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PHILIPPINES ECONOMIC UPDATE

April 2017

Advancing The Investment Agenda

WORLD BANK GROUP
Macroeconomics and Fiscal Management Global Practice
East Asia and Pacific Region

ADVANCING THE INVESTMENT AGENDA

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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 findings from recent World Bank analysis, situating them in the context of the country's long-term development trends and assessing their implications for its medium-term economic outlook. The PEU covers issues ranging from macroeconomic management, 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, Social Protection & Labor, and Trade & Competitiveness Global Practices (GPs). Birgit Hansl (Lead Economist and Program Leader) and Ndiame Diop (Practice Manager for the MFM GP) led 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, Nataliya Mylenko (Senior Financial Sector Specialist) and Griselda Santos (Senior Financial Sector Specialist) from the Finance & Markets GP, Gabriel Demombynes (Program Leader), Xubei Luo (Senior Economist), Sharon Faye Alariao Piza (Economist) from the Poverty & Equity GP, Olivier Cattaneo (Senior Economist), Deborah Winkler (Consultant), Mauro Boffa (Consultant), Victor Kümmritz (Consultant), Gianluca Santoni (Consultant) and Na Zhang (Consultant) from the Trade & Competitiveness GP, Masud Cader (Senior Portfolio Officer) and Kirstin Roster (Consultant) from Country Economics and Engagement at IFC. The report was edited by Maryam Ali-Lothrop (Consultant), and the graphic designer was Robert Waiharo (Consultant). Peer reviewers were Julio E. Revilla (Lead Economist), Frederico Gil Sander (Senior Country Economist) and Emmanuel Lartey (Economist). Logistics and publication support were provided by Maria Consuelo Sy (Program Assistant). The Manila External Communications Team, consisting of David Llorito (Communications Officer), Justine Letargo (Online Communications Officer), and Geralyn Rigor (Program Assistant), 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 April 6, 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).

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EXECUTIVE SUMMARY

The Philippine economy remained resilient to global headwinds in 2016. While a slower-than-expected global recovery weakened net exports, surging domestic demand pushed the annual GDP growth rate to 6.8 percent, year-on-year. Investment drove economy-wide growth for the first time since 2013, as the government's expansionary fiscal-policy stance helped capital formation to expand by 20.8 percent year-on-year led by the construction sector. Consumption growth remained strong at a rate of 6.9 percent year-on-year, as accommodative monetary policies kept interest rates low, supporting a double-digit expansion in consumer lending. Meanwhile, low inflation at 1.8 percent boosted households' purchasing power, while a steady increase in remittance inflows accelerated the growth of household consumption. Overall, 2016 saw a marked rise in consumer confidence, reflecting a healthy job market and effective social protection programs.

Softening demand for the Philippines' main exports has revealed important weaknesses in its trade competitiveness. Due to the anemic recovery in advanced economies, external demand for electronics components grew by just 7.1 percent in 2016, down from 20.1 percent in 2015. While overall exports expanded at a healthy rate of 9.1 percent, imports expanded at a much faster rate of 17.5 percent. High levels of investment bolstered capital-goods imports, while rising wages, transfers, remittances, and credit increased household purchasing power, driving a surge in consumer-goods imports. Meanwhile, despite years of strong economic growth, an analysis of trade competitiveness, global value-chain integration, and the product and service space reveals adverse trends. For example, the growth rates of both exports and overall trade in the Philippines have been among the slowest in the region.

The rapidly growing domestic economy has yielded substantial gains in employment and poverty reduction. This means growth became more inclusive. Unemployment fell to a historic low of 4.7 percent in 2016, as 1.4 million net jobs were created. However, unemployment remains high among 15- to 24-year-olds, many of whom are entering the job market for the first time. In addition, the country's 18 percent underemployment level has remained broadly unchanged over the last ten years, reflecting the prevalence of informality and related job-quality concerns. The poverty incidence among Filipinos dropped to 21.6 percent in 2015 from 25.2 percent in 2012. This presents 1.8 million Filipinos lifted out of poverty within three years. Higher employment, low inflation and improved incomes contributed to the decline in the number of poor. One factor in the decline in poverty was the government's conditional cash transfer program, the *Pantawid Pamilyang Pilipino Program*, whose budget increased by almost 200 percent to PHP62.3 billion between 2011 and 2015, and whose household coverage almost doubled to 4.4 million households.

The Philippines' growth outlook remains positive. The World Bank projects that real GDP will grow at a rate of 6.9 percent in 2017 and 2018. Supported by sound domestic macroeconomic fundamentals and an accelerating recovery among other emerging markets and developing economies, the Philippines is expected to remain one of East Asia's top growth performers. The government's commitment to further increasing public infrastructure investment is expected to sustain the country's growth momentum through 2018 and reinforce business and consumer confidence. The implementation of planned infrastructure projects could generate positive spillover effects for the rest of the economy, spurring additional business activity, accelerating job creation, and ultimately contributing to higher household consumption. Strong and inclusive economic growth is projected to further increase household consumption and speed the pace of poverty reduction.

The country's growth prospects are subject to several important downside risks. On the external front, rising global interest rates could weaken the peso, adversely affecting capital flows to the Philippines and driving up domestic inflation. Commodity prices, specifically global crude oil prices, are projected to rise in 2017, which could also increase inflationary pressures. On the domestic front, strong macroeconomic fundamentals have opened some fiscal space for the government to implement its public investment and social spending agenda, but fiscal risks are intensifying. As rising public spending is expected to significantly increase the country's financing needs, the success and timeliness of the administration's planned tax reforms will be vital to preserve fiscal sustainability. Moreover, planning and implementation bottlenecks could diminish the government's ability to implement its planned infrastructure investment program.

Over the medium term, the Philippines can leverage several emerging trends to accelerate its growth and development, including the potential for a demographic dividend. The Philippines is undergoing a demographic transition, which has given rise to a large cohort of young workers in the context of an ongoing process of rural-urban migration. As a result, the working-age population is unusually large relative to the nonworking population of children and elderly people—creating the potential for a demographic dividend, as the low share of dependents allows workers to save and invest. However, the dividend period offers a brief window of opportunity, and the Philippines will only be able to reap its benefits if structural reforms facilitate savings and investment and allow young workers to develop the appropriate skills to succeed in a dynamic labor market.

Similarly, the Philippines has a chance to capitalize on its growing services sector to accelerate its structural economic transformation. Despite the rapid expansion of the services sector in general, and the growth of business-process outsourcing in particular, linkages between services and traditional sectors such as manufacturing remain weak. The Philippines' highly capable workforce and solid macroeconomic fundamentals could enable it to leverage the growth of the services sector to increase domestic value addition and accelerate the creation of high-quality jobs. Trends in trade competitiveness and the increasingly important role of the services sector in the Philippines are discussed in greater detail in this report's special focus section.

Sustaining the inclusive pattern of recent growth will require an enduring commitment to structural reforms that facilitate private investment. The economy's failure to complete its structural transformation reflects limited competition in key sectors, restrictions on foreign investment, insecure property rights, regulatory challenges, and other obstacles to Doing Business, which continue to discourage private investment. Underinvestment in turn contributes to high rates of informality and low job quality, and it weakens the impact of employment growth on poverty reduction. The new Philippine Development Plan (PDP) 2017-2022 and the *AmBisyon Natin* 2040 strive to address these challenges. The PDP articulates the administration's main policy goals over the next six years and its objective of enabling the Philippines to become an upper-middle-income country by 2022.

PART I:

RECENT ECONOMIC AND POLICY DEVELOPMENTS

The Philippine economy remained resilient to global headwinds in 2016, as robust domestic demand pushed the GDP growth rate to 6.8 percent, year-on-year. Capital formation drove overall growth for the first time since 2013, supported by an expansionary fiscal policy focused on public infrastructure spending, which spurred construction activity. Consumption growth accelerated significantly for the second consecutive year, as an accommodative monetary policy kept interest rates low, supporting consumer lending while low inflation boosted households' purchasing power. Meanwhile, a continued increase in remittance inflows bolstered household consumption. However, import growth outpaced export growth due to softer external demand in a weaker-than-expected global economy. The industrial and services sectors expanded, while the agriculture sector contracted due to structural vulnerabilities. Growth has become more inclusive in recent years, and the expansion in 2016 contributed to increased job creation. By the end of the year, the unemployment rate had fallen to a historic low of 4.7 percent. However, underemployment has remained high at around 20 percent over the last ten years, raising job-quality concerns. The industrial and services sectors drove job creation in 2016, largely offsetting substantial job losses in the agriculture sector. The latest available poverty estimates, which are based on 2015 data, show a significant reduction in national poverty levels, with the incidence of poverty declining from 25.2 percent in 2012 to 21.6 percent in 2015.

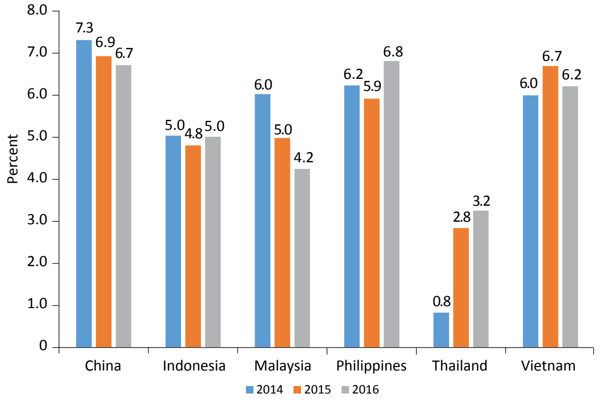
1.1 Growth: Resilience in the Face of Global Headwinds

The GDP growth rate accelerated to 6.8 percent year-on-year in 2016, up almost 1 percentage point from 2015. An expansionary fiscal policy supported robust capital formation and consumer demand, but net exports slowed overall growth.

1. **Due to strong domestic economic policies, the Philippines was among the region's fastest-growing economies in 2016 despite a weak external environment.** The GDP growth rate accelerated from 5.9 percent in 2015 to 6.8 percent year-on-year in 2016, outpacing most regional comparators (Figure 1).[1] Accelerating capital formation and expanding private consumption contributed to robust domestic demand, driving economic growth despite sluggish global trade and investment flows and heightened policy uncertainty in many advanced economies. Financial market disruptions and capital outflows from the region toward the end of the year exacerbated these challenges. The global economic growth rate decreased from 2.7 percent in 2015 to an estimated 2.3 percent year-on-year in 2016, the lowest level since the global financial crisis (Box 1). Despite these global headwinds, the Philippine economy remained resilient, supported by the government's expansionary fiscal stance and accommodative monetary policies, which fueled domestic demand.

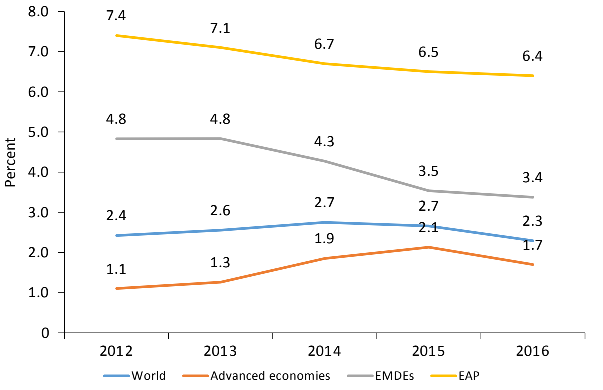
2. **Capital formation became the main driver of economic growth in 2016, supported by expansionary fiscal policies that contributed to higher public investment.** The capital-formation growth rate rose from 15.1 percent in 2015 to 20.8 percent year-on-year in 2016 and contributed 4.9 percentage points to GDP growth, making it the country's main growth engine for the first time since 2013 (Figure 3). Investment in the construction sector increased from 8.9 percent in 2015 to 13.6 percent year-on-year in 2016, supported both by healthy levels of private construction and by surging public construction expenditures as part of the government's new infrastructure agenda. Public construction grew by 29.0 percent year-on-year, driven by several large projects.[2] The government is poised to accelerate public construction through a planned 13.8 percent increase in the 2017 infrastructure budget (see Section 1.4). In addition, investment in durable equipment rose by 32.6 percent year-on-year as firms expanded their production capacity.[3]

Figure 1: The Philippines' economy performed well in 2016 relative to regional comparators…



Source: World Bank

Figure 2: …despite the slowing global growth rate, which fell to a post-crisis low of 2.3 percent



Source: World Bank

1 See Appendix 1 for a summary of key economic indicators and Table 7 for growth components data.

2 Completed and ongoing public infrastructure projects are mainly concentrated in the transport sector with roads, expressways and transport systems such as the Metro Manila Skyway, Manila Metro Rail Transit System Line 7, Cavite-Laguna Expressway, and airport passenger terminal hubs. Priorities also go to infrastructure investments in the education and health sectors with public projects on new school buildings and health centers.

3 However, about half of the total amount invested supported the delivery of transport equipment, while only a third was used for general and specialized machinery. This suggests that the additional expenditures on durable equipment may have a limited effect on improving productive capacity.

Box 1 Recent trends in global growth

Slowing global trade, weak investment, and heightened policy uncertainty have depressed worldwide economic activity. Global growth is estimated to have grown at 2.3 percent in 2016, its weakest performance since the global financial crisis.

Advanced economies continue to struggle with subdued growth rates and low inflation levels in a context of increased policy uncertainty, tepid investment, and sluggish productivity growth. Economic activity decelerated in the United States and, to a lesser degree, in other major economies. As a result, the aggregate growth rate among advanced economies is estimated to have slowed to 1.7 percent in 2016. The anemic growth in advanced economies was accompanied by a further weakening of global trade. Global trade growth slowed further in 2016 as soft imports from major economies continued to depress trade flows, compounded by structural factors and increased protectionism. Meanwhile, the rise in U.S. Treasury yields since early November has led to a notable tightening of financing conditions for emerging markets and developing economies, in some cases resulting in significant currency depreciation and portfolio outflows. Nevertheless, financing conditions remain generally favorable, as major central banks maintain their accommodative monetary stance.

Together, emerging markets and developing economies grew at an estimated aggregate rate of 3.4 percent in 2016, broadly in line with previous expectations. Commodity exporters continued to grow at markedly lower rates than commodity importers. The aggregate growth rate among commodity exporters was estimated at just 0.3 percent in 2016. Improved performance among some large emerging markets and developing economies exporters—including a more rapid bottoming-out in the Russian Federation and a slowing contraction in Brazil—and an increase in commodity prices from their early-2016 lows helped offset weaknesses among other exporters, especially in Sub-Saharan Africa. Meanwhile, commodity importers grew at an estimated aggregate rate of 5.6 percent, reflecting resilient domestic demand, low commodity prices, and generally accommodative macroeconomic policies.

Sluggish global growth underscores the need to implement structural reforms that support domestic demand and reinvigorate investment. In advanced economies, extremely low and even negative real equilibrium interest rates constrain the effectiveness of monetary policy and may warrant more supportive fiscal policies. More generally, macroeconomic policies should remain accommodative until evidence of capacity constraints in production emerge and inflation is on a clear upward trend. Striking an appropriate balance between fiscal adjustment policies, measures to reduce vulnerabilities, and growth-oriented reforms aimed at building human capital and physical infrastructure will be challenging for some emerging markets and developing economies. Policies that boost domestic sources of long-term growth—especially long-term investment and productivity—are a priority for all emerging markets and developing economies. Investing in human and physical capital will help narrow gaps in skills and infrastructure. Efforts to further international integration—for example, by supporting growth in emerging markets and developing economies services trade—and create an environment to maximize the benefits of foreign direct investment (FDI) could reinforce these policies.

Source: World Bank Global Economic Prospects, January 2017

3. Household consumption growth continued to accelerate rapidly, supported by accommodative monetary policies and strong consumer confidence. The household consumption growth rate accelerated for a second consecutive year, rising from 6.3 percent in 2015 to 6.9 percent year-on-year in 2016. After capital formation, private consumption made the second-largest contribution to growth, accounting for 4.8 percentage points.[4] Consumption growth remained robust due to the relatively low inflation and the administration's accommodative monetary stance, which kept interest rates low. The annual inflation rate averaged 1.8 percent, boosting real household purchasing power, while low interest rates supported a double-digit expansion in consumer lending (see Section 1.3). Remittance inflows grew at a robust pace, at 4.9 percent in 2016 (compared to 3.8 percent in 2015) (see Section 1.2), and supported greater household consumption.[5] In addition, the number of Filipinos with a formal source of income increased, and the unemployment rate fell (see Section 1.5). Together, these factors contributed to record levels of consumer confidence, with Filipinos reporting high rates of satisfaction with government policies, ample job availability, and anticipated salary increases.[6]

4. Net exports remained a source of weakness for the Philippines economy in 2016 as the rapid expansion of imports outpaced export growth.[7] Annual import growth accelerated from 14.0 percent in 2015 to 17.5 percent year-on-year in 2016, as rising investment and household income levels boosted both capital- and consumer-goods imports. Meanwhile, annual exports also grew steadily, 9.1 percent year-on-year in 2016, compared to 9.0 percent in 2015. Service exports contributed the most to export growth, accelerating by 15.6 percent in 2016, up from 15.3 percent in 2015, while merchandise exports grew at a slower rate of 7.4 percent year-on-year, similarly to the 7.5 percent in 2015. Exports of electronic components—the country's main export good—slipped from 20.1 percent in 2015 to 7.1 percent year-on-year in 2016, due in part to weaker global demand stemming from the tepid recovery among advanced economies and the ongoing rebalancing of the Chinese economy, though it also reflects a longer-term trend in the Philippines of gradually declining export competitiveness. Trends in export competitiveness in the Philippines are discussed in this report's special focus section, which is presented in Part III.

5. The services sector continues to drive growth on the supply side, and it accounted for more than 60 percent of total output in 2016. The services sector expanded by 7.5 percent year-on-year in 2016, up from 6.8 percent in 2015 (Figure 4). The country's real estate and business services subsector drove the expansion with a growth rate of 9.1 percent year-on-year, supported by expanding economic activity in commercial and residential real estate and the information technology and business-process outsourcing (IT-BPO) sector.[8] Increased manufacturing activity drove the growth of the industrial sector, while the mining and quarrying subsector contracted (Box 2).[9] A thriving real-estate market contributed to the growth of the construction subsector, while robust domestic economic activity nearly doubled the output of the utilities subsector. Food manufacturing accounted for nearly half

[4] Basic goods such as food and non-alcoholic beverages (41.3 percent), and housing, water, gas, electricity and fuels (10.8 percent) accounted for bulk of the share of households' consumption expenditure in 2016. In terms of growth, however, the fastest rates were recorded with transport (10.5 percent), and non-essential goods and services such as recreation and culture (8.0 percent), and restaurants and hotels (8.0 percent).

[5] Based on the central bank's Consumer Expectations Survey, around 96.5 percent of overseas Filipino households use remittances for food and other household expenditures.

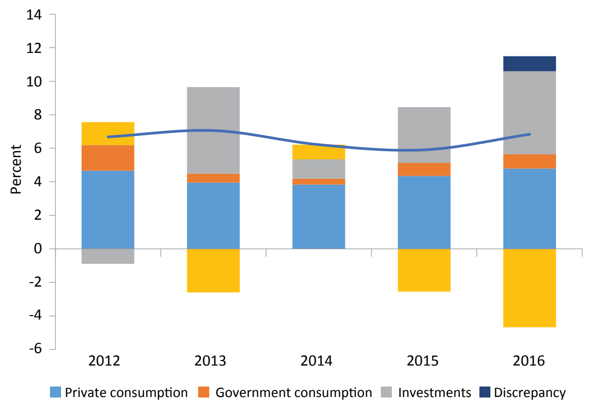
[6] BSP Consumer Expectations Survey for quarter three and quarter four 2016; and the Social Weather Stations Survey for quarter four.

[7] The discussion of net exports in this section assesses values at constant 2000 prices. This differs from the discussion of balance of payments, where net exports assesses values at current prices.

[8] Greater demand for domestic credit and banking services drove growth in the finance subsector, which increased by 7.7 percent year-on-year in 2016, up from 6.1 percent in 2015. Meanwhile, growth in the wholesale and retail trade subsector accelerated from 7.1 percent in 2015 to 7.3 percent year-on-year in 2016, supported by robust household consumption. The country's IT-BPO industry continues to play a key role in the growth of the services sector. Total revenues in the sector, including both domestic and export receipts, increased from about US$22.0 billion in 2015 to US$25.0 billion in in 2016.

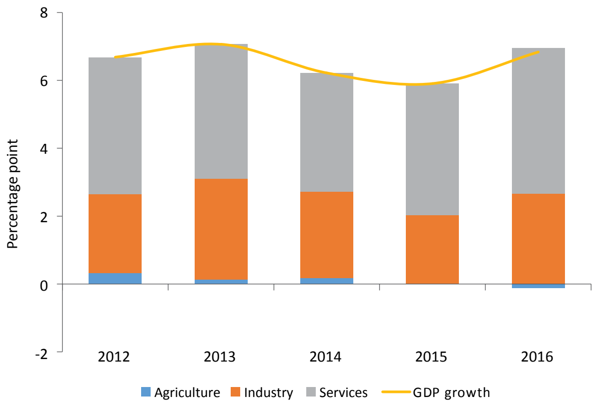
[9] Growth in the mining and quarrying subsector contracted by 0.3 percent year-on-year in 2016, as low commodity prices affected production in the nickel-mining industry in early 2016 and the government conducted a nationwide audit of mining firms. By the end of 2016, three-fourths of the country's operating mines were either suspended or facing suspension. See: http://business.mb.com.ph/2017/01/02/denr-to-start-the-year-shutting-down-non-compliant-mining-firms/

Figure 3: Robust domestic demand drove growth in 2016, fueled by investment and consumption



Source: Philippine Statistics Authority (PSA)

Figure 4: Services and industry contributed the most to overall growth, as the agriculture sector continued to struggle



Source: PSA

of total manufacturing output in the Philippines, increasing at an annual rate of 8.5 percent despite anemic agricultural output. The agriculture sector remained the poorest performer in 2016, as agricultural production declined by 1.3 percent year-on-year, its sharpest contraction since 2010, when it also contracted, but by only 0.2 percent. Structural weaknesses, including low investment levels, inadequate extension services, and inefficient transportation and logistics linkages[10], as well as the country's exposure to weather-related shocks—which inflicted at least PHP25.6 billion in damages in 2016—contributed to the decline of agricultural output.[11]

Box 2 Trends in the manufacturing sector

The manufacturing sector's growth rate increased from 5.7 percent in 2015 to 7.0 percent in 2016. The production of consumer and capital goods drove manufacturing growth in 2016 (Figure 5).[12] Optimistic consumer sentiment, combined with positive employment dynamics and real income growth, increased demand for consumer goods. Food and beverages remained the country's top manufactures, accounting for about 40 percent of total manufacturing production and contributing 3.3 percentage points to annual growth in 2016. Meanwhile, capital-goods manufacturing was also strong, with double-digit growth recorded in the production of basic metals, transport equipment, machinery, and electrical and non-electrical equipment. The production of intermediate goods, which feeds into the country's exports, moderated from a strong annual growth rate of 12.0 percent in 2015 to a rate of 2.9 percent in 2016.

The Volume of Production Index (VoPI) for manufacturing has risen steadily in recent years, indicating that output growth is likely to remain robust over the near term. The VoPI rose by 23.0 percent year-on-year in December 2016, compared to 5.0 percent in December 2015 (Figure 6), reflecting robust manufacturing activity since August 2015. The growth of key commodity

[10] See the Philippine Development Report 2013: Creating more and better jobs, for a comprehensive discussion of the policy distortions and drivers of low productivity in the Philippines agriculture sector.

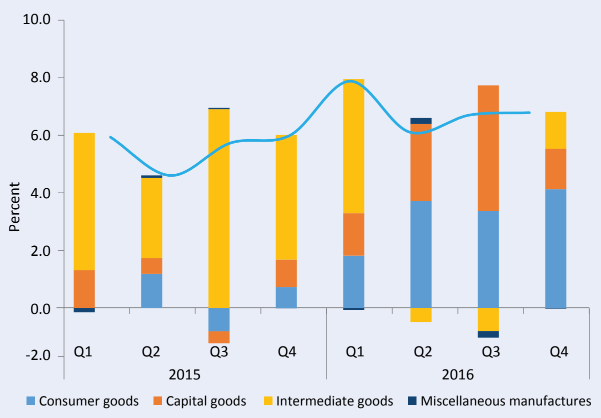
[11] The Department of Agriculture has estimated the following economic damages from weather-related events: (i) PHP7.0 billion due to El Niño; (ii) PHP10.2 billion due to Typhoon Lawin; (iii) PHP3.0 billion due to Typhoon Karen; (iv) PHP4.1 billion due to Typhoon Nina; and (v) PHP1.3 billion due to Typhoon Ferdie.

[12] Manufactured goods are classified as consumer, capital, or intermediate goods under the classification system used by the National Economic and Development Authority (NEDA). Consumer goods include food, beverages, tobacco, footwear and apparel, and furniture and fixtures. Capital goods include basic metals, fabricated metal products, and machinery, except electrical machinery and transport equipment. Intermediate goods include textiles, wood and wood products, paper and paper products, printing, leather products, rubber and plastic products, chemical products, petroleum products, and non-metallic mineral products. The World Bank classifies radio, television, and communication equipment and devices as intermediate goods.

subsectors, such as food and petroleum products, as well as fabricated metals, machinery, and transport equipment, continued to drive the sector's strong performance through January 2016. Meanwhile, the Nikkei ASEAN Manufacturing Purchasing Managers' Index (PMI), an alternative indicator that measures factory activities, for the Philippines[13] expanded throughout 2016, though its growth slowed during the last quarter of the year. In February, however, the index increased again, signaling renewed optimism.

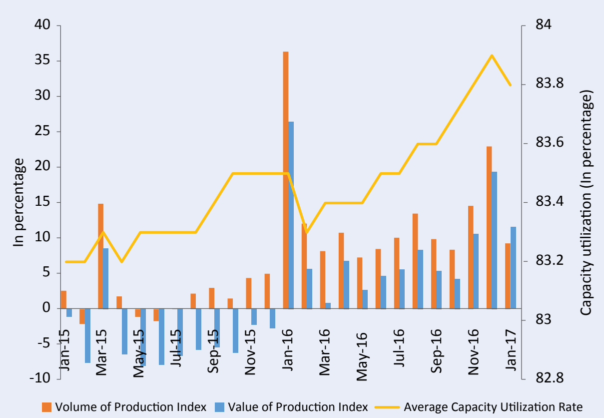
The average capacity-utilization rate continues to rise, underscoring the importance of expanding production capacity. The average capacity-utilization rate rose from 83.5 percent in December 2015 to 83.9 percent in December 2016—the tenth consecutive monthly increase since February 2016 and consistent with a general rising trend observed since 2015. The rate moderated slightly to 83.8 in January 2017. Eleven of the country's 20 major industries are now operating at or above 80 percent capacity utilization, which effectively constitutes full capacity. As a result, investments in new production capacity will be critical to ensure continued medium-term output growth.

Figure 5: The manufacturing sector expanded in 2016...



Source: PSA

Figure 6: ...bringing the average capacity-utilization rate nearer to full capacity



Source: PSA

1.2 The Exchange Rate and the External Sector: Increased Volatility and Vulnerability

Global events toward the end of the year led to renewed market uncertainty and volatility, causing the Philippine peso to depreciate and the balance of payments to weaken.

6. In November 2016, the Philippine peso depreciated to its lowest level in ten years in the context of a volatile foreign-exchange market. Uncertainty surrounding national elections in the Philippines and the United States, as well as the U.K.'s prospective withdrawal from the European Union, combined with volatile global crude oil prices, have contributed to an unpredictable foreign-exchange market since early 2016. In November, the Philippine peso passed the PHP/US$50.00 mark as investors priced-in the prospect of an interest rate increase by the U.S. Federal Reserve.[14] This sudden depreciation followed a general weakening of the peso that began as early as 2013. The peso closed the year at PHP/US$49.81, marking a 5.6 percent year-on-year

13 The PMI is a composite of five sub-indices: new orders, output, employment, suppliers' delivery times, and stocks of purchases.

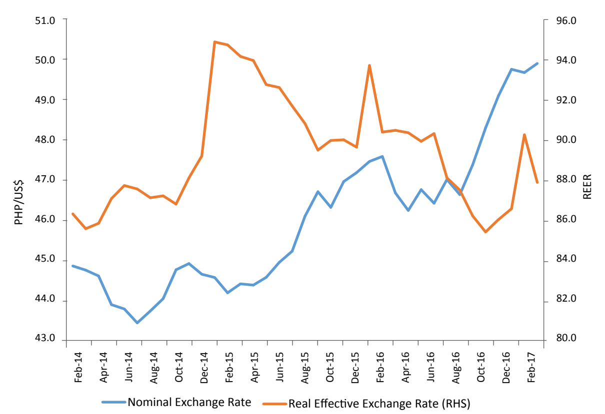
14 The currency depreciation was largely a regional phenomenon, with currencies in neighboring economies such as Malaysia, Indonesia, Singapore, and Thailand also weakening in November.

depreciation from its closing value in 2015 (Figure 9). Meanwhile, the real effective exchange rate depreciated by 3.2 percent year-on-year in 2016, though it has not yet impacted the country's trade performance. The peso has come under renewed pressure since February 2017 due to rising U.S. Treasury yields and the anticipation of an additional U.S. Federal Funds Rate increase in March. The peso closed in February at PHP/US$50.26, its lowest level since September 2006.

7. The balance of payments (BOP) deteriorated sharply in November 2016, as net capital outflows pushed the BOP into deficit. The BOP shifted from a surplus of 2.6 percent of GDP (US$2.6 billion) in 2015 to a deficit of 0.1 percent of GDP (US$0.4 billion) in 2016 (Table 1). This deterioration occurred during the last quarter of 2016, and in November alone a US$1.7 billion BOP deficit wiped out the year-to-date October surplus of US$1.5 billion. An interest rate hike by the U.S. Federal Reserve and the U.S. presidential election increased uncertainty among emerging markets, weakening the peso and contributing to foreign-equity outflows from the Philippines. In 2016, portfolio investments resulted in US$1.4 billion in net outflows, while other investments contributed to US$3.8 billion in net outflows.[15] Meanwhile, FDI, which typically represents long-term investment, remained solid, with net inflows of US$7.9 billion in 2016 reflecting a 40.7 percent year-on-year increase from 2015 (Box 3).

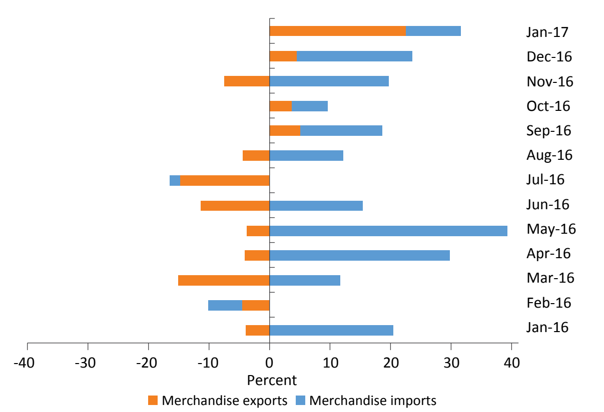
8. The current-account surplus shrank significantly in 2016 due to a widening trade deficit, which services exports and remittance receipts only barely offset. The current-account surplus narrowed by 91.7 percent between 2015 and 2016, falling from US$7.3 billion to US$0.6 billion. The trade deficit widened as double-digit import growth (16.6 percent) outpaced export growth (0.6 percent) (Figure 8). A 41.6 percent increase in capital-goods purchases and a 16.8 percent increase in purchases of raw materials and intermediate goods in 2016 contributed to the growth of imports. At the same time, despite the peso's depreciation, demand for Philippine exports remained relatively weak among the country's major trading partners. However, increased services exports and remittances offset the weakening trade balance. Export earnings from the IT-BPO subsector rose from US$17.9 billion in 2015 to US$20.2 billion in 2016, a 12.8 percent increase. After declining for two consecutive years, the pace of remittance growth rebounded in 2015, rising from 3.8 percent in 2015 to 4.9 percent year-on-year in 2016 (Box 4).

Figure 7: The exchange rate depreciated both in real and nominal terms in 2016 ...



Source: BSP

Figure 8: ... while export growth slowed



Source: BSP

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

9. The drop in international reserves during the last quarter of 2016 coincided with substantial portfolio investment outflows and the peso's depreciation. Gross international reserves declined from an all-time high of US$86.1 billion in September 2016 to US$80.7 billion at end-December. Nevertheless, the year-end figure was still 0.5 percent higher year-on-year than the year-end figure in 2015, covering 9.2 months' worth of goods imports and payments for services and primary income. Gross international reserves are also 5.8 times the size of country's short-term external debt stock based on original maturity, or 4.2 times based on residual maturity.[16]

Table 1: Balance of payments, 2013 to 2016

	2013		2014		2015		2016	
Current account	11,384	4.2	10,756	3.8	7,266	2.5	601	0.2
Goods	(17,662)	(6.5)	(17,330)	(6.1)	(23,309)	(8.0)	(34,079)	(11.2)
Services	7,015	2.6	4,576	1.6	5,455	1.9	7,125	2.3
Primary Income	957	0.4	727	0.3	1,857	0.6	2,594	0.9
Secondary Income	21,073	7.8	22,782	8.0	23,263	8.0	24,962	8.2
Capital and Financial accounts	(2,096)	(0.8)	(9,523)	(3.3)	(2,216)	(0.8)	(846)	(0.3)
Capital account	134	0.0	108	0.0	84	0.0	102	0.0
Financial account	2,230	0.8	9,631	3.4	2,301	0.8	949	0.3
Direct investment	(90)	(0.0)	1,014	0.4	(100)	(0.0)	(4,235)	(1.4)
Net acquisition of financial assets	3,647	1.3	6,754	2.4	5,540	1.9	3,698	1.2
Net incurrence of liabilities[1]/	3,737	1.4	5,740	2.0	5,639	1.9	7,933	2.6
Portfolio investment	(1,001)	(0.4)	2,708	1.0	5,471	1.9	1,383	0.5
Financial derivatives	(88)	(0.0)	4	0.0	6	0.0	(32)	(0.0)
Other investments	3,410	1.3	5,905	2.1	(3,076)	(1.1)	3,832	1.3
Net unclassified items[2]/	(4,202)	(1.5)	(4,091)	(1.4)	(2,433)	(0.8)	(175)	(0.1)
Overall BOP position	**5,085**	**1.9**	**(2,858)**	**(1.0)**	**2,616**	**0.9**	**(420)**	**(0.1)**
Memo:								
Basic Balance	11,474	4.2	9,742	3.4	7,365	2.5	4,835	1.6

[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.

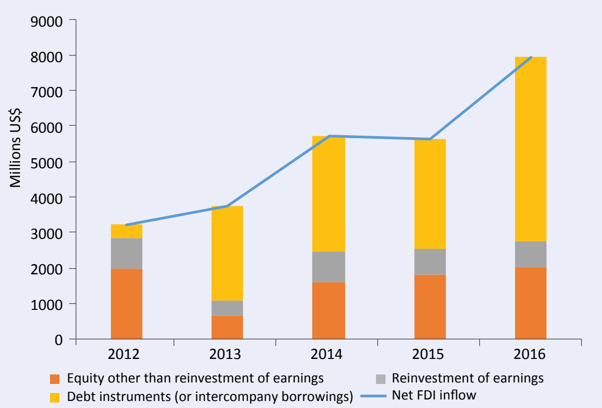
[16] Roughly 84.6 percent of reserves are in the form of foreign investment, 9 percent are in gold, and the remaining balance is in foreign-exchange holdings, Special Drawing Rights, and IMF reserves.

Box 3 Net FDI and foreign portfolio investment flows to the Philippines

While net FDI inflows to the Philippines have risen consistently in recent years, they remain relatively low by the standards of comparable countries in Southeast Asia. Net FDI inflows to the Philippines reached US$7.9 billion in 2016, a 40.7 percent year-on-year increase from 2015 and the highest level of net inflows recorded in the country's history (Figure 9). A substantial portion of the FDI represents intercompany borrowing in the form of debt securities or supplier credits, followed by the infusion of fresh equity and the reinvestment of earnings. In 2016, FDI to the Philippines originated primarily from Japan, Hong Kong, Singapore, the United States, and Taiwan, and it largely supported the financial and insurance, real estate and construction, and manufacturing sectors. Net FDI inflows in the Philippines have historically lagged those of other Southeast Asian countries. In 2015, net FDI in the Philippines reached US$5.8 billion, compared to US$9.0 billion in Thailand, US$11.0 billion in Malaysia, US$11.8 billion in Vietnam, US$20.2 billion in Indonesia, and US$65.3 billion in Singapore. In 2016, net FDI inflows to the Philippines surpassed those of Thailand (US$3.3 billion) and Indonesia (US$3.8 billion) but remained below those of Malaysia (US$12.6 billion) and Singapore (US$61.6 billion).

Meanwhile, foreign portfolio investments registered by the Central Bank of the Philippines (Bangko Sentral ng Pilipinas, BSP) experienced a modest recovery in 2016 after recording net outflows in 2014-2015. Foreign portfolio investments typically take the form of stocks, bonds, and money-market instruments, which are domestically and internationally tradable. The net outflow of BSP-registered foreign portfolio investment in 2014 and 2015 reflected anemic demand for government securities and net outflows from the stock market, respectively (Figure 10). However, in 2016, foreign portfolio investment in the Philippines yielded a net inflow of US$404.4 million, compared to a net outflow of US$599.7 million in 2015. Foreign demand for government securities, term deposits, and peso-denominated debt instruments rebounded last year as the stock market weakened. Top investor countries included the United Kingdom, the United States, Singapore, Luxembourg, and Hong Kong.

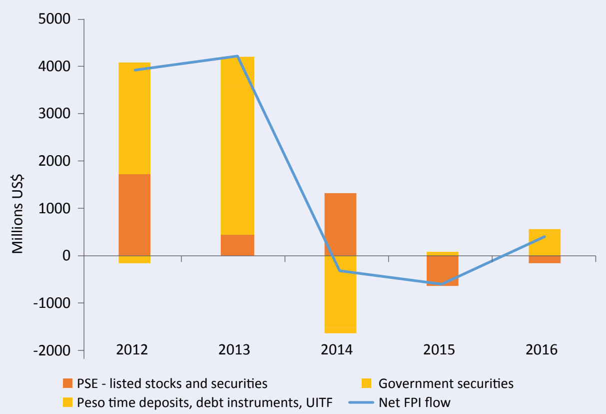
Figure 9: Composition of net FDI flows*



Source: BSP

** Net FDI flows refer to non-residents' net equity capital, reinvestment of earnings, and debt instruments.*

Figure 10: Composition of BSP-registered net foreign portfolio investment flows



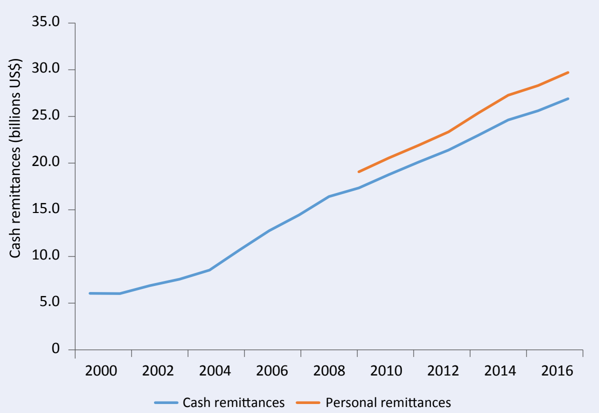
Source: BSP

Box 4 Recent trends in remittances

Remittance growth accelerated in 2016, following two consecutive years of slowing growth. The growth rate of personal remittances rose from 3.8 percent in 2015 to 4.9 percent year-on-year in 2016, well above the BSP forecast of 4.0 percent (Figure 11). Overall, remittances have grown at an annual average rate of 6.6 percent since 2010. Remittance growth has remained solid despite several adverse trends, including a slower-than-expected global economic recovery and the continued "de-risking"[17] by commercial banks, which have increased transaction costs for remittance transfers.

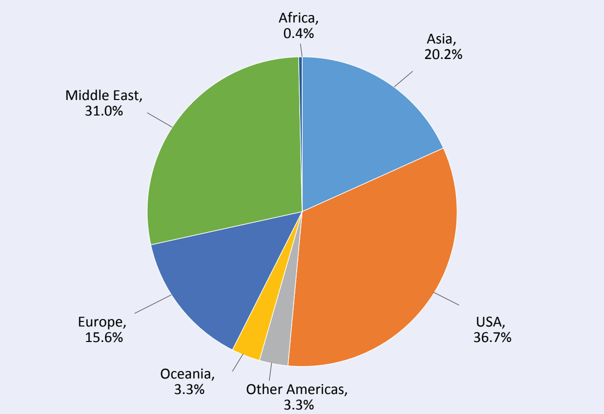
The sources of remittance inflows largely reflect the distribution of Filipinos abroad. The United States remained the primary source of remittance inflows to the Philippines in 2016 (Figure 12), accounting for more than a third of cash remittances. However, these figures may be overstated due to data limitations.[18] The Middle East was the second-largest source of remittances, accounting for 31.0 percent of cash remittances, followed by Asia (20.2 percent) and Europe (15.6 percent). The sources of cash remittances largely reflect the overseas distribution of more than 10 million Filipino migrants, the majority of whom are located in the U.S. (35.8 percent), followed by the Middle East (25.2 percent), Asia (16.9 percent), and Europe (8.8 percent).[19]

Figure 11: Remittances continued to expand, despite a slower global recovery…



Source: BSP

Figure 12: …and most remittances came from the United States and the Middle East



Source: BSP

17 De-risking refers to the process of closing money-transfer operators' bank accounts due to money-laundering risks. Many international banks have closed the correspondent bank accounts of money-transfer operators, disrupting remittance flows.

18 Remittance flows attributed to the United States may be overestimated since remittances are typically transferred through correspondent banks, most of which are in the United States. In addition, remittances sent through money-transfer operators cannot be disaggregated by source country and are recorded under the country where the main office is located, which is usually in the United States. (Source: BSP)

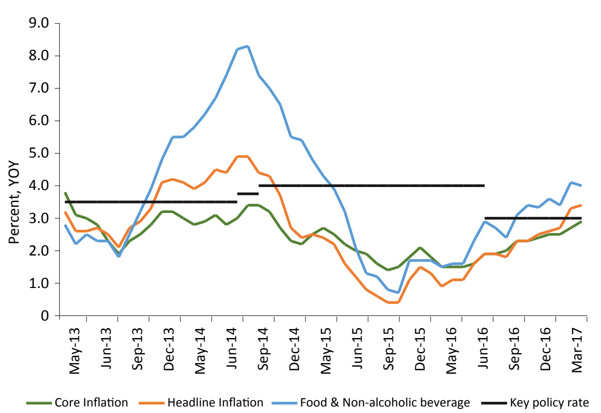
19 Data are based on the latest available stock estimates of overseas Filipinos (both temporary and permanent) as of December 2013 from the Commission on Filipinos Overseas. 2015 United Nations Population Division data reflect similar trends, but account only for permanent migrants (there are an estimated 5.1 million international migrants from the Philippines).

1.3 Monetary Policy and Financial Markets: Supporting Growth

An accommodative monetary policy supported growth by keeping interest rates low, promoting household consumption and facilitating a double-digit credit expansion. The financial system remains well-capitalized and stable, with low nonperforming loan ratios.

10. The government's monetary policies targeted manageable inflation levels, but inflationary pressures mounted towards the end of 2016. Prices rose throughout 2016, increasing markedly in the last quarter of the year (Figure 13). The headline inflation rate rose from an average of 1.4 percent in 2015 to 1.8 percent in 2016, but remained below the central bank's 2-4 percent target range. By end-2016, the headline inflation rate was at 2.6 percent year-on-year, and it has continued to increase since January 2017, reaching 3.4 percent year-on-year in March. Rising food prices remained the largest contributor to inflation. Weather-related shocks disrupted domestic food production, driving up prices for fruits, vegetables, corn, sugar, and other foods. Food-price inflation rose from 1.7 percent year-on-year in January 2016 to 3.6 percent in December 2016 and reached 4.0 percent in March 2017.[20] Meanwhile, fuel, gas, and electricity prices decreased in 2016 as global commodity prices remained low, but have since begun to rise. Core inflation averaged 1.9 percent in 2016, compared to 2.0 percent in 2015, though demand-side pressures started to build as prices for services and clothing increased along with income and credit growth. Despite intensifying inflationary pressures, the BSP only lowered the key policy rate once, from 4.0 to 3.0 percent, in June 2016.[21]

Figure 13: Inflationary pressures grew in 2016



Source: BSP

11. Low interest rates contributed to rapid credit growth and supported the economic expansion. Total credit growth rose from an average of 13.6 percent in December 2015 to 16.6 percent year-on-year in December 2016 (Figure 14). Credit to firms grew by 15.5 percent in 2016, slightly higher than in 2015, while the growth of loans for household consumption slowed to 22.7 percent.[12] The overall credit growth rate has averaged 15.4 percent a year since 2010, boosting the country's credit stock from 29.6 percent of GDP in 2010 to 46.7 percent in 2016. The sectoral composition of the bank's credit portfolio has remained broadly stable, with new loans primarily supporting real estate, manufacturing, and wholesale-retail trade. Consumption loans continued to rise at the fastest pace, and salary loans have significantly contributed to the increase in consumption loans in recent years (Box 5). Expanding deposits have funded this remarkable credit expansion, which has contributed to increased liquidity, with the money supply (M3) increasing by 12.4 percent to reach PHP9.5 trillion at end-2016. Meanwhile, the loan-to-deposit ratio has gradually increased from 65.9 percent in 2010 to 72.5 percent in 2016, though it remains low relative to that of neighboring countries (Figure 15).

12. The Philippine financial system remains stable and well-capitalized. Nonperforming loans (NPLs) declined from 2.1 percent of the total loan portfolio in December 2015 to 1.9 percent in December 2016. The capital-adequacy

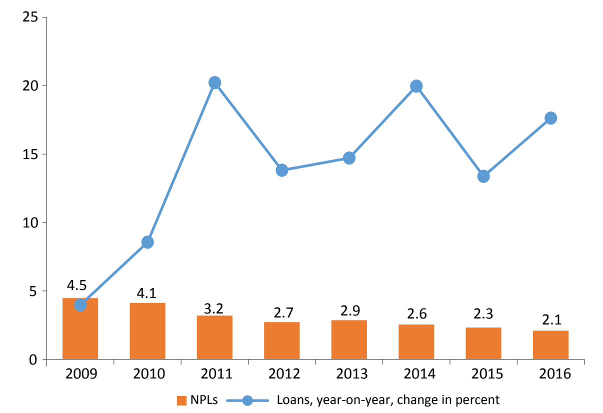
[20] Food-price inflation reflects prices for food and nonalcoholic beverages.

[21] The easing of the key policy rate coincided with a shift to the interest-rate corridor system. The central bank has stated that these reforms were primarily operational in nature and that their implementation was not intended to significantly affect the prevailing monetary policy stance.

[22] Data on outstanding loans in the Philippine banking system have a series break in June 2014, marking the central bank's shift from the 1994 to the 2009 Philippine Standard Industrial Classification regime.

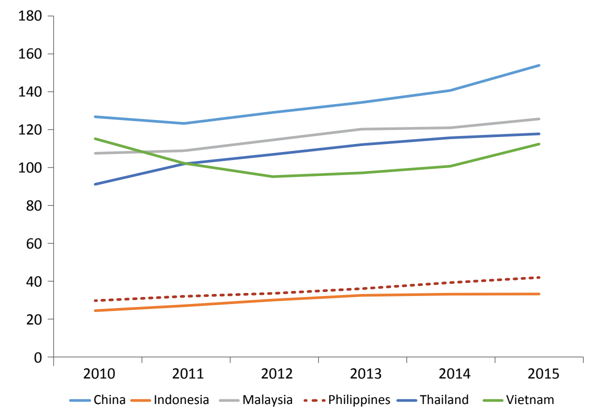
ratio for the banking system stood at 15.6 percent in September 2016, well above the 10.0 percent regulatory minimum. In addition, the BSP continued to enhance its regulatory capacity over potentially high-risk sectors and introduced a range of measures to enhance risk management among banks and minimize their exposure to the real-estate sector. The banking system's profitability remained stable at the system level, with a 1.2 percent return on assets and 10.4 percent return on equity. The net interest margin was also stable throughout 2016 at 3.3 percent, and net interest income remained at 72.2 percent of total income.

Figure 14: Loan volumes in the Philippines have grown over time...



Source: BSP

Figure 15: ...but the domestic credit-to-GDP ratio remains low relative to neighboring countries



Source: BSP

Box 5 The growth of salary loans

The BSP has sought to monitor the utilization of salary loans, which are the fastest-growing loan segment in many banks due to their low perceived risk. Under Circular 837, the BSP amended the reporting package associated with salary loans in 2014. Whereas previously only credit card and auto loans were reported as separate line items, salary loans are now separately reported under the "loans to individuals for consumption purposes" sub-category. This reform was designed to promote consumer lending under fair and sound credit practices. Moreover, salary loans were renamed "salary-based general-purpose consumption loans" (SBGPCLs) in 2015 and were redefined to cover unsecured loans for a broad range of consumption purposes, granted to individuals who have a regular salary, pension, or other fixed income source. The current definition also covers credit issued for education, hospitalization, emergency, travel, household use, and other personal consumption needs.

The accelerating growth of salary loans has drawn attention to the share of total consumer NPLs. As of December 2016, SBGPCLs in the Philippines amounted to PHP165.1 billion, a 36.4 percent year-on-year increase from their December 2015 level. Since December 2014, the total value of SBGPCLs has grown at an annualized rate of 50.1 percent. This increase appears to be due to the use of credit to smooth consumption, given the slower growth of net disposable income. Based on the latest PSA data, the pace of net disposable income growth slowed from 9.2 percent in 2014 to 6.1 percent in 2015. Since repayment is tied to monthly employee earnings, salary loans are generally perceived as low risk. As of December 2016, the ratio of nonperforming SBGPCLs to total SBGPCLs stood at 3.7 percent—slightly lower than the 3.9 percent reported in December 2015.

1.4 Fiscal Policy: From Restraint to Expansion

Accelerated public infrastructure spending led to double-digit expenditure growth in 2016 while total revenue growth slowed, resulting in the fiscal deficit more than doubling.

13. Following years of fiscal restraint, the Philippines shifted to an expansionary fiscal-policy stance in 2016. Expenditures grew in nominal terms by 14.3 percent year-on-year from 16.7 percent of GDP in 2015 to 17.6 percent in 2016, as infrastructure spending nearly doubled and budget execution significantly improved (Figure 16). Pre-election spending and the new government's ambitious infrastructure agenda drove expenditure growth in the first half of 2016. Annual expenditure growth accelerated in nominal terms from 25.1 percent in 2015 to 40.1 percent year-on-year in 2016.[23] Budget execution also improved, with average underspending shrinking from 12.8 percent of programmed spending in 2015 to 3.6 percent in 2016. Improvements in budget execution remain a key priority, and several planned reforms are designed to improve the efficiency and timeliness of public spending.[24]

Table 2: The fiscal accounts, 2013-2016

	2013	2014	2015	2016	2013	2014	2015	2016
	(billions PHP)				(percent of GDP)			
Revenues	1,716.1	1,908.5	2,109.0	2,195.9	14.9	15.1	15.8	15.2
Tax Revenues	1,535.7	1,719.0	1,815.5	1,980.4	13.3	13.6	13.6	13.7
Taxes on net income and profits	718.2	784.9	846.2	n/a	6.2	6.2	6.4	n/a
Taxes on property	3.6	5.5	5.6	n/a	0.0	0.0	0.0	n/a
Taxes on domestic goods and services	509.0	560.5	596.1	n/a	4.4	4.4	4.5	n/a
Taxes on international trade and transactions	304.9	369.3	367.5	n/a	2.6	2.9	2.8	n/a
Non-tax revenues	180.1	189.3	293.3	215.4	1.6	1.5	2.2	1.5
Grants	0.3	0.2	0.2	0.1	0.0	0.0	0.0	0.0
Expenditures[1]	1,880.2	1,981.6	2,230.6	2,549.3	16.3	15.7	16.8	17.6
Current operating expenditures	1,519.2	1,616.7	1,784.9	1,928.5	13.2	12.8	13.4	13.3
Interest payments	323.4	321.2	309.4	304.5	2.8	2.5	2.3	2.1
Capital outlays	344.3	351.5	436.0	605.5	3.0	2.8	3.3	4.2
Net lending	16.6	13.4	9.7	15.3	0.1	0.1	0.1	0.1
Fiscal balance	-164.1	-73.1	-121.7	-353.4	-1.4	-0.6	-0.9	-2.4
Primary balance	159.3	248.1	187.7	-49.0	1.4	2.0	1.4	-0.3
National government debt	5,681.2	5,735.2	5,954.5	6,090.3	49.2	45.4	44.7	42.1
Domestic	3,733.4	3,820.6	3,884.4	3,934.1	32.4	30.2	29.2	27.2
External	1,947.7	1,914.6	2,070.2	2,156.2	16.9	15.1	15.6	14.9

Note: [1] Data for current operating expenditures, Capital outlays, and Net lending are estimates
Source: Department of Finance, Bureau of Treasury, Department of Budget and Management

[23] This increase in infrastructure spending can be attributed to a number of projects implemented by the Department of Public Works and Highways, including regular maintenance and upgrading of national roads, the Department of National Defense–Armed Forces of the Philippines' modernization program, and various capital outlay projects (e.g., the construction and rehabilitation of state universities and colleges and health facilities).

[24] These reforms include the government's "24/7 construction" program, which aims to fast track the construction of public infrastructure projects, as well as strengthening of project monitoring processes through geo-tagging and modernization of the government's information-technology systems.

14. Revenues fell as a share of GDP in 2016, driven by a significant decline in nontax revenue (Table 2). Government revenue increased in nominal terms by 4.1 percent year-on-year in 2016, yet resulted in a decline in revenue effort from 15.8 percent of GDP in 2015 to 15.2 percent in 2016 due to a 26.5 percent decline in nominal nontax revenue in 2016. By contrast, revenue grew by 10.5 percent in 2015 in nominal terms, driven by a 54.9 percent increase in nontax revenue. Lower nontax revenues in 2016 primarily stemmed from the one-time PHP74.7 billion asset reacquisition of the Coco Levy Fund by the Bureau of the Treasury's in May 2015.[25] Despite the absence of new tax-policy measures, improvements in tax administration—particularly the streamlining of Bureau of Internal Revenue (BIR) processes—boosted nominal tax-revenue collection by 9.1 percent year-on-year, nearly double the rate of the previous year. The Philippines reported PHP2.0 trillion in tax revenue in 2016, or 13.7 percent of GDP, similar to the 13.6 percent share reported in the previous two years.[26]

15. As expenditure growth outpaced revenue growth, the fiscal deficit more than doubled to 2.4 percent of GDP in 2016. The fiscal deficit reached PHP353.4 billion in 2016, or 2.4 percent of GDP, more than twice its 2015 level of PHP121.7 billion, or 0.9 percent of GDP. However, the deficit remained within the government's 2016 fiscal-deficit target of 2.0-2.7 percent of GDP. The government primarily financed the deficit through domestic resources (Figure 17). Net domestic financing increased sixfold in 2016, reaching PHP250.3 billion, while net foreign financing decreased from PHP64.8 billion in 2015 to PHP24.1 billion in 2016.[27] The increased reliance on domestic financing reflects the government's preference for an 80:20 ratio of domestic to foreign financing. However, the overall debt-to-GDP ratio improved as GDP growth outpaced the growth of the debt stock, reaching 42.1 percent of GDP in 2016.[28]

16. The new administration enacted its 2017 budget in December 2016. At PHP3.35 trillion, the approved budget, known as "a budget for real change," is 11.6 percent larger than the 2016 budget and larger than any previous national budget. The 2017 budget reflects the expenditure priorities of the administration's 10-point socioeconomic agenda. It emphasizes investment in both physical and human capital, as well as rural development.[29] The budget for infrastructure investment is projected to increase to PHP860.7 billion in 2017 (around 5.4 percent of GDP), a 12.3 percent increase from the 2016 budget allocation of PHP766.5 billion. The budget also seeks to increase spending for both health and education from a combined 4.7 percent of GDP in 2016 to 5.3 percent in 2017. The authorities have raised the deficit target over the next two years to 3.0 percent of GDP, as expenditures are expected to continue to rise as the country aims to achieve the long-term vision embodied in the *AmBisyon Natin* 2040 (Box 6).[30] This aggressive expansion in spending could pose fiscal sustainability challenges, and mitigating policy measures are being planned.

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25 In 2015, the government initiated the transfer of the Coco Levy Fund to the Bureau of the Treasury through Executive Order 179. The fund includes PHP62.5 billion in cash and PHP12.8 billion in government securities. See: http://pcgg.gov.ph/wp-content/uploads/2016/12/Accomplishment-Report-FY-2015.pdf

26 The Philippines' Department of Finance (DOF) attributes the increase in BIR collections, which accounted for nearly 80 percent of total tax revenue, to the streamlining of BIR processes, which has improved both tax collection and monitoring efficiency. The BIR has implemented several policies that have reduced the burden of tax compliance, including reduced documentary requirements for one-time transactions, reduced processing times and the release of tax clearances within two days of submitting complete documents, and strict compliance with the BIR's prescribed timelines for taking action on taxpayer applications and requests. The BIR has also improved monitoring of workflow processes in the agency's offices. See: http://business.inquirer.net/221671/bir-collections-9-6-p1-45t-first-11--months and http://www.sgv.ph/change-is-also-coming-to-the-bir-by-tesi-lou-s-guanzon-october-17-2016/

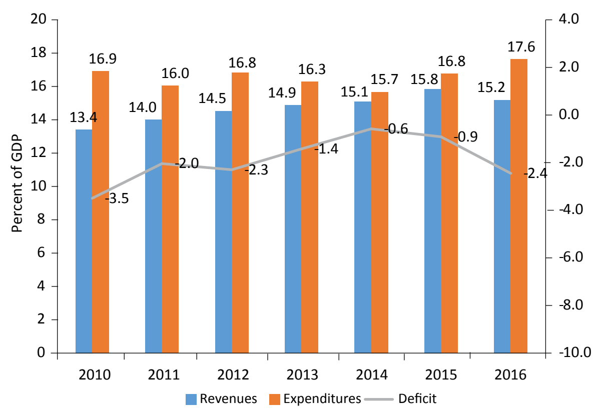
27 Net domestic financing is defined as gross domestic financing minus amortization. Net foreign financing is defined as gross foreign financing minus amortization.

28 This marks the seventh consecutive year in which the government's debt-to-GDP ratio shows improvement. Over the past decade, the debt-to-GDP ratio declined by 19.2 percentage points, highlighting the country's improved fiscal position which allowed the government to pursue expansionary fiscal policy. Moreover, the government's external debt-to-GDP ratio fell to 14.9 percent in 2016 from 15.6 percent in 2015.

29 Currently, 64 large-scale infrastructure projects are underway, including the development of major road networks, railway systems, and public transportation, as well as air and seaport modernization. See: http://www.dof.gov.ph/index.php/64-major-projects-underway-in-golden-age-of-infrastructure/

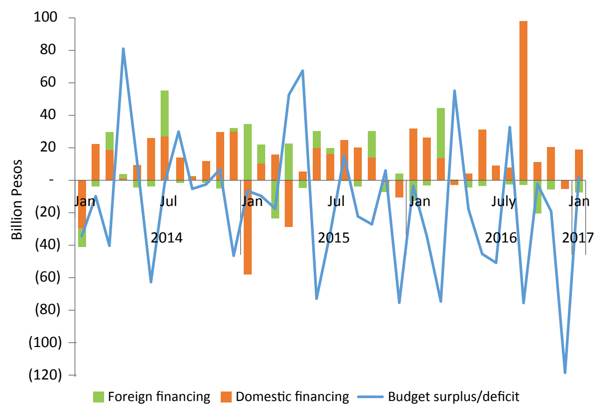
30 The government, through the Development Budget Coordination Committee, has stated that the planned increase in the 2018 budget will be contingent on the passage of the government's first tax-reform package. See: https://business.inquirer.net/222113/record-p3-8-t-budget-18-pushed

Figure 16: The fiscal deficit more than doubled in 2016…



Source: Bureau of the Treasury (BTr)

Figure 17: …and was financed primarily through domestic sources



Source: BTr

Box 6 The *AmBisyon Natin* 2040

On October 15, 2016, the President signed signed Executive Order No.5, adopting a long-term vision for the Philippines known as *AmBisyon Natin* 2040.[31] The country's central planning agency, the National Economic and Development Authority (NEDA), developed the strategy, which represents "the collective long-term vision and aspirations of the Filipino people for themselves and for the country in the next 25 years."[32] Under NEDA's leadership, this central vision will guide development planning in the Philippines over the next four administrations through each administration's Philippine Development Plan.

The strategy is based on a set of household consumption and asset-ownership targets for 2040. These include owning a house and a car and having enough money to send children to college while maintaining a middle-class lifestyle. For a family of four, this consumption level translates into an estimated gross monthly income of PHP120,000. To achieve this long-term vision, per-capita income in the Philippines would need to triple over the next 25 years.

Achieving this ambitious long-term vision will require careful policy coordination and an enduring commitment from both the public and private sectors. The government will need to maintain strong macroeconomic fundamentals through sound fiscal and monetary policies while promoting more inclusive growth, including by promoting competition, simplifying business regulations, and ramping up investment. Finally, ensuring the success of the structural reform agenda will require the buy-in of various stakeholders, including the public administration and the country's future leaders.

[31] AmBisyon Natin roughly translates to "Our Ambition."

[32] The process of developing the AmBisyon Natin 2040 began in 2015 and involved focus-group discussions with some 300 citizens, as well as a national survey of around 10,000 individuals. Technical studies were also prepared to identify strategic options for realizing the collective vision by 2040. An advisory committee composed of government officials and representatives from the private sector, academia, and civil society provided guidance throughout the process. See: http://2040.neda.gov.ph/wp-content/uploads/2016/04/A-Long-Term-Vision-for-the-Philippines.pdf

[33] House Bill (HB) 4774.

17. The government has proposed an ambitious tax-reform package to help balance planned spending increases. The government submitted the Tax Reform for Acceleration and Inclusion (TRAIN) proposal to Congress in January 2017. The package aims to redesign the tax system to be fairer, simpler, and more efficient in raising the resources required to invest in infrastructure and human capital (Box 7). It would lower the country's income-tax brackets and adjust tax rates to improve overall equity, and it would reduce rates for both the donor's tax and the estate tax.[34] To offset the loss in revenue resulting from lower tax rates, the government would expand the value-added tax (VAT) base by limiting exemptions. In addition, the government would adjust excise taxes on fuel and automobiles to further offset revenue losses. To complement these policy reforms, the government is proposing several complementary tax-administration measures. The authorities estimate that implementing the first package of tax reforms would yield revenues of PHP206.8 billion, or around 1.1 percent of GDP, by end-2018.

Box 7 The TRAIN reform package

The initial component of the government's tax-reform agenda involves simplifying income-tax brackets and restructuring both the donor's tax and the estate tax. The reforms would reduce the number of income-tax brackets from seven to six and gradually lower tax rates over several years. Under the government's proposed schedule (Table 3), taxpayers with incomes below PHP250,000 per year will be exempt from paying taxes, and marginal tax rates and base taxes will increase as individuals move up the proposed tax schedule. The simplified personal income-tax system is expected to increase net incomes for most taxpayers and improve the equity of the tax structure. In addition, both the donor's tax and the estate tax will be subject to a single rate of 6 percent.

Table 3: The proposed income-tax reforms would reduce the number of tax brackets to six and gradually lower tax rates over several years

Annual Income Bracket (PHP)	H2 2017 - 2019	2020 onwards
0-250,000	0%	0%
Over 250,000 - 400,000	20% of the excess over 250,000	15% of the excess over 250,000
Over 400,000 - 800,000	30,000 + 25% of the excess over 400,000	22,500 + 2% of the excess over 400,000
Over 800,000 - 2,000,000	130,000 + 30% of the excess over 800,000	102,500 + 25% of the excess over 800,000
Over 2,000,000 - 5,000,000	490,000 +32% of the excess over 2,000,000	402,500 + 30% of the excess over 2,000,000
Over 5,000,000	1,450,000 + 35% of the excess over 5,000,000	1,302,500 + 35% of the excess over 5,000,000

Source: DOF

The TRAIN package also includes measures to reduce leakages and improve the efficiency of the current tax system. The TRAIN would expand the VAT base by removing special exemptions, excluding those for senior citizens and persons with disabilities. In addition, excise taxes on petroleum, which have not been adjusted since 1997, will undergo a phased rate increase (Table 4). Diesel fuel, which is not currently subject to excise taxes, will be subject to an excise tax of PHP3.0 per liter in the second half of 2017, PHP5.0 per liter in 2018, and PHP6.0 per liter by 2019. Meanwhile, the excise tax on gasoline and other items deemed "nonessential" will increase from PHP4.35 per liter in 2016 to PHP7.0 per liter in the second half of 2017, PHP9.0 in 2018, and PHP10.0 by 2019. Beginning in 2020, excise tax rates for both categories will be subject to annual indexation of 4 percent, except if Dubai crude oil exceeds US$100 per barrel. Finally, excise tax

[34] The donor's tax is a tax on a donation or gift. It is imposed on the gratuitous transfer of property between two or more persons who are living at the time of the transfer. It applies whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, and tangible or intangible.

rates on automobiles will be adjusted, with base taxes doubling for each tax bracket, and the marginal tax rates of the four brackets will increase to 4 percent, 40 percent, 100 percent, and 200 percent, respectively (Table 5).

Table 4: Petroleum excise taxes will be adjusted for the first time since 1997

PHP per litre	Current	H2 2017	2018	2019
Diesel and essentials	0.00	3.00	5.00	6.00
Gas and non-essentials	4.35	7.00	9.00	1.00

Source: DOF

Table 5: Automobile tax rates will be restructured, and the largest rate increases will be applied to luxury automobiles

Net manufacturing/importation in PHP	Current	Proposed
Up to PHP600,000	2%	4%
Over PHP600,000 to PHP1 million	PHP12,000 + 20% in excess of PHP600,000	PHP24,000 + 40% in excess of PHP600,000
Over PHP1.1 million to PHP2.1 million	PHP112,000 + 40% in excess of PHP1.1 million	PHP224,000 + 100% in excess of PHP1.1 million
Over PHP2.1 million	PHP512,000 + 60% in excess of PHP1.1 million	PHP1,224,000 + 200% in excess of PHP2.1 million

Source: DOF

Finally, various legislated reforms will be implemented to improve tax administration. The TRAIN proposal includes several reforms to improve tax administration by both the BIR and the Bureau of Customs. Proposed reforms include: (i) fuel marking by the Department of Finance (DOF) to prevent smuggling; (ii) requiring that electronic receipts be simultaneously issued to the purchaser and transmitted to the BIR; (iii) mandatory connection of the point-of-sale system to the BIR; and (iv) the relaxation of bank secrecy laws to combat tax fraud.

1.5 Employment and Poverty: More Inclusive Growth

Sustained economic growth has led to gains in employment creation and poverty reduction. A net total of 1.4 million jobs were created in 2016, driving the unemployment rate to a historic low of 4.7 percent. Over the past three years millions of people escaped extreme poverty.

18. Economic growth has contributed to job creation in recent years. Employment rates reached a decade high in 2016 and have continued to trend upward, from an average of 91.2 percent of the economically active population in 2005 to a peak of 95.3 percent at end-2016. Meanwhile, the unemployment rate fell from 5.6 percent in 2015 to a historic low of 4.7 percent by end-2016 (Figure 18), though exogenous shocks are likely to have caused an uptick in the unemployment rate in January 2017.[35] Metro Manila has driven the overall decline in unemployment, and the local unemployment rate fell from an average of 11.8 percent in 2005-2015 to just 5.9 percent in 2016. The unemployment rate for men remained higher than the rate for women at 4.9 percent and 4.3 percent, respectively. Unemployment is highest among workers between the ages of 15 and 24. The labor-force participation rate fell slightly from an average of 64.2 percent in 2005-2015 to 63.6 percent in 2016, and high underemployment levels over the last ten

[35] The latest Labor Force Survey reports that the unemployment rate rose to 6.6 percent in January 2017, up 0.9 percent year-on-year. This likely reflects employment losses in the agriculture sector, which was negatively affected by two typhoons in December and January.

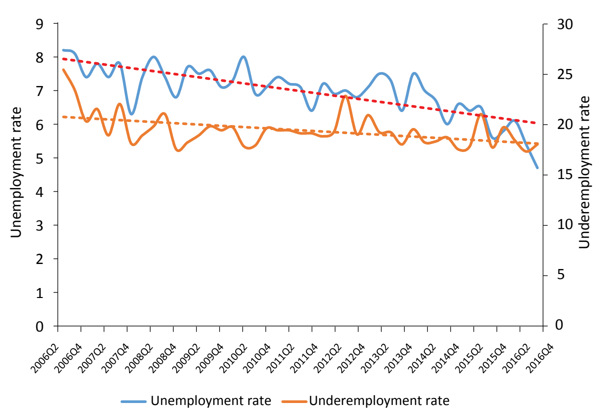
years indicate that improving job quality still poses a challenge. The underemployment rate remained high at 18.0 percent at end-2016, though it has stabilized below the ten-year average of 19.1 percent.

19. Robust net job creation in both the industrial and services sectors more than offset significant job losses in the agriculture sector in 2016. The country's rapid economic growth helped generate a net total of 1.4 million jobs in 2016, up dramatically from just 0.1 million jobs in 2015. The services sector drove job creation, creating some 1.1 million jobs in 2016, more than double the 0.5 million jobs the sector generated in 2015. However, around 65.0 percent of these jobs consisted of relatively low-paid, low-skill employment in the wholesale and retail trade and transportation subsectors. The industrial sector created around 0.8 million jobs in 2016, compared to 0.1 million in 2015, with the construction subsector accounting for 0.6 million of these jobs. Meanwhile, the agriculture sector continued to shed jobs, with net job losses amounting to 0.5 million in 2016, a similar amount as in 2015.

20. Sustained economic growth in recent years led to significant poverty reduction. This means that growth became more inclusive. Using the national poverty thresholds, poverty incidence among Filipinos dropped to 21.6 percent in 2015 from 25.2 percent in 2012 (Figure 19). This presents 1.8 million Filipinos lifted out of poverty within three years. The 2015 poverty rate is within the 20-23 percent target range set by the Philippine Development Plan 2011-2016. While the World Bank is currently completing a poverty assessment to identify the key factors behind the observed drop in the poverty rate, rising employment and income levels, as well as low inflation, likely contributed to the declining trend. The government's conditional cash-transfer program, the *Pantawid Pamilyang Pilipino Program*, has bolstered the income of many poor households. Between 2011 and 2015, the government increased the program's budget by nearly 200 percent to PHP62.3 billion, and the program now serves some 4.4 million households (approximately 20 million of the poorest Filipinos).

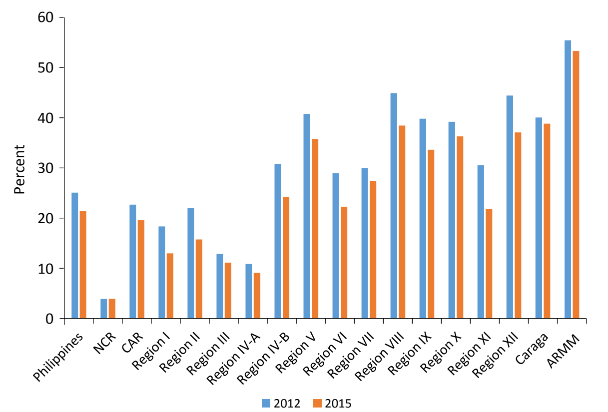
21. In previous decades poverty in the Philippines had been largely unresponsive to growth. Despite reasonably strong overall economic growth rates from 2000-2012, moderate poverty as defined by the World Bank's US$3.10/day in 2011 purchasing power parity, declined only slightly from 36.5 to 32.0 percent. Several factors help explain the low responsiveness of poverty to economic growth. First, the country's relatively high fertility rate (averaging 3 children per woman) translates into a high population growth rate, which slows per-capita income growth and poverty reduction. Second, growth has been largely driven by the industrial and services sectors, as opposed to the agriculture sector, where three-fifth of the poor work, and agricultural production and wages

Figure 18: The unemployment rate has fallen to its lowest level in a decade but the underemployment rate remains high



Source: PSA

Figure 19: Poverty incidence dropped in 2015



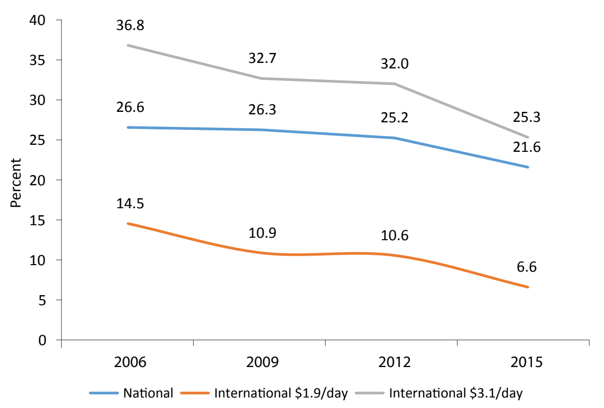
Source: PSA

have been stagnant for several years. Third, a portion of the gains from growth accrue to the owners of capital, and given the high levels of wealth inequality in the country, those gains have gone to a very small segment of the population.

22. Recent poverty data suggest that economic growth has begun to coincide with substantial gains in poverty reduction. The moderate poverty rate, measured against the World Bank's international poverty line of US$3.1/day in 2011, fell rapidly from 32.0 percent in 2012 to 25.3 percent in 2015, while the extreme poverty, measured by the World Bank international poverty line of US$1.9/day in 2011 purchasing power parity, fell from 10.6 percent in 2012 to 6.6 percent in 2015 (Figure 20).[36] This translates to roughly 3.2 million Filipinos escaping extreme poverty within three years. In addition to the *Pantawid Pamilyang Pilipino Program*, or 4Ps program, aimed at keeping children healthy and in school, the movement of workers out of the agriculture sector has likely contributed to the decline in the poverty rate.

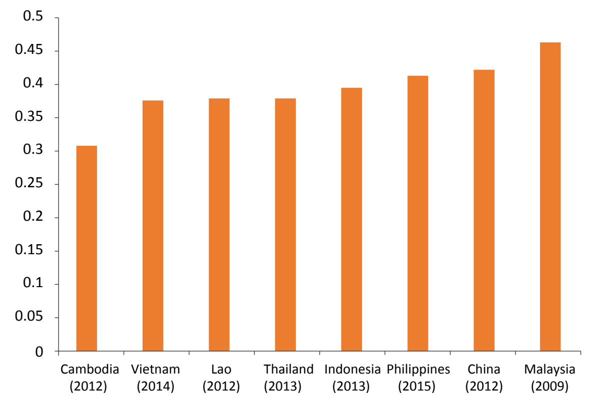
23. While recent growth has been increasingly inclusive and equitable, the relatively high level of inequality remains a concern. The Gini coefficient declined from 46.5 percent in 2012 to 44.4 percent in 2015, but remained high compared to other countries in East Asia (Figure 21). Almost 80 percent of households experienced real per-capita household income growth of over 6 percent during this three-year period. Moreover, income among households in the bottom 40 percent of the distribution grew at twice the average rate, boosting shared prosperity and driving inequality to its lowest level in the past decade. Going forward, sustaining inclusive growth and poverty reduction will require efforts to support the creation of more productive jobs, including for the poor and less skilled, and improve the efficiency and effectiveness of cash transfers.

Figure 20: The Philippines has achieved significant gains in poverty reduction over the past three years…



Source: World Bank staff estimates

Figure 21: …but the Gini coefficient remains high relative to other countries in East Asia



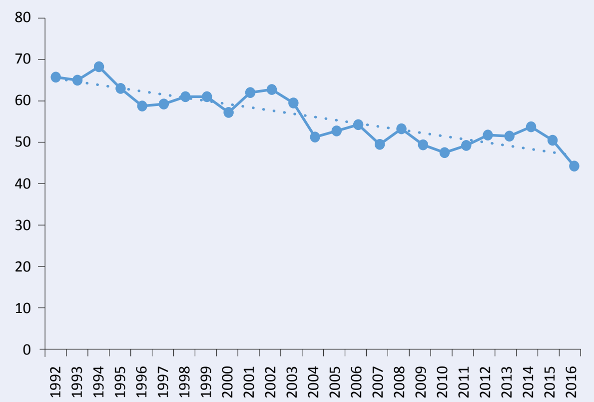
Source: World Bank staff estimates, PSA

[36] As noted above, the moderate poverty rate is based on a poverty line equivalent to US$3.10 per day in 2011 PPP terms, while the extreme poverty line is equivalent to US$1.90 per day. Self-rated poverty estimates have also declined in recent years (Box 8).

Box 8 The decline in self-rated poverty rates

Annual self-rated poverty estimates trended downward between 1992 and 2016 (Figure 22). The self-rated poverty incidence declined by 22 percentage points over the past two-and-a-half decades to reach 44.0 percent in 2016, the lowest level recorded since quarterly surveys were first conducted in 1992.

Figure 22: The self-rated poverty incidence has declined over time



Source: Social Weather Station, various rounds

The Social Weather Station, a private non-profit research institution, regularly conducts the Social Weather Survey, which provides self-rated indicators of poverty and hunger. It has monitored core indicators of self-rated poverty since 1983, providing a longer and more frequent time series based on an alternative poverty-measurement methodology. The national survey is conducted using face-to-face interviews of sample households randomly drawn from Metro Manila, the rest of Luzon (also referred to as "balance Luzon"), Visayas, and Mindanao. The survey uses two questionnaires for adult respondents aged 18 years and older. Respondents are first asked where they place themselves on the scale of "not poor," "on the line," or "poor." If the respondents indicate that they consider themselves poor, they are subsequently asked the amount of money they would need for home expenses each month in order not to be poor. The household questionnaire, which is administered to the household head, contains information on the socio-demographic characteristics of the household, as well as poverty and hunger perceptions. Additional questions are sometimes commissioned to address other socially relevant topics such as governance, politics, and economics.

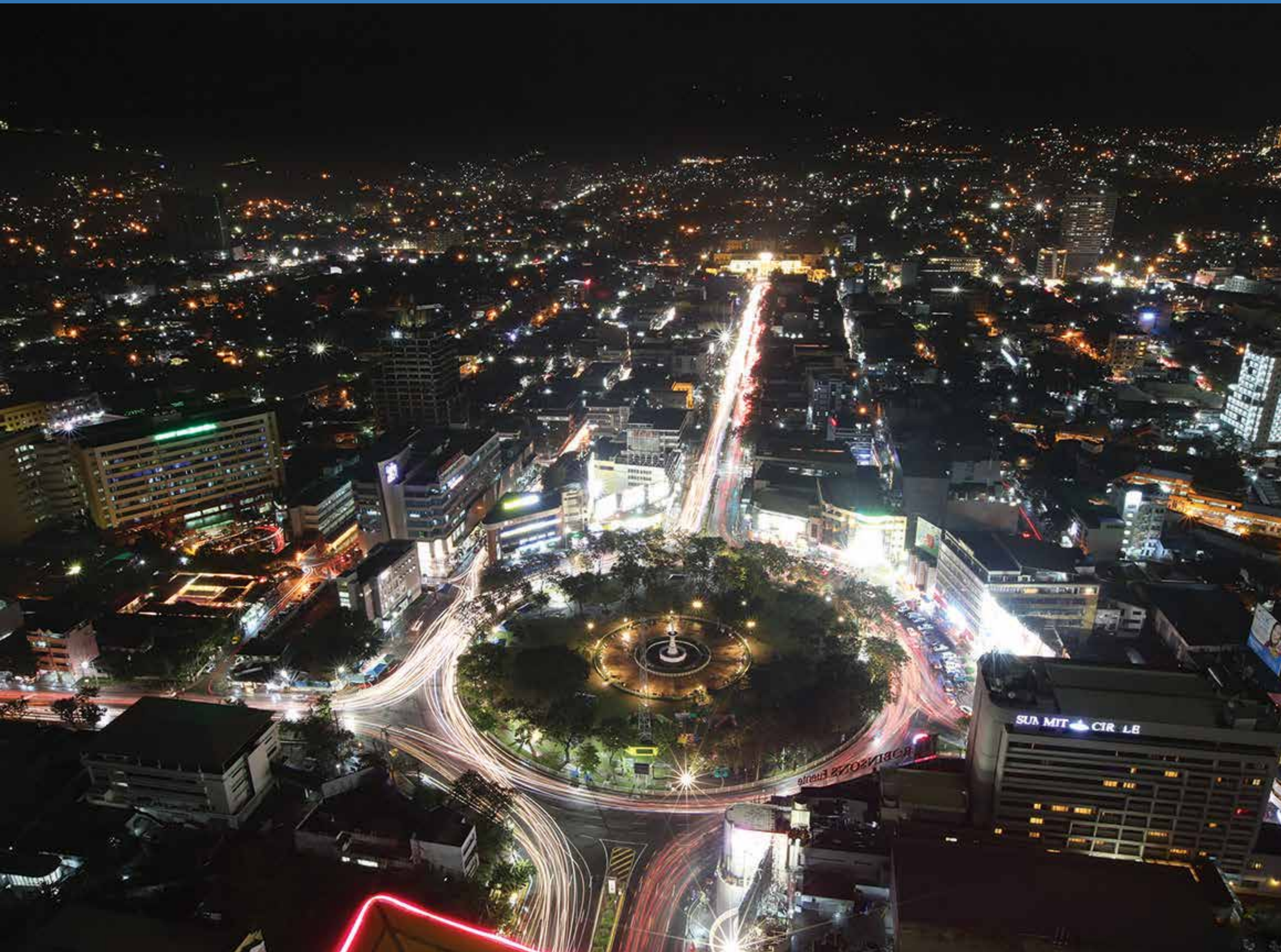
Self-rated poverty assessments rely on a household's perception of its circumstances at the time of the survey. Respondents provide a minimum household budget as their subjective poverty threshold. The median poverty threshold in Metro Manila in December 2016 was PHP18,000, while balance Luzon, Visayas, and Mindanao registered a lower threshold of PHP10,000. These self-reported thresholds are not significantly different from the poverty thresholds used in official statistics. The equivalent official poverty thresholds for an average household of five in 2016 was PHP18,755 in Metro Manila, PHP11,085 in balance Luzon, PHP10,749 in Visayas, and PHP10,896 in Mindanao. However, self-rated poverty estimates are significantly and consistently higher than official statistics based on objective welfare measures. Studies have shown that while objective welfare measures, such as income and expenditures, affect subjective perceptions, underlying psychological factors based on the respondent's characteristics (e.g., demographic, socioeconomic, or health status) are also important.[37]

[37] See: Pradhan and Ravallion (2000), Ravallion and Lokshin (2002), and Angelillo (2014).

PART II:

OUTLOOK AND RISKS

In the near term, favorable macroeconomic conditions are expected to support robust growth in the Philippines. The economy is projected to expand at a rate of 6.9 percent in 2017 and 2018. High levels of consumer and business confidence and the government's strong policy commitment to increased public infrastructure spending are the foundation for the positive baseline outlook. Poverty reduction is projected to accelerate under the baseline growth forecast, as growth is expected to remain inclusive. The extreme poverty rate (measured by the World Bank's international poverty line of US$1.90/day in 2011 PPP terms) is projected to fall from 5.8 percent in 2016 to 5.1 percent in 2017. The continuous movement of the labor force from agriculture to more productive sectors, combined with a gradual improvement in agricultural productivity and more effective and efficient public and private transfers are expected to drive poverty alleviation and promote shared prosperity. Strong macroeconomic fundamentals will provide some space for the government to implement its public-spending and social-investment agenda, but fiscal risks are rising. While monetary policy is expected to remain accommodative, a gradual tightening is likely if inflationary pressures continue to mount. The government has made progress in outlining its ambitious infrastructure agenda, including projects to be executed through public-private partnerships, but implementation bottlenecks persist and fiscal sustainability concerns may temper the pace of public capital spending. Over the long term, the Philippines will be well-positioned to take advantage of critical development opportunities, including a potential demographic dividend and a rapidly expanding services sector.



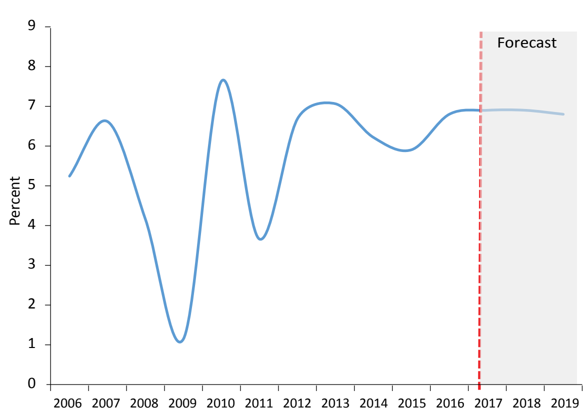
2.1 Growth Outlook

Due to its strong macroeconomic fundamentals the Philippines' economy is projected to grow at an annual rate of about 7 percent.

24. The Philippines' medium-term growth trajectory is expected to be positive, as the country's macroeconomic fundamentals remain robust. The country is projected to remain among East Asia's top growth performers over the short-to-medium term (Figure 24). Despite continued global headwinds, the Philippines' growth outlook remains optimistic, and the economy is projected to benefit from the anticipated recovery of emerging markets and developing economies worldwide (Box 9). The administration's continued commitment to implementing planned increases in public infrastructure spending is expected to boost the economy's growth momentum through 2017-2018. The World Bank projects a real GDP growth rate of 6.9 percent in 2017 and 2018 (Figure 23), supported by high levels of consumer and business confidence.[38] These projections reflect the World Bank's revisions to its December 2016 growth forecast for the Philippines and the January 2017 World Bank Global Economic Prospects report.[39]

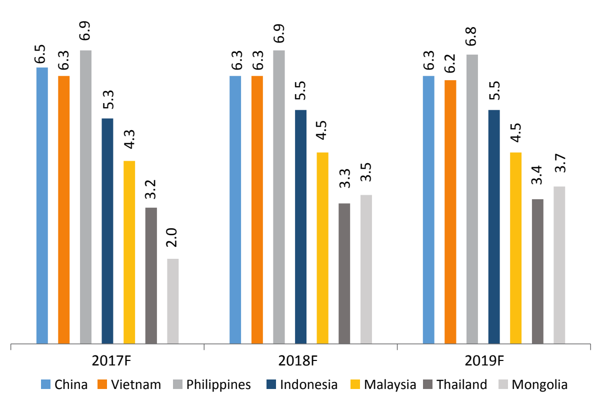
25. The Philippines' medium-term growth outlook depends in part on the government's ability to realize its ambitious infrastructure spending agenda. The economy's primary growth engine over the coming years will likely be increased capital investment, largely driven by the administration's public infrastructure development agenda. The government approved about 16 new infrastructure projects in the second half of 2016, which are slated to be implemented beginning in 2017. The successful implementation of these projects could generate positive spillover effects for the rest of the economy, spurring additional business activity, accelerating job creation, and ultimately contributing to higher household consumption. Private firms are expected to sustain high investment levels in durable equipment and machineries to address production-capacity limits as utilization rates, particularly in the manufacturing sector, are near maximum capacity. If infrastructure projects are implemented in their proposed timeframes, gross-fixed capital formation is projected to grow from an annual rate of 23.5 percent in 2016 to 23.6 percent in 2017. This would support an annual growth rate of almost 7 percent over the next two years (Table 7).

Figure 23: The World Bank forecasts that economic growth will remain robust and stable over the near term...



Source: PSA, WB staff estimates

Figure 24: ...and the Philippines is projected to remain one of East Asia's fastest-growing economies



Source: WB staff estimates

[38] Consumer confidence hit a record high in the fourth quarter of 2016 based on the BSP's Consumer Expectations Survey, with the overall confidence index increasing from 2.5 percent in quarter three 2016 to a high of 9.2 percent in quarter four 2016. Meanwhile, overall business confidence remained steady in the first quarter of 2017 based on the BSP's Business Expectations Survey, which registered an overall confidence index of 39.4 percent in quarter one 2017.

[39] The January 2017 edition of the World Bank Global Economic Prospects report can be accessed at https://openknowledge.worldbank.org/bitstream/handle/10986/25823/9781464810169.pdf?sequence=5&isAllowed=y.

Box 9 The global economic outlook

Global economic growth is projected to rebound in 2017, driven by the recovery of emerging market and developing economies. The pace of global growth is projected to accelerate from an estimated 2.3 percent in 2016 to 2.7 percent year-on-year in 2017 (Table 6). Emerging market and developing economies are expected to account for about 60 percent of global growth in 2017. The aggregate growth rate for emerging market and developing economies is projected to rise from 3.4 percent in 2016 to 4.2 percent year-on-year in 2017, aided by a modest expected recovery in commodity prices and solid growth among commodity importers. Global growth is projected to increase slowly to 2.9 percent year-on-year at by the end of the forecast period, fueled by the sustained growth of emerging market and developing economies anticipated until 2019.

Several downside risks threaten global growth prospects. Heightened levels of policy uncertainty, most notably regarding global trade, financial market disruptions due to tightening global financing conditions, and slower potential growth among major economies, are key risks which could derail the potential global economic recovery. The potential for a fiscal stimulus in other countries represents an upside risk.

The expected increase in global interest rates could result in sharp swings in both borrowing costs and exchange rates in emerging market and developing economies if market expectations adjust abruptly. Long-term interest rates in the United States remain low, but have started to increase amid the ongoing normalization of U.S. monetary policy and rising inflationary expectations.[40] An increase in yields driven by a reassessment of monetary policy expectations could have large adverse effects on financial markets and capital flows in emerging market and developing economies.[41] Higher interest rates make U.S. debt more attractive, and could lead to capital flows back to the United States. This in turn could lead to an appreciation of the U.S. dollar, which could raise debt-servicing costs and credit risks among emerging market and developing economies.[42] Although the share of both private and public debt denominated in foreign currency has declined, several countries with elevated short-term foreign-currency-denominated debt and weak or deteriorating current-account positions are vulnerable to rollover and interest-rate risks, as well as to a drying up of foreign-exchange liquidity.[43]

Table 6: Global GDP growth rates, recent and projected

	2014	2015	2016e	2017f	2018f	2019f
World	2.7	2.7	2.3	2.7	2.9	2.9
High-income countries	1.9	2.1	1.7	1.8	1.8	1.7
Developing countries	4.3	3.5	3.4	4.2	4.6	4.7
Developing East Asia & Pacific	6.8	6.5	6.4	6.2	6.1	6.0
Philippines	6.2	5.9	6.8	6.9	6.9	6.8

Source: World Bank Global Economic Prospects, January 2017

40 Fischer (2016).

41 Arteta, *et al.* (2015)

42 Hofmann, *et al.* (2016)

43 Chow, *et al.* (2015).

Table 7: Economic indicators for the baseline projection

	2014	2015	2016	2017f	2018f	2019f
Real GDP growth, at constant market prices	6.2	5.9	6.8	6.9	6.9	6.8
Private consumption	5.5	6.3	6.9	6.8	6.7	6.6
Government consumption	3.2	7.8	8.3	13.0	12.2	11.4
Gross Fixed Capital Investment	6.2	15.2	23.5	23.6	23.6	23.2
Exports, goods and services	11.7	9.0	9.1	10.2	10.4	10.7
Imports, goods and services	9.3	14.0	17.5	18.4	18.5	18.6
Inflation (period average)	4.1	1.4	1.8	3.3	3.0	2.8
National government balance (% of GDP)	-0.6	-0.9	-2.2	-3.0	-3.3	-3.5
National government debt (% of GDP)	45.4	44.8	42.1	40.4	39.2	38.5
Current account balance	3.8	2.9	0.6	0.8	0.9	1.1

Source: PSA, BSP, BTr, WB staff estimates

26. While monetary policy has been accommodative, a gradual tightening would be appropriate if inflationary pressure continues to grow. The inflation rate is projected to rise from an average of 1.8 percent in 2016 to 3.3 percent in 2017, before moderating to 3.0 percent in 2018. Robust economic growth is expected to entail greater demand for capital goods and result in higher employment and real wages, thus increasing demand for consumer goods. This would contribute both to a projected expansion of credit and the money supply, as well as to the build-up of demand-side inflationary pressures. Meanwhile, slowly rebounding global commodity prices, especially oil prices, are expected to drive domestic fuel-price inflation, which could be further aggravated by an increase in the excise tax on fuel. Crude oil prices are projected to recover from US$42.8 per barrel in 2016 to US$55.0 per barrel in 2017 and US$60.0 per barrel in 2018. A gradual increase in interest rates by the U.S. Federal Reserve, as well as the new U.S. administration's planned fiscal expansion, could further weaken the peso and create an inflationary pass-through effect.

27. The government is expected to continue pursuing an expansionary fiscal policy. The new administration has committed to a significant surge in public infrastructure spending, as reflected in the 2017 budget's 13.8 percent increase in planned infrastructure expenditures. Of the PHP3.4 trillion 2017 budget, PHP860.7 billion, or an estimated 5.4 percent of GDP, is allocated to public infrastructure.[44] Moreover, the administration plans to spend up to PHP9 trillion from 2017-2022 on new infrastructure projects. The 2017 fiscal deficit is projected to increase to 3.0 percent of GDP. As discussed in the previous section, the government intends to finance the deficit primarily through domestic sources.[45] GDP growth is expected to continue to outpace growth of the debt stock, and the debt-to-GDP ratio is projected to decline from 42.1 in 2016 to 40.4 in 2017. Nevertheless, fiscal sustainability may emerge as a concern in the coming years if the fiscal deficit keeps rising.

28. Private consumption is anticipated to remain robust. Historically, consumption has driven growth in the Philippines. Household expenditures represent more than two-thirds of GDP. The prospect of maintaining consumption growth at current levels in the medium term is supported by several factors. First, remittance flows reached record-high levels in 2016, and are projected to remain robust in the coming years.[46] Second, given continued economic growth, job opportunities are expected to increase, especially in the services sector. Finally, the sustained economic

[44] Newly approved projects in 2016 include the Ninoy Aquino International Airport PPP project, the North-South Railway Project (South line), the New Bohol Airport Development and Operations/Maintenance Project, the New Cebu International Port, and the Metro Manila Bus Rapid Transit. See NEDA's website for a comprehensive list of approved projects.

[45] This is currently reflected in the 2017 Budget of Expenditures and Sources of Financing for FY2017.

[46] The BSP expects cash remittances to grow by 4 percent in 2017, from US$26.9 billion in 2016 to US$30.0 billion. See: http://www.bworldonline.com/content.php?section=TopStory&title=remittances-top-forecast&id=140776

expansion has begun to contribute to increasing incomes across all deciles. Between 2012 and 2015, household income among the bottom 40 percent of the distribution rose by an average annual rate of 7.6 percent, while income among households in the fifth to eighth deciles increased by an average annual rate of 5.4 percent.[47]

29. Import growth is expected to outpace export growth in the near term as increased infrastructure spending raises demand for capital goods. Global trade remains sluggish despite the anticipated global economic recovery, and external demand for Philippine goods is not expected to keep pace with import growth over the next few years. Greater demand for capital goods for planned infrastructure investments, as well as increased demand for consumer-goods imports fueled by continued economic growth and rising household incomes, are expected to drive import growth (Box 10). A modest recovery among advanced economies is projected to boost external demand for Philippine exports. Services exports are expected to remain particularly robust, fueled by the country's fast-growing IT-BPO industry. Revenue from the IT-BPO industry is projected to increase from an estimated US$25.0 billion in 2016 to US$38.9 billion in 2022, overtaking remittances as the primary source of dollar receipts.[49]

30. The services sector is projected to grow at a rate of over 7.0 percent in 2017-2019, and it is expected to remain the largest contributor to output growth in the Philippines. Real estate properties and financial services are expected to expand at a healthy rate, supported by rapid economic growth, rising incomes, and strong remittance inflows. Foreign investment continues to focus on the finance and insurance subsector, which accounted for 53.9 percent of total FDI in 2016 (Figure 27). Meanwhile, domestic lending to the real estate and construction and wholesale- and retail-trade subsectors has been substantial at 22.4 percent and 15.6 percent of total domestic loans, respectively.

Box 10 Global trade and protectionism

Global trade is expected to recover in 2017-2018, but its growth rate is expected to remain below its long-term average due to a less favorable policy environment. Import demand is projected to rebound among large emerging market and developing economies, as well as among advanced economies, which are expected to see modest gains in 2017-2019 (Figure 25). However, the pace of the recovery is expected to be slower than anticipated due to persistent weakness in global investment (Figure 26) and delayed trade liberalization as a result of uncertain U.S. and European trade policy priorities. The recent slowdown in global investment may dampen trade prospects as capital goods account for about one-third of global goods trade. Meanwhile, the new U.S. administration's more inward-looking policy stance, combined with the U.K.'s decision to leave the European Union, could make the global trade policy environment less favorable.

Trade in services is expected to be more resilient than trade in goods, as the former does not entail fixed storage costs and is therefore less sensitive to changes in credit and trade-financing conditions.[49] Services account for about two-thirds of global economic output and over 50 percent of output in most emerging market and developing economies. However, trade in services is very sensitive to barriers to entry, local-content requirements, restrictions on the movement of professionals, and regulatory discrimination in business licensing.

47 See: Philippines Statistics Authority, Family Income and Expenditure Survey 2012 and 2015.

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

49 See Borchert, I. and A. Mattoo (2010) and Ariu (2016).

Increased protectionism and the possible undoing of existing trade agreements could greatly exacerbate welfare losses in emerging market and developing economies. Protectionist policies appear to be gaining traction worldwide, with new trade restrictions reaching a post-crisis high in 2016.[50] Among advanced economies, measures such as anti-dumping laws, countervailing duties, and safeguards have been the most commonly used instruments, while emerging market and developing economies have used a broader set of restrictive measures, including import tariffs and export taxes. Even within the parameters of current international standards, WTO members could legally triple import tariffs, which would entail a 10 percent drop in world trade from the baseline and large welfare losses for the global economy.[51] These losses would disproportionately affect the poorest emerging market and developing economies, which rely on trade as a key engine for growth and development.[52]

Figure 25: Goods and services import-volume growth, actual and projected

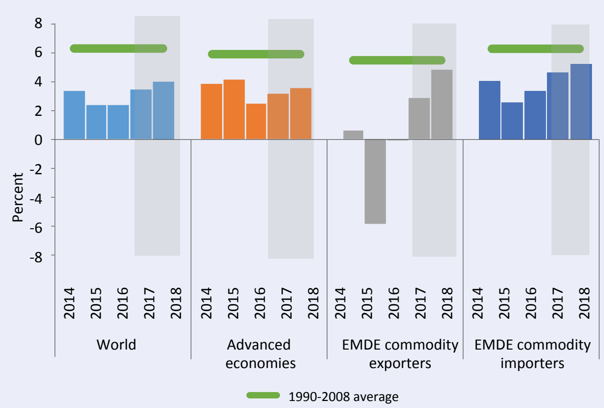
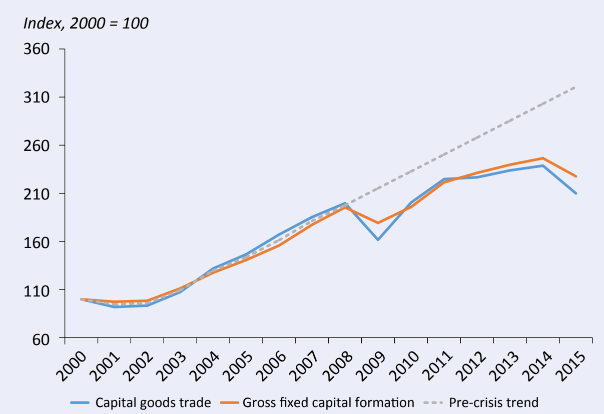


Figure 26: Global capital goods trade and investment



Source: World Bank Global Economic Prospect January 2017

31. Increased manufacturing activities in 2016 will likely spillover into 2017, but investment in productive capacity will be necessary for further output increases in the sector. The country's manufacturing sector, which expanded by 7.0 percent year-on-year in 2016, is expected to sustain its growth momentum in 2017. The PMI remains upbeat and points to continued growth in factory activities in 2017. Business confidence also remains high as firms anticipate robust market demand, new product releases, and an improvement in production capacity.[53,54]

32. The Philippines could leverage its strong performance in the country's rapidly growing services sector to spur a wider economic transformation. The services sector and services exports, particularly in the BOP subsector, have grown rapidly in recent years. However, the bulk of the services sector consists of relatively low-skilled, less-productive activities. The Philippines could leverage its strong performance in IT-BPO and its access to the key skills required by the sector, such as proficiency in English, customer service, and IT capabilities, to expand into

50 World Trade Organization (2016).

51 Bouet and Laborde (2010).

52 Evenett and Fritz (2009).

53 See: https://www.markiteconomics.com/Survey/PressRelease.mvc/a17b8a102e46485a88bd188e9f8993b9

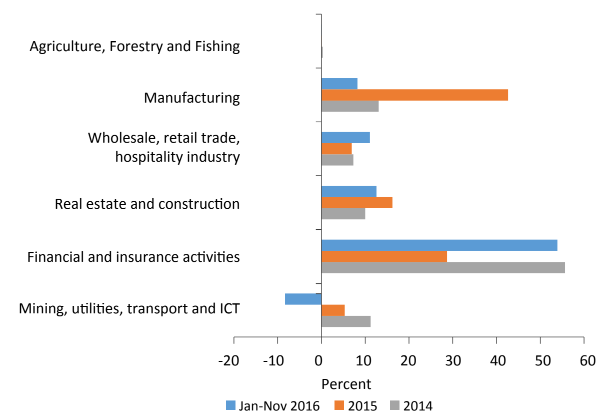
54 The manufacturing sector has been steadily expanding since 2009 and its contribution to growth has been marginally higher in the post crisis period, averaging 1.7 percent since 2010, compared to 0.8 percent from 2000 to 2009. The volume of the production index in manufacturing has sustained growth for 18 consecutive months since mid-2015. While the average capacity utilization rate reached 83.9 in December 2016, investment in durable equipment to support manufacturing is rising. However, only a third of this investment is on general and specialized machinery, indicating additional scope for new investment.

other service-based sectors such as tourism and healthcare. Given that three-quarters of services trade is in intermediate services, and that global networks play a key role in business development, the development of the domestic services sector will require trade openness, particularly with regard to professional services. However, the Philippines maintains a number of barriers to trade in services, as discussed in the report's special focus section.

33. The agriculture sector is central to achieving inclusive growth in the Philippines. Agriculture employs a disproportionate share of the labor force, accounting for around one-fourth of total employment in the Philippines, and its output has a significant influence on price levels. Vulnerabilities stemming from the agriculture sector continue to threaten inflation targeting and the economy's long-term structural reform agenda. Instead of rising agricultural productivity paving the way for the development of a vibrant labor-intensive manufacturing sector, and subsequently a high-skill services sector, agricultural productivity has remained depressed, and low-productivity, low-skilled services have emerged as the dominant economic sector.

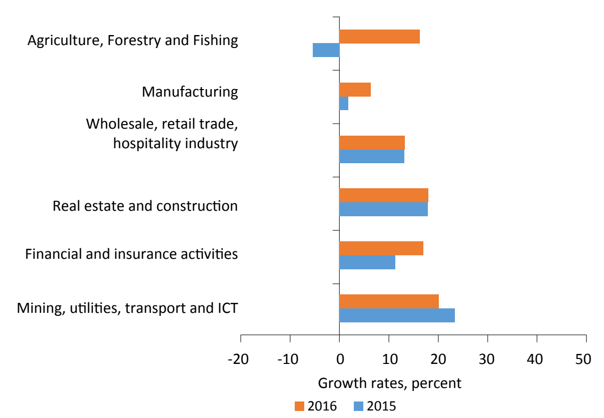
34. Despite its economic importance, the agriculture sector is projected to grow modestly as structural weaknesses in the sector persist. Following a 1.3 percent year-on-year contraction in 2016, the agriculture sector is expected to expand slowly from 2017 to 2019 due to the low base effect. Decades of underinvestment and a history of policy distortions in the sector, along with weather-related shocks, have diminished agricultural output, and a lack of infrastructure and insurance mechanisms has depressed productivity. Moreover, the agriculture sector has suffered from underinvestment and underfinancing despite mandatory lending targets.[55] In the past three years, the sector received minimal FDI, with domestic lending only picking up slightly in 2016 (Figure 27 and Figure 28). Boosting agricultural growth and productivity will require a long-term political commitment to deep structural reforms, including efforts to address protectionist policies, input subsidies, land-tenure issues, and value-chain weaknesses. Food imports currently complement local production. One immediate policy challenge is whether to lift quantitative restrictions on rice imports in July, as the planned removal of the restrictions should reinforce the resilience of the food supply.[56]

Figure 27: The agriculture sector has received little FDI over the past three years…



Source: BSP

Figure 28: …but domestic lending to the sector rose in 2016



Source: BSP

55 Republic Act 10000, also known as the Agri-Agra Law, requires all banks to allocate one-fourth of their total loanable funds to borrowers in the agriculture and fisheries sector.

56 Quantitative restrictions on rice imports have been in place since 1995. The WTO permitted the Philippines to impose a 10-year rice QR system, which was extended in 2004 and extended once more in 2014 for three years. The QR caps the volume of private rice imports at 805,200 metric tons and establishes a rice tariff of 35 percent. The administration's economic team plans to lift the QR to increase the sector's competitiveness and attract more private-sector participation. However, the Department of Agriculture prefers a grace period of two additional years to give farmers more time to adjust to the flooding of imports.

2.2 Poverty and Shared Prosperity Outlook

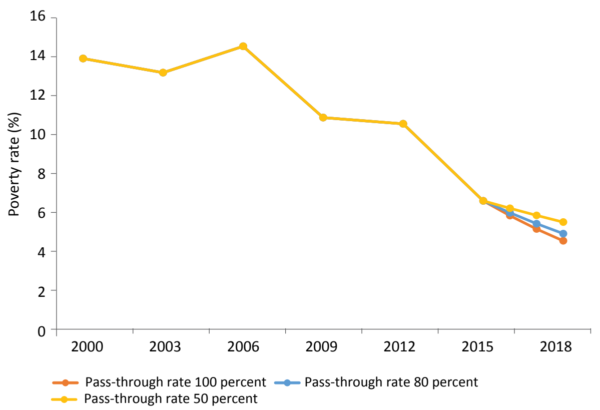
In line with the Philippines' strong growth outlook, poverty levels are expected to fall sharply with extreme poverty (measured by the World Bank's international poverty line of US$1.90/day) projected to drop from 5.8 percent to 5.1 percent

35. The pace of poverty reduction will likely accelerate if economic growth is sustained and becomes more inclusive. Under the baseline scenario, the extreme poverty rate (measured by the World Bank's international poverty line of US$1.90/day) is projected to decrease from 5.8 percent in 2016 to 5.1 percent in 2017, while the moderate poverty rate (measured by the World Bank's international poverty line of US$3.10/day) is projected to fall from 23.9 percent in 2016 to 22.5 percent in 2017—lifting roughly a million Filipinos out of poverty.[57] Productivity improvements in the agriculture sector and the continued movement of labor from agriculture to more productive sectors are expected to further reduce poverty rates. Poor and vulnerable household are more likely to benefit from strong economic growth if they acquire the skills necessary to capitalize on higher-productivity and higher-wage job opportunities. Improving the targeting of cash transfers and other social assistance programs would promote greater human-capital accumulation and accelerate long-term poverty reduction.

36. The country's positive poverty outlook depends on sustaining the close link between growth and poverty reduction observed in recent years. If growth remains inclusive, the extreme poverty rate could decline to 5.1 percent in 2017 and reach 4.5 percent by 2018. However, should the relationship between growth and poverty reduction weaken, the extreme poverty rate would remain unchanged at 5.8 percent in 2017, leaving more than 0.7 million Filipinos in extreme poverty than would be the case under the more optimistic scenario (Figure 29 and Figure 30).[58]

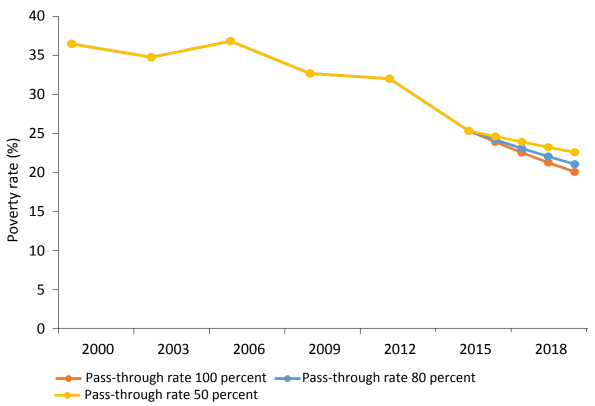
37. The impact of growth on poverty will depend in part on government policies. In the near term, enhancing the *Pantawid Pamilyang Pilipino Program* program could directly lift more Filipinos out of poverty. Over the longer term, the government will need to renew efforts to facilitate the country's structural transformation and expand economic opportunities for poor households.

Figure 29: Actual and projected poverty rates, US$1.90/day PPP



Source: PSA, World Bank staff estimates

Figure 30: Actual and projected poverty rates, US$3.10/day PPP



Source: PSA, World Bank staff estimates

57 As noted above, the moderate and extreme poverty rates are based on poverty lines equivalent to US$3.10 and US$1.90 per person per day, respectively, calculated in 2011 PPP terms.

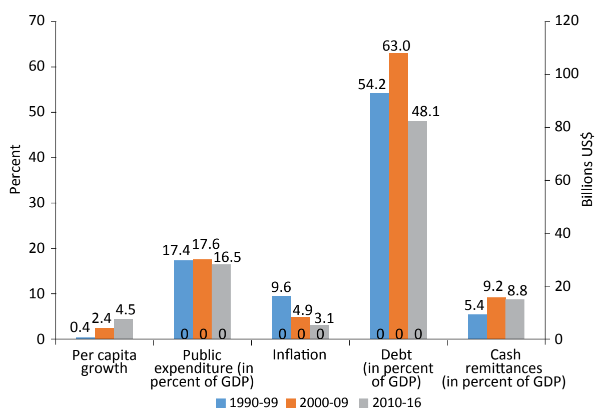
58 In technical terms, these high and low projections differ in terms in the extent to which they assume that growth in GDP per capita passes through to income growth at the household level. The high case assumes a 100 percent pass-through rate, while the low case assumes a 50 percent pass-through rate.

2.3 Risks and the Policy Agenda

The Philippines' outlook is marked by a number of downside risks, which are balanced by a number of medium-term development opportunities.

38. **Strong macroeconomic fundamentals have provided some fiscal and monetary space for the administration's ambitious public spending and social investment agenda, but risks are growing (Figure 31).** Rising global interest rates and commodity prices will remain a key source of external risk in the short term and could lead to a weaker peso, adversely affecting capital flows to the Philippines and inflation levels. Domestically, the key short-term downside risk to growth is the government's ability to deliver on its significant infrastructure investment commitments, which are projected to be the main driver of economic growth from 2017-2018. In the medium-to-long term, the government's planned expansionary fiscal strategy could lead to fiscal sustainability challenges. However, the Philippines could also leverage the benefits of a potential demographic dividend and a rapidly expanding services sector to boost economy-wide growth.

Figure 31: The Philippine economy is grounded in strong macroeconomic fundamentals



Source: PSA, BSP, World Bank staff estimates
Note: Data for the current-account balance are only available through Q3 2016.

39. **A faster-than-expected increase in global interest rates and commodity prices could rapidly deteriorate the Philippines' external balances and drive up the inflation rate.** A further increase in U.S. yields, driven by a sudden reassessment of U.S. monetary policy expectations, could lead to a renewed tightening of financing conditions, resulting in the peso's depreciation and portfolio outflows.[59] A weakening peso could exacerbate the country's external balances given the significant amount of imported capital goods needed to achieve the infrastructure investment agenda in the medium term. It could also drive up consumer prices as many consumer goods, such as rice, cereals, and dairy products, and raw materials, such as wheat, fertilizers, and animal feeds, are partially imported. Global crude oil prices are projected to recover from a 15.1 percent contraction in 2016 to 28.2 percent in 2017. This could adversely impact energy and fuel prices in the Philippines, which is already suffering from the effects of rising food inflation.

40. **The pace of economic growth in the Philippines could be slower if the government is unable to address bottlenecks in the development and implementation of planned infrastructure projects.** The administration's ambitious infrastructure agenda was introduced without yet addressing existing constraints to public investment management. Progress could be slower-than expected if the country's capacity to plan, coordinate, and implement such large-scale infrastructure projects is not improved. Similarly, public financial management constraints, including procurement-related delays, could hinder the budget's timely execution.

41. **Should some of these medium-term downside risks to the Philippines' growth outlook materialize, would need to be intensified to preserve the country's investment grade ratings.**[60] Containing inflation levels and maintaining fiscal sustainability remain key

[59] An rise in U.S. long-term yields supported by a stronger U.S. economy (a real shock) could increase equity prices and spur industrial production in the Philippines. In contrast, an increase in yields driven by a sudden reassessment of monetary policy expectations (a monetary shock) could have sizable adverse effects on Philippine equity markets, exchange rates, industrial production, and capital flows. See World Bank Global Economic Prospects, January 2017.

[60] The Philippines has maintained its BBB rating with Standard and Poor's and Baa2 rating with Moody's, and Fitch gave it a BBB rating in 2016.

medium-term challenges. If the government is unsuccessful in crowding-in the private sector or sufficiently increasing domestic revenues to finance its ambitious agenda, then higher fiscal deficits in the coming years will be likely.[61] PPPs could be used to implement infrastructure projects; however, no PPP contracts have been awarded since the new administration came into office. The government issued its first public bid for a PPP project in January 2017 for the operation, maintenance, and upgrading of five regional airports.

42. The success and timeliness of the administration's tax reform packages will be vital to balance planned spending increases under its public expenditure plan without overburdening the public finances. The administration's initial tax reform package has been revised since it was first submitted to Congress in September 2016. Provisions on VAT exemptions for senior citizens and persons with disabilities were retained and measures to improve tax-collection efficiency were added. The Department of Finance estimates that the first package of tax reforms will yield PHP206.8 billion, or around 1.1. percent of GDP, in the initial year of implementation. Roughly four-fifths of this amount would derive from tax-policy reforms, while the remaining fifth would stem from improvements in tax administration. The bill is currently pending approval by Congress and the Senate. The new tax schedule could become effective in the second half of 2017.

43. The Philippines is poised to take advantage of several important development opportunities, one being a potential demographic dividend. The Philippines' population is relatively young, and the country still has the potential to achieve a significant demographic dividend. The Philippines is experiencing a demographic transition from a largely rural, agrarian society with high fertility and mortality rates to a predominantly urban, industrial society with low fertility and mortality rates. As fertility rates fall, the labor force grows more rapidly than the population dependent on it, which allows for higher per-capita income growth and greater savings and investment. However, the dividend period offers a window of opportunity rather than a guarantee of improved living standards. Structural reforms are required to promote greater savings and investment and ensure that young workers develop the appropriate skills to succeed in a dynamic labor market.

44. The Philippines could leverage the strong performance of the country's rapidly growing services sector to accelerate its structural economic transformation. As about half of all services are traded indirectly and embedded in goods, the distinction between goods and services has become increasingly obsolete. For example, services represent more than 17 percent of the domestic value added to gross computer exports from the Philippines. The increased dependence of manufacturing activities on services is referred to as "servicification," and implies the globalization of both manufacturing and services. This report's special focus note on trade competitiveness and global value-chain integration discusses the process of servicification in the Philippines and the opportunities it presents to increase commerce, promote local sourcing, and enhance value addition. Servicification also plays an important role in attracting foreign direct investment, as firms willing to invest in emerging sectors in the Philippines will require an adequate supply of necessary services. Despite the rapid expansion of the services sector in general, and the growth of business-process outsourcing in particular, linkages between services and traditional sectors such as manufacturing remain tenuous and insufficiently developed. The Philippines' highly capable workforce and solid macroeconomic fundamentals could enable it to leverage the growth of the services sector to increase domestic value addition and accelerate the creation of high-quality jobs.

[61] The government recently reported that it had secured investment pledges and cooperation deals with China and Japan to overhaul the country's infrastructure and development aid over the next five years. China has reportedly pledged US$24.0 billion; of which US$15.0 billion is for business-to-business contracts and US$9.0 billion is in soft loans. Joint projects and infrastructure deals were identified in the areas of renewable energy, port and terminal development, hydropower, transportation, and bridge and flood controls. Various memoranda of understanding have been agreed to, including between the National Economic and Development Authority and China's Ministry of Commerce, to formulate a development program for economic cooperation. The administration also reported US$1.8 billion in business deals with Japan, as well as a verbal pledge from the Japanese conglomerate Marubeni to invest US$17.2 billion in water, power and infrastructure improvements.

45. The Philippines recent more inclusive growth pattern is a great achievement, maintaining it will require a commitment to structural reforms that encourages human-capital development and investments in sectors that create quality employment. Economic growth in the Philippines has become more inclusive in recent years, as evidenced by declining poverty and unemployment levels, and the falling Gini coefficient. However, severe underinvestment stemming from a lack of competition in key sectors, restrictions on foreign investment, insecure property rights, a high degree of regulatory complexity and other obstacles to Doing Business, continue to discourage private investment, and have prevented the economy from completing its structural transformation. These weaknesses in the policy framework have led to an anomalous growth pattern, which has failed to generate a larger number of high-quality, formal-sector jobs and has limited the pace of poverty reduction, as reflected in the large number of working poor. The government is attempting to address these issues through the Philippine Development Plan 2017-2022 and the *AmBisyon Natin* 2040.

46. In February 2017, the Philippine Development Plan 2017-2022 was approved, laying out the new administration's policy goals over the next six years. The Philippine Development Plan (PDP) was drafted through a consultative process involving a wide range of stakeholders from the private sector, academia, and civil society. It is grounded in the long-term vision advanced in the *AmBisