the former was a brief dip to 6.3 percent in October 2007, and for the latter the trough was 17.5 percent in October 2008. These troughs were achieved after six years of sustained, accelerating and high growth (average GDP growth between 2002 and 2007 was 5.5 percent and culminated at 7.1 percent in 2007) and during a time of when overseas work deployment accelerated noticeably.

Balance of Payments

24. The overall balance of payment is projected to moderate while remaining firmly in surplus in 2011 thanks to continued support from remittances and services exports. The current account surplus is projected to decrease moderately to 4.2 percent of GDP in 2011 from 5.2 percent in 2010 as remittance inflows continue to gather pace on the back of strong deployment of OFWs in 2010 while the trade deficit remains broadly stable at 5.1 percent of GDP as export growth remains strong. Exports from the large electronics and semi-conductor sectors are projected to remain brisk as leading indicators for the sector remain favorable (Figure 22) while planned investment by electronic

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15 The 2010 World Bank report entitled Philippines: Fostering Inclusive Growth sheds lights on these.
16 These are the income gap, the poverty gap, and the severity of poverty.
17 Specifically, the first wave of the 4Ps/CCT program identified its recipients through the following algorithm based on the FIES 2006 official poverty data. First, select the 20 poorest regions of the Philippines. Within these, select the poorest municipalities based on the small area estimates of poverty. Second, the poorest municipalities (i.e., those with poverty incidence about 50 percent) are completely enumerated using a household assessment form that collects information to run a proxy means test. Third, the poorest households in the poorest municipalities were enrolled in the first wave of the 4Ps.
18 Another 300,000 households was newly enrolled at the time but not yet receiving cash.
manufacturing firms reached a record-high in 2010.\textsuperscript{19} Financial inflows, particularly direct and portfolio flows, to the Philippines are projected to increase given the overall weak performance in 2010 and rapid peso appreciation is no longer perceived as a baseline case following the very effective intervention from the BSP in November 2010 in the FX swap market—which proved that the central bank has the means to prevent rapid appreciation of the currency. Risks to our baseline scenario include shocks to oil and, to a lower extent, food prices as sharp increases would have a large negative impact on the trade balance.

25. Over the medium term, policymakers need to focus on shifting the composition of the overall balance of payments surplus to support stronger and more inclusive growth (World Bank, 2011 Philippines Development Report, forthcoming). Such a strategy could include the following elements:

- Improving the investment climate to attract larger inflows of foreign direct investment and create incentives for residents to invest more at home rather than abroad. These larger investments will likely result in a surge in imports of capital goods that may ease the current account surplus in the short term while generating stronger growth thereafter.

- Advancing fiscal consolidation to restore the fiscal space needed to address future economic shocks will help limit government borrowing, reduce government bond yields and limit nonresident purchases of government debt. This should help reduce the burden of debt service on the budget while reducing the risk of sudden stops or reversals of capital flows and relieving some pressure for exchange rate appreciation.

- Further strengthening macro-prudential regulations to reduce vulnerabilities to the financial system may be needed (notwithstanding the positive overall assessment from the IMF-World Bank Financial System Stability Assessment Update undertaken in November 2009\textsuperscript{20}). These could include lower loan-to-value and payments-to-income ratios, countercyclical capital requirements, and tighter regulations on open positions.

- Expanding job opportunities at home will allow the economy to absorb more of the talent the Philippines sends abroad every year through overseas workers. While this would mean slower—and perhaps smaller—inflows of remittances it will boost the domestic economy and rapidly raise the size of the middle class.

**Monetary Policy**

26. Notwithstanding an assumed gradual policy tightening, inflation is projected to move towards the upper band of the BSP’s target in 2011. The inflation rate is projected to accelerate during the first six months of 2011 and then decelerate through the rest of the year. Average inflation is projected to rise from 3.8 percent in 2010 to 4.8 percent in 2011, within the top of the BSP’s target band of 3 to 5 percent. Food inflation, which accounts for about half of the total consumption basket, is projected to increase moderately from the 2 percent pace observed in Q4 2010 but should remain moderate in 2011 barring major supply shocks (see Special Focus section below for more details). The impact of various increases in transportation fares\textsuperscript{21} would moderately push up headline inflation given their weight in the CPI basket and the scale of the increases.

27. The distribution of risks on inflation is tilted upwards, as global food and fuel supply shocks could return and would push headline inflation outside of the target band. While oil prices are projected to increase from $79 per barrel in 2010 to $85 per barrel in 2011,\textsuperscript{22} developments in Egypt that pushed oil prices above $100 per barrel clearly point to upside risk. Data reveal that the pass through from international gasoline and diesel price changes to the Philippines is significant (Figure 23). As food accounts for about half of the CPI basket in the Philippines, supply shocks would

\textsuperscript{19} Source: Semiconductor and Electronics Industries in the Philippines, Inc. (SEIPI).


\textsuperscript{21} These include a nationwide increase in taxicab rates, the approval of higher toll rates in most of the expressways to Metro Manila—including a 260 percent increase in the South Luzon expressway—and a pending increase in Metro Manila railways.

\textsuperscript{22} Simple average of Dubai, Brent and West Texas Intermediate. Estimate for 2010 and forecast for 2011 are from the January 2011 Global Economic Prospects report from the World Bank.
have a large impact on headline CPI and, based on the 2008 food and fuel global price shocks, it transpires that core inflation tracked relatively quickly the increase in food prices (Figure 19). However, the BSP’s credible inflation targeting regime—which has proven to be a good anchor of inflation expectations in past episodes of large supply shocks (Figure 20)—should continue to dampen second-round effects of temporary supply shocks such as those related to global food and fuel prices.

Figure 23. Strong pass-through between international and domestic prices of gasoline and diesel

Monetary policy is projected to tighten gradually in the second half of 2011 as demand pressures are limited and inflation expectations remain within the BSP target band. With real GDP growth projected to be in line with potential output and structural slack in the labor market, strong demand pressures are not expected to materialize. Monetary indicators (e.g., M3, bank lending) are growing at or below nominal GDP growth. Inflation expectations remain firmly within the central bank’s target zone. This would enable the BSP to gradually withdraw its accommodative policy stance. Policy rates were cut by a cumulative 200 basis points from December 2008 to July 2009 and have been unchanged since then (Figure 20).

Fiscal Policy

The 2011 budget—the first to be approved ahead of the fiscal year in eleven years—kick starts important reforms in spending efficiency and transparency. The 2011 NG budget (January-December) was approved in December 2010 thereby providing departments and line agencies with increased fund predictability and programming than has been the case with recent budgets. The approved budget is broadly kept intact to the budget submitted to Congress by the Government (i.e., the NEP); the latter, as detailed in the September 2010 Philippines Quarterly Update, renews the fiscal consolidation and contains significant reform measures. These measures aim to improve spending efficiency, transparency and accountability of the budget. Notable differences between the proposed and the approved budget include the reallocation of the P2.5 billion budget for the Public-Private Partnership Support under the Department of Agriculture to the National Food Authority, which had zero allocation in the NEP 2011. Some special purpose funds

23 Compared to both headline inflation and core inflation, inflation expectations are (1) significantly less volatile (e.g., since January 2006, the standard deviation of the monthly inflation expectations series is 0.9 against 3.0 and 1.6 for headline and core inflation, respectively), and (2) fall within the BSP’s target zone far more often (e.g., since January 2006, monthly inflation expectations were within the target zone about half of the time while that proportion falls to 39 percent for core inflation, and 26 percent for headline inflation).

24 Over the past few years, NG budgets have often been approved in March (e.g., 2005, 2007, 2008, and 2009) or even in April (e.g., 2003).
were reduced\textsuperscript{25} to free up funds for the following new programs (not originally in the NEP): financial subsidy to LGUs, payment of total administrative disability pension and support for pre-school education (under the un-programmed fund).

30. Several initiatives to strengthen the debt structure have been/are being introduced and should ultimately generate large payoffs in terms of risk and cost. A Debt and Risk Management Office (DRMO) has been created inside the Department of Finance. A debt consolidation program was put in place by the national government at the end of 2010. The program aims to establish a benchmark for long-term financing and extend the duration of the existing domestic debt with the exchange of existing government securities for longer dated securities.\textsuperscript{26} In September 2010, in an effort reduce its currency risk and to deepen the domestic bond market, the Philippines successfully issued its first Peso-denominated global bond.\textsuperscript{27} Given the success and appetite for such a product, the country issued a second global Peso bond in January. This issue generated the largest participation from offshore accounts of any Philippine bond issuance to date. Issuances of global Peso bonds, in lieu of global bonds in foreign currencies, also help reduce pressure on the Peso to appreciate and mop up some of the large accumulation of domestic liquidity.

31. A moderate degree of fiscal consolidation is projected for 2011 (Table 2). The overall fiscal deficit (GFS basis) is projected to decline from an estimated 3.6 percent of GDP in 2010 to 3.3 percent in 2011. As no tax policy measures are included in the 2011 budget, incremental increases in the tax effort will be driven by tax administrative efforts to improve tax compliance. As a result, we estimate the tax effort to rise by 0.3 percentage points of GDP to 13.2 percent of GDP in 2011. Non-tax revenue (excluding privatization) is projected to remain unchanged at 1.4 percent of GDP. Total spending is projected to remain at 18.1 percent of GDP.

32. Fiscal consolidation is mostly driven by structural improvements; the structural fiscal balance is improving for the first time in five years (Figure 24). As detailed above and in our previous Philippines Quarterly Update, significant reforms on the expenditure side of the budget have been introduced with the 2011 budget. These are increasing fiscal space. Similarly, the tax administration measures recently introduced or re-invigorated are also—moderately—improving the tax effort (Figure 25). Notwithstanding these welcome developments, the structural fiscal balance remains high, especially since it is combined with a relatively high level of fiscal risks—these have been assessed and disclosed for the first time in an annex to the 2011 NG budget (see Special Focus below for details).

33. With the economy firmly over the global recession’s impact, a faster unwinding of the fiscal stimulus would generate important benefits. Key benefits include: (1) less pressure on the peso to appreciate and for potentially destabilizing short-term capital inflows to enter the country; (2) reduced risks of overheating the economy and of putting pressure on prices at a time when inflation risks are clearly tilted upwards as global food and fuel supply shocks could materialize; (3) generating more fiscal space for priority spending programs; and (4) providing the economy with better resiliency to shocks (lower structural fiscal deficit).

34. Beyond compliance-increasing administrative reforms, the revenue effort contemplated in the Philippines Development Plan will require tax policy measures. President Aquino’s election pledge regarding revenue mobilization was to boost the tax effort first through administrative measures aimed at improving tax compliance. Given the large priority expenditure needs, however, administrative measures would need to be complemented by tax policy measures. To keep with the government’s election pledge of no new taxes and tax increases in the first 18 months of the new administration, these could be introduced in 2012 and onwards. A well designed tax system facilitates tax

\textsuperscript{25} These include the Miscellaneous Personnel Benefits Fund (decreased by P1 billion), the Priority Development Assistance Fund (decreased by P0.2 billion), and the Support to Infrastructure Projects and Social Programs fund (decreased by P9.9 billion).

\textsuperscript{26} One such operation took place in December 2010 with a bond swap operation totaling P199 billion of new 10 and 25-year benchmark bonds (with coupon rates of 5.875 percent and 8.125 percent, respectively). These bonds will serve as the new benchmarks for long term financing in line with government initiatives to promote public-private partnerships (“PPP”) in infrastructure projects.

\textsuperscript{27} $1 billion-worth of 10-year bonds was issued; the yield at issuance was 5.0 percent. An increase in risk aversion towards emerging markets due initially to inflation concerns in mid-January 2011 did not spare the Philippines. The September global bond, for example, reached a peak of 106 prior to the sell-off (from the issue price of 99.607) but subsequently declined to 98.25 in late January.
administration, tax compliance cost, and reduces opportunities for corruption. These are essential components of a sound investment climate that fosters domestic and foreign investment and hence economic growth. Equitable tax laws and the impartial application of those laws are also necessary to achieve the objectives of horizontal and vertical equity (see below); these in turn even the playing field among tax payers.

**Figure 24. Structural and cyclical balances shift towards improvement in 2011**


**Figure 25. Improving structural balance thanks to revenue and spending measures**

35. **An improved tax effort calls for improvements along both the efficiency and equity dimensions of the tax system.** Tax efficiency generally requires a broad tax base and low tax rates to minimize economic distortions, encourage compliance and limit corruption. Tax equity involves two important aspects: (1) vertical equity, which dictates that lower earning taxpayers should face lower effective tax rates, and (2) horizontal equity, which means that taxpayers with similar income or profits should face similar effective tax rates—where the stress on “effectiveness” refers to both the design of the tax system, as well as to compliance in its implementation.

**SPECIAL FOCUS**

**Food Prices in the Philippines**

36. **In contrast to many countries in the region, food price inflation has been muted so far in the Philippines and is expected to remain moderate in 2011 though risks are tilted upwards.** In the short-term, concerns about a return of a 2008-style food crisis in the Philippines seem limited as rice price increases are projected to remain contained thanks to recent strong domestic palay production, good planting intentions, record stock piles of rice, and domestic retail prices significantly above international prices. Food prices are nonetheless expected to rise moderately, not least as the base impact of the increase in some food prices (especially vegetables) following typhoons Ondoy and Pepeng wears out. Key risks to this outlook include severe weather events that would disrupt domestic food supply, and a sharp increase in the international price of oil.

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Regional developments: the Philippines stands out

37. Food prices throughout the world have risen significantly since 2009, pushing up headline inflation in many countries in the region. After tumbling since mid-2008 and the onset of the global financial crisis and global recession, aggregate food prices started increasing anew in 2009 and, since the middle of 2010, have posted rapid increases. By January 2011, the FAO’s Food Price Index had risen for seven consecutive months, had exceeded the peak reached in June 2008, and reached its highest level since records began in 1990 (Figure 26). Most countries in the East Asia region have been affected by these price developments—e.g., Mongolia, Indonesia, Vietnam, and China have experienced double digit food inflation (Figure 27). In 2010, only two countries in the region did not witness an increase in their 12-month food inflation compared to a year earlier, namely Cambodia and the Philippines.

38. Countries in the region have found their domestic food prices to be affected in different ways by international and local factors. Maize and wheat prices increased by 84 and 67 percent, respectively, since the middle of 2010, and were close to the 2008 peak in late December as global production was affected by severe weather events (Figure 28). Notwithstanding some price increases in the second half of 2010, rice prices remain about 40 percent below their 2008 peak; in January they recorded a moderate dip (Figure 28). Local factors contributing to increased food prices include the appreciation of local currencies, price controls and severe weather events that disrupted local supply. Country-specific issues are varied and include a foot and mouth outbreak in Mongolia causing meat prices to surge, an increase in the price of imported food due to the depreciation of the currency in Vietnam, and severe weather-related disruptions in a number of countries (e.g., floods, cold streaks, rains, droughts). In general, the pass through from international price changes to domestic ones has been incomplete to date, with the Philippines experiencing the lowest pass through in the region (Figure 29).

Sources: Food and Agriculture Organization (FAO).

Sources: National sources, CEIC and Bank staff calculations.
1/ difference, 12-month headline and food inflation in 2010 less the rate a year earlier, percentage points.
39. To contain food-driven inflation affected countries have responded through broader fiscal and monetary policy instruments and/or sector specific measures. In the short-term, several East Asian countries have (1) begun tightening monetary policy and withdrawing the fiscal stimulus introduced during the global recession; (2) introduced measures to help procure additional quantities of food (typically rice—e.g., in Indonesia, BULOG has been provided the mandate to procure additional rice imports from the international market29; and (3) taken steps to protect the most vulnerable—e.g., Indonesia plans to increase the frequency of rice transfers for the poor (RASKIN program), Mongolia doubled its universal (untargeted) cash transfers in the 2011 budget.

![Figure 28. Some international prices have surged but rice prices have risen moderately](image)

<table>
<thead>
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<th>International price of rice, wheat and maize</th>
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<td>Rice [Thai 100% second grade]</td>
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<td>Wheat</td>
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Source: Food and Agriculture Organization (FAO).

![Figure 29. Local food prices have increased by much less than international prices 1/](image)

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<td>Philippines</td>
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Sources: National sources, CEIC and Bank staff calculations.
1/ percent change: international prices in dollar terms, domestic prices in local currency terms

**Domestic developments**

40. Thanks to stable production and record stocks, there appears to be no immediate threat to the stability of the rice market in the Philippines. Domestic rice production is essentially stable. While paddy production fell by about 15 percent during the first nine months of 2010 (9.3 million metric tons or Mn MT) compared to the same period in 2009 primarily due to El Niño-related drought, production recovered in Q4 so that the 2010 output estimate is only about 1.5 percent lower than in 2009 (16.02 versus 16.27 Mn MT). Based on planting intentions and early rains due to La Niña phenomenon, production during Q1 2011 is expected to be 16 percent higher than in the same period last year (an anticipated 11 percent increase in area planted and about 5 percent increase in yield). Rice stocks have grown rapidly from 2009 to 2010 and significantly exceed the Government’s total target amount of rice stocks for the country: as of November 2010, rice stocks reached 3.8 Mn MT (111 days’ worth of consumption against a target of 90 days) and are 28.3 percent higher than in 2009. Similarly, the National Food Authority (NFA) depositories currently have 53 days’ worth of consumption against a target of 30 days (84 percent of these NFA stocks are imported)—Figure 30. Hence, the NFA announced it will import only a moderate amount of rice in 2011—1.0 Mn MT against 2.6 MN MT in 2010.

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29 Indonesia will also simplify import procedure for food commodities to reduce costs, including by removing the five percent import tariff on wheat.
Robust Growth, Stubborn Poverty

41. As a result, paddy and rice price movements were fairly stable during 2010, despite international increases in the price of rice (Figure 31). Farm gate prices increased by an average of only 2.7 percent while the average increases in the wholesale and retail prices of well-milled rice were even lower at 1 percent and 0.9 percent, respectively. For January 2011, retail prices of rice rose by 1.5 percent year-on-year, significantly below headline inflation of 3.5 percent. Nevertheless, domestic rice prices are considerably higher than that of imports, thanks in part to a 40 percent import tariff and quotas. The domestic wholesale price of rice is about 57-81 percent higher than the world price. Historically, the Philippines imports around 10 percent of its total rice supply.

Figure 30. Rice stock reached a record-high as of September last year

Figure 31. Food inflation in the global market is much more volatile than domestically

Source: Bureau of Agricultural Statistics (BAS).

Sources: National Statistics Office (NSO), World bank.

42. There are some potential sources of upward pressure on domestic rice prices, notably through the cost of fertilizer (mostly related to international oil price developments). As of December 2010, the domestic price of urea had increased 6.1 percent year-on-year, suggesting the emergence of a moderate pressure on production costs in the short term. The international price of urea has increased much more steeply (by 43.7 percent) over the same period. Other fertilizers have seen even greater price increases. However, until now, the transmission to the domestic market of these price increases has been limited.

43. Some specific agriculture products have seen recent price pressures but these are localized and are not expected to have major aggregate price impacts. In December 2010, the price of yellow corn, which is primarily used as animal feed, increased by 18.9 percent and 3.2 percent year-on-year at the wholesale and retail level, respectively. Similarly, the price of cooking oil increased by almost 50 percent over the first nine months of 2010. On average the prices of white corn in 2010 were 7.3 percent and 7.8 percent lower compared to 2009 at the wholesale and retail levels, respectively. The decrease in the price of white corn will benefit poor households in the Visayas and Mindanao, where its consumption is prevalent. The price of pork has remained relatively stable throughout 2010. The increase in the wholesale price of yellow corn may put some pressure in the short run on the price of hogs and poultry, although this is expected to be rather limited.
Fiscal Risks in the Philippines

“Every nation, rich or poor, powerful or not, is susceptible to fiscal risks as the recent global economic crisis has proven. As such, dealing with these risks and finding ways to avoid or at the very least minimize them is a constant challenge to all countries. To foster greater transparency and to help deal with these fiscal vulnerabilities, [the government drafted a fiscal risk statement]. This document provides a brief but comprehensive account of the sources of fiscal risks [in the Philippines].”

Foreword to the (first) Philippines Fiscal Risk Statement published in November 2010 by the Development Budget Coordination Committee (DBCC) as an annex to the 2011 National Government budget

44. Fresh into office the Aquino government established a comprehensive assessment of fiscal risks and published the outcome in a fiscal risk statement in November 2010. International experience reveals that disclosure of fiscal risks generates important benefits in terms of lower and better managed fiscal risks, improved policies, and lower cost of financing. Historically, fiscal risks have been prevalent in the Philippines and at times have generated large and unexpected fiscal costs. Important weaknesses in the Philippines public financial management framework have contributed to heightened fiscal risks. As the Fiscal Risk Statement (FRS) of the government reveals, while fiscal risks have abated in important areas they still remain sizeable in 2010. To improve the management of fiscal risks, the government is actively pursuing a program of institutional capacity building.

45. Disclosure of fiscal risks generates important benefits in terms of lower and better managed fiscal risks, improved policies, and lower cost of financing. Countries have found that disclosing fiscal risks could (1) help internalize potential future costs—be it at the executive decision-making, Congress approval, execution, or even at a later election stage—(2) produce better risk management and/or to modification of policies that entail too large a risk for the budget, (3) help strengthen accountability for risk management; and (4) could help lower financing costs by improving sovereign bond ratings and access to international capital markets in the long run.

46. Fresh into office the Aquino government established a comprehensive assessment of fiscal risks and published the outcome in a fiscal risk statement in November 2010. Along with other important reforms undertaken in the way public resources are managed—such as the reforms introduced in the 2011 National Government budget—the government’s aim is to increase transparency and accountability of public finances in the Philippines as well as strengthen fiscal policy making. With this measure, the Philippines joined a select group of countries that are at the forefront of fiscal risk assessment, monitoring and management (e.g., Australia, Brazil, Chile, Colombia, Indonesia, and New Zealand).

The nature and extent of fiscal risks in the Philippines

47. Historically, fiscal risks have been prevalent in the Philippines and at times have generated large and unexpected fiscal costs (World Bank, 2010, 2009 Philippines Development Report). Large fiscal risks include two banking bailout episodes (early 1980s and 1997/98), large and repeated bank recapitalizations—these include the recapitalization of the former central bank in 1993 (cost of 22 percent of GDP), of the Development Bank of the Philippines in 1986 (cost of 10 percent of GDP), the repeated recapitalization of the Philippine National Bank before its complete privatization in 2007—and the government assumption of part of the National Power Corporation debt in 2002 (5 percent of GDP). These events significantly reduced fiscal space and increased sovereign debt.

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30 This section draws extensively from the forthcoming 2011 Philippines Development Report.
32 Our previous Philippines Quarterly Update includes a Special Focus section on the specific reform measures contained in the 2011 budget.
48. **Important weaknesses in the Philippines public financial management framework have contributed to heightened fiscal risks.** These include (1) weak transparency and accountability of public finances, (2) difficulty in assessing budget predictability because of the difference in reporting budget plans and outturns, and (3) extensive reallocation of the budget between line agencies and special purpose funds (World Bank, 2010, Philippines Public Expenditure and Financial Accountability). Prior to the publication of a Fiscal Risk Statement, the National Government budget did not include a statement on off-budget operations that risk becoming on-budget.

49. **As the Fiscal Risk Statement (FRS) of the government reveals, while fiscal risks have abated in important areas they still remain sizeable in 2010.** The prominent sources of risks are the public debt and contingent liabilities. For the former, the FRS reveals that the debt-to-GDP ratio is relatively large and particularly sensitive to growth slowdowns and exchange rate shocks. Debt rollover risks and contingent liabilities are also large. The legal framework for debt management is relatively weak. For the latter, key risks arise from the realization of contingent liabilities from the GOCCs and PPPs and, to a lower extent, the financial sector, and natural disasters. In particular, GOCCs have systematically required fiscal transfers higher than budgeted and some have significant foreign denominated debt or debt that they cannot sustain; PPPs generate large and complex fiscal risks. Government guarantees on fixed contractual payments have a high likelihood of occurrence, as are risks from political/regulatory actions.

**Ongoing reforms to manage and mitigate fiscal risks in the Philippines**

50. **To improve the management of fiscal risks, the government is actively pursuing a program of institutional capacity building.** A first step/pre-condition for optimal management of fiscal risks is to have a timely and accurate risk assessment. This has already been partially been achieved in the process of establishing the Fiscal Risk Statement; regular monitoring of fiscal risks would complete this first step. Once a FRS exists, relative or absolute weaknesses in risk management can better be identified and prioritized. To that end, the key government initiatives to structurally improve institutional capacity in managing and ultimately reducing fiscal risks center on public debt, GOCCs, and PPPs. In particular:

- For public debt: (1) set up a Debt and Risk Management Division (DRMD) within the Department of Finance; the DRMD will function as a middle office and will enable a more proactive liability management, first of the National Government but eventually of the non-financial public sector; and (2) publish a debt management strategy. This strategy, in line with international best practices, would set out the goals and objectives that debt managers have to accomplish and would be accountable for.
- For contingent liabilities (e.g., linked to GOCCs or to BOT/PPPs): (1) issuance of a joint ICC-DBCC resolution to strengthen contingent liability management; (2) preparation of a contingent liability management plan.
- For GOCCs/GFIs: (1) strengthen GOCCs/GFIs oversight, including through legislative and changes (including to GOCC charters), and the creation of a Government Corporate Council; (2) decouple regulatory from proprietary functions and ensure that the appropriate agencies have direct oversight responsibilities over GOCCs and GFIs; (3) review the price stabilization policy on rice and corn at farm gate and consumer levels; (4) remove non-targeted subsidies and shift towards a transparent, targeted and means-tested cash transfer system for the poor; and (5) remove automatic guarantee provision in the charters of some GOCCs; (6) adopt a users-pay policy; (7) reform the ridership fee structure to allow cost recovery or better sharing of cost among the riders, Government/taxpayers and the private sector; and (8) sale and disposition of assets.
- For PPPs: Efforts from DOF, DBM and NEDA to improve monitoring of contingent liabilities are ongoing to establish a system that will estimate on a frequent basis the extent and cost of exposure from PPP projects.

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33 Other types of fiscal risks identified in the FRS include the exposure of the NG budget to economic growth, inflation, and interest and exchange rates. The FRS reveals the absence of systematic bias in budget forecasts of the overall fiscal balance, but the presence of biases among its revenue and expenditure components. Macroeconomic forecasts used for the budget have been reasonably accurate.

34 The financial sector has generated the costliest sources of fiscal risk, but these have abated, thanks to improved regulatory and supervisory controls and strengthened bank balance sheets (IMF and World Bank, 2010, Philippines: Financial System Stability Assessment Update). Natural disasters present a large and recurrent source of fiscal risk since the Philippines is one of the most disaster-prone countries in the world.
Exports of Services: Lessons from the BPO and Tourism Sectors

51. Services exports are rising strongly in the Philippines and provide an important source of diversification of the country’s exports as these have long been dominated by electronics and semi-conductors. The rapidly rising business process outsourcing (BPO) sector is building on the natural comparative advantages of the Philippines, namely a cost-competitive platform built around an English-speaking, technology-savvy young labor force, readily available telecommunication infrastructure, and a favorable economic zone environment. Tourism could become an important source of diversification for the country but the sector is constrained by a weak investment climate, periodic security concerns, weak transport and tourism-related infrastructure, and regulations on air transport services.

52. Unlike many other developing and/or emerging countries, the Philippines is a net services exporter. Exports of services have been growing rapidly in the Philippines (Figure 32) as the fast growth of the BPO sector more than offset declining tourism receipts (Figure 33). What explains this diverging contribution to services exports?

53. The BPO sector, an intensive user of human capital and communications and information technology, has expanded rapidly even during the global financial crisis. The sector’s revenue amounted to 71 percent of all services exports (or 4 percent of GDP) in 2009. The BPO sector has gained comparative advantage in world BPO services. According to the Business Process Association of the Philippines (BPAP), nearly 100 percent of the sector’s production is for exports. To illustrate its importance:

- The sector has long existed in the Philippines. It is apparent in the expansion of BPO categories—data entry, especially accounting, until 1970s, software development and animation in 1980s, contact centers in the late 1990s, medical, legal transcription, and back-office function in 2000s. The country is now a leader in the contact center field.

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36 Nonetheless, services exports are yet to take off, standing at 6.3 percent of GDP in 2009, or 0.3 percent of world commercial services exports. In other words, only one-tenth of the services production is for exports. Labor-intensive services (construction) are exported in a small scale but are in trade surplus. High-skill services (financial services) shared only one percent of total services exports in 2009 and recorded trade deficit.
The sector has continued to thrive during the global recession, with a net increase in staff of 70,199 during 2009, to 442,164 full time employees. A total of 515 firms are in operation, of which 236 are Filipino-owned and 150 are from the U.S.

Export destination has become more diversified. The U.S. has been the major client but its share has been declining from 86 percent of total BPO revenues in 2004 to 68 percent in 2008. Japan, on the other hand has grown from 3 percent in 2004 to 16 percent in 2008. Europe takes up 9 percent and the remainder is mostly exported to other Asian countries and Australia.

The U.S. is the main importer of contact center BPO, while Japan is for software development, animation and other IT-related BPO.

54. Factors that contribute to the rapid take-off of the BPO include:

- Comparative cost advantage. The total labor costs of the Philippines are at 16 percent of the US and compensation costs of the Philippines are on par with that of India. Owing to telecommunication liberalization in the 1990s, the industry enjoys lowest-cost business-grade voice-over-internet protocol to the US at US$0.01 per minute. As for real estate costs, Makati city in central Manila offers rates of US$23/ m2, lower than Beijing (US$29/ m2) and Mumbai (US$100/ m2).

- Human capital. In 2008, a total of 444,810 college graduates entered the market with skills appropriate for the BPO sector: 125,000 students from the medical and science-related field, some 100,000 from business, accounting and related fields and another some 100,000 from the IT, engineering and architecture fields. These young talents in the IT-related field are a key factor to host software development and other IT-BPOs from Japan. English proficiency and Filipinos’ affinities to the U.S. culture and accounting and legal system contribute to strong exports of contact center and back office BPO services.

- Generous, competitive tax incentives, including income tax holiday of six to eight years and a 5 percent gross income tax rate thereafter (in lieu of all national and local taxes). During the tax holiday period, the net margin rate is estimated at 11-21 percent for the Philippines and 13-16 for India (owing to India’s Minimum Alternate Tax in place). After the income tax holiday period, the two countries are roughly on par: 9-14 percent for the Philippines and 10-13 percent for India.

- Greater global demand. Wide-spread success stories on BPO accompanied with rapid advance in technology and an attention on global risk diversification increased global demand for Philippine BPO and introduced new BPO candidates into the market such as IT management, engineering and even R&D. Demand has expanded from the traditional US market to Japan and Europe.

- Pro-active industry players (“Champions”) developed a strategic plan for the industry development and actively promoted the industry domestically and abroad.

55. The tourism sector builds on a vast array of natural resource endowments and reasonable price competitiveness. The Philippines boasts ample natural resources: the Travel & Tourism Competitiveness Index (TTCI) 2009 ranks the country 23rd in terms of the number of World Heritage sites and 40th in terms of total known species in the country. Despite these, the tourism sector has been on a declining trend with receipts averaging 3 percent of GDP over the past two decades. This cyclical sector, as expected, suffered badly from the crisis, down to 1.5 percent of GDP. However, over the past two decades, the industry has been losing comparative advantage. Key features of underperformance are:

- The Philippines ranks 86th out of 133 countries in the 2009 Travel & Tourism Competitiveness Index (TTCI), five ranks behind Indonesia.
During the past decade, flat employment at 9.6 percent of total employment and only around 3 international visitor arrivals per 1,000 Filipinos.\(^{37}\)

- A weak relationship between the number of international tourist arrivals and visitor exports—0.44 for the Philippines, significantly below Thailand (0.98) and Vietnam (0.91).

- High value-added health and retirement-related tourism services still at the infant stage.

56. Factors that inhibit tourism exports include the following, as shown in Figure 34:

- Safety and security concerns. The TTCI 2009 ranks the Philippines 125\(^{th}\) out of 133 countries in terms of the threat of terrorism and 93\(^{rd}\) in terms of the incidence of common crime and violence. TTCI reports that police service is comparatively not so reliable to enforce law and order (rank 98\(^{th}\)). Safety and security-related events can cause changes in tourists’ perception of risks and therefore tourism exports get adversely affected,\(^{38}\) as evidenced during the outbreak of SARS in 2003. It should be noted however that Indonesia and Thailand perform equally worse in these areas but score higher tourism receipts than the Philippines.

- Limited international air transport services liberalization. The Philippines has only a third of Thailand’s capacity in terms of available international seat kilometers.\(^{39}\) There is no government control on domestic airlines but foreign ownership in an air carrier is limited to 40 percent. Earlier liberalization efforts resulted in concluding many bilateral air services agreements but the agreements remain restrictive—e.g., airlines are restricted by third and fourth freedom rights,\(^{40}\) by controls on service capacity and frequency and by the requirement of a fare approval by both partners. No open skies agreement has yet been implemented though the Aquino government announced its intention to implement such agreements. The Philippines imposes Common Carrier Tax and Gross Philippine Billing Tax only on foreign carriers operating in the country, creating an unequal playing field as far as international carriers are concerned.\(^{41}\)

- Weak quality of transport infrastructure. In terms of ground transport, one fifth of paved roads are in poor condition and the quality of the ground transportation network remains weak, restricting the accessibility of touristic sites. For example, Banaue’s rice terraces—a UNESCO World Heritage site—are 350 kilometers away from Manila but it takes 8 to 10.5 hours by car or bus to reach them. Neither public air transport nor railway is available.\(^{42}\) Regarding air transport, airport infrastructures require major expansion and upgrades. Ninoy Aquino International Airport in Manila, the main international gateway is outdated (designed in 1974 and completed in 1981) and reached its capacity in the early 1990s. As a result, it ranks at the bottom among major Asian international airports.\(^{43}\)

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\(^{37}\) In 2008, half of international tourists arrive from three countries: Korea (about 20 percent), the U.S. (18 percent, largely overseas Filipino workers visiting relatives), and Japan (11 percent).


\(^{39}\) The Philippines scores 3.5 in an international air transport services restrictiveness index (0 = most liberal, 7 = most restrictive) while both Thailand and Malaysia score only 1.67. The index is constructed by Findlay and Zhang (2008), “Services Sector Reform: the Case of Air Transport,” mimeo.

\(^{40}\) Third freedom of air is the right to fly from an airline’s own country to another; and fourth freedom, from another country to the airline’s own country.

\(^{41}\) These taxes are applied to all revenues, including tickets sold outside the Philippines. The International Air Transportation Association claims these tax measures to be discriminatory and attributes the withdrawal of some foreign carriers from the Philippines market to these measures—e.g., British Airways, Air France, Alitalia, United Airlines, and Lufthansa. In addition to these taxes, foreign carriers are subject to pay Customs, Immigration and Quarantine charges (i.e., meal, transport and overtime charges for inspectors).

\(^{42}\) In contrast, Chiang Mai in Thailand is 696 kilometers from Bangkok and can be reached within an hour by air (seven airlines operate the route), 8 hours by car, 10-11 hours by bus, or 11-12 hours by train.

Ineffective marketing. The Philippines spent 3.6 percent of the total NG budget on travel and tourism in 2008, higher than Thailand’s 2.7 percent and Malaysia’s 1.7 percent. However, the correlation between the tourism budget and tourist arrivals in the Philippines is below a cross-country average. Furthermore, business executives in the Philippines perceive that the Philippines’ tourism marketing is only moderately effective in attracting tourists (scoring 4.9 out of 7) (TTCI, 2009). More effective marketing and branding could potentially augment tourism exports at this juncture when the Tourism Act of 2009 avails greater financial resources to the Tourism Promotion Board, a marketing body of the Department of Tourism.

Additional weaknesses include (1) poor health and hygiene, (2) weak room capacity (less than one hotel room per 1,000 people as opposed to 6 rooms in Thailand), and (3) limited usage of the internet by business for interacting with customers and suppliers, including the absence of on-line travel reservation portals, such as MakeMyTrip.com of India.

Figure 34. The Philippines: lags in infrastructure and prioritization of travel and tourism 1/

Source: WEF TTCI 2009.

1/ Ranking in respective category is converted into percentile (1=best, 0=worst).

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It is important to identify tourism attributes and to brand accordingly. Tourism competitiveness attributes vary across locations, depending on product mix and target market segments: e.g., cultural attractions is more important for Bangkok than Hong Kong; and for shopping and free port status, Hong Kong scores higher than Singapore, which also owes to Hong Kong’s ability to access the China market. For details, see Enright and Newton (2005), “Determinants of Tourism Destination Competitiveness in Asia Pacific: Competitiveness and Universality,” *Journal of Travel Research*, 43, 339-350.
## Data Appendix

### Table 1. Philippines: Selected Economic Indicators, 2008-12

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<td>12.9</td>
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<td>Merchandise exports (% change)</td>
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<td>Merchandise imports (% change)</td>
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<td>Gross official reserves 1/ (billions of dollars)</td>
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<td>Gross official reserves (months of import)</td>
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<td>Total 2/</td>
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<td>39.0</td>
<td>38.1</td>
<td>34.9</td>
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Source: GOP for historical, World Bank for projections. 1/ Excludes privatization receipts and includes CB-BOL restructuring revenues and expenditures (in accordance with GFSM); 2/ Includes gold; 3/ World Bank definition.

### Table 2. Philippines: National Government Cash Accounts (GFS Basis), 2008-11

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<td>Non-tax revenue 1/</td>
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<td>1.61</td>
<td>1.80</td>
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<td>Grant</td>
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<td><strong>Total expenditure 2/</strong></td>
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<td>Nominal GDP (PHP billions)</td>
<td>7.409</td>
<td>7.629</td>
<td>7.629</td>
<td>8.513</td>
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Source: Department of Finance, Bureau of Treasury, and Department of Budget and Management; 1/ Excludes privatization receipts (these are treated as financing items, in accordance with GFSM); 2/ Data from the Department of Budget and Management; Allocation to Local Government Units excludes capital transfers to LGUs (these are in capital outlays); 3/ Nominal GDP for 2011 is World Bank staff forecast.
Selected Special Focus from Recent Quarterly Updates

September 2010 PQU: Stepping Up Reforms to Sustain Growth

The 2011 National Government budget: structural reforms and consolidation: (Special Focus 1) The 2011 budget could be the turning point the country public finances as it changes dynamics in two critical areas: (1) the (structural and cyclical) fiscal policy stance, and (2) the efficiency, transparency and accountability of public finances. The budget renews the fiscal consolidation effort—albeit modestly—and contains significant reforms measures aimed at improving spending efficiency, transparency and accountability of the budget. For the 2011 budget to indeed turn the country away from a weak fiscal position, inconsistent spending efficiency, and significant gaps in public expenditure and financial accountability, efforts initiated in this budget will have to both be sustained over time and expanded. Strengthening revenue mobilization—through a modern tax system with efficiency and equity at its core—would enable to scale up spending needed to generate inclusive growth.

Employment, Poverty and distributional impacts of El Niño in the Philippines: (Special Focus 2) The 2010 El Niño phenomenon was less intense than the 1998 one. It is nonetheless estimated to lead to a large reduction in agricultural output and to subtract 0.9 percentage points to 2010 real GDP growth. Using a micro-simulation model, we find that El Niño will result in (1) a 0.9 percent reduction in total household income in 2010 mainly due to a combination of lower employment levels and individual earnings; (2) moderate increases in poverty incidence and poverty gap (0.4 and 0.2 percentage points increases, respectively); and (3) no significant impacts on the indices of overall inequality—though income losses are larger at the bottom of the income distribution—and a similar impact for urban and rural areas at the bottom half of the distribution.

The Philippines during the recent international financial shocks: (Special Focus 3) Contrary to some expectations, the Philippine economy has shown to be remarkably resilient to recent international financial shocks. Using equity price indices and sovereign credit default swaps (CDS) spreads, we document the extent to which the country was affected in absolute and relative terms by the global financial crisis and the more recent European sovereign turmoil. Financial data reveal that: (1) during the last decade, the Philippines stock market exhibited strong co-integration with the US market and, to a lower extent with China’s, (2) the historically high volatility of the Philippine equity index decreased noticeably since the global financial crisis, (3) the sovereign credit quality of the Philippines is emerging favorably from the global financial crisis, and (4) Philippines sovereign CDS have not been correlated with CDSs of the fiscally weak European countries.

Constraints to growth: the agribusiness value chain in Mindanao (Special Focus 4) Understanding how the Philippines could improve its competitiveness in agribusiness and agricultural commodities markets in which the country, particularly the island of Mindanao, enjoys strong comparative advantages is critical to fighting poverty and boosting rural incomes. A recent World Bank study of the performance of two key agricultural value chains in Mindanao—yellow corn and export bananas—reveals that both corn and banana value chains offer significant future growth potential; yet they are facing some critical issues in terms of their long-term viability and sustainability. These include average farm-level productivity well behind international benchmarks, in large part due to infrastructure and logistics deficiencies. As the specific channels by which these constraints curtail growth prospects resonate with constraints that other regions and sectors also struggle with, this study is illustrative of the developmental challenges facing the Philippines, especially as regards inclusive growth generation and the fight against poverty.

June 2010 PQU: The Recovery Continues Despite Global Financial Turbulence

Economic development and peace: the case of Mindanao: (Box 1)

Philippines migration patterns during the global recession: resiliency through diversification and flexibility: (Box 2) Despite the global recession, total deployments (both new hires and rehires) to all destinations actually posted stronger growth rates than in the pre-crisis period, with females, service workers, seafarers, and rehires less susceptible to negative shocks from the financial crisis. Due to financial constraints, the shipping industry shifted to more inexpensive Filipino labor, thus inducing large increases in the employment of Filipino seafarers.
The European sovereign debt turmoil and the Philippines: (Box 3)

Bottlenecks to the Philippines competitiveness: (Box 4) The marked decline in competitiveness relative to key neighboring ASEAN countries is mostly driven by the opacity of government policy making, favoritism in decisions of government officials, a weak judicial system, high inflation in 2008, high agricultural policy costs, and a weaker relationship between wage and labor productivity.

February 2010 PQU: Layout the Exit Strategies

Cyclical and permanent changes in fiscal policy during the global recession: The large counter-cyclical fiscal policy engineered to fight the global recession helped buffer the economy but generated a large and mostly structural fiscal deficit, as permanent revenue-eroding and expenditure-increasing measures were introduced. To enable a measured unwinding of this fiscal expansion, laying out a specific and credible medium-term plan that takes into account the country’s inclusive growth agenda is warranted.

Petroleum Taxation in the Philippines (Box 1): Tax collection from petroleum excises is 1.8 percentage points of GDP lower than in 1997. Raising revenue through such excises would (1) generate minimal economic distortions (excises are “efficient” taxes); (2) predominantly impact the most well-off Filipinos (consumption is strongly “progressive” therefore guaranteeing vertical equity: the richer you are the more you pay); (3) reduce bad side effects of consuming petroleum products (“negative externalities”) such as traffic congestion, accidents, but also pollution which creates health hazards and environmental damages—the Philippines under-taxes compared to the rest of the world a major source of global warming; and (4) be easy to administer provided effective border controls are in place.

November 2009 PQU: Towards an Inclusive Recovery

Comparing the NFA and the 4Ps/CCT as social safety net instruments (Box 3): As a subsidy program for the poor, the NFA rice subsidy program suffers from serious deficiencies, not least: (1) limited assistance reaching the poor as they get only get 16 percent of their rice consumption from the NFA; (2) high leakage to the non poor with about half of NFA rice by the non poor; (3) a very expensive program due to limited operational efficiency of NFA—in 2008, for every peso-equivalent given to the poor through the rice subsidy program, the Philippine taxpayers spent between 3 to 8.6 pesos. Reallocating NFA’s fiscal support to the 4Ps/CCT would cover 100 percent of the poor against 25 percent with NFA, with each poor household receiving 7 times the benefits it receives with the NFA. Reallocating the NFA’s fiscal support to the 4Ps/CCT would generate major social protection gains and notable fiscal savings.

July 2009 PQU: Sailing Through Stormy Waters

Consumption and remittances during the global recession (Box 2)

Assessing and containing fiscal risks in the Philippines: a comprehensive assessment (Box 3)

Risks to the Philippines banking sector during the global recession: an assessment (Box 5)
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(for an exhaustive list, please go to: [http://go.worldbank.org/BRHFJLLQD0](http://go.worldbank.org/BRHFJLLQD0))

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<tr>
<td>Skills for the labor market in the Philippines</td>
<td>2010/10/01</td>
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<td>Philippines Quarterly Update (PQU): Stepping up reforms to sustain growth</td>
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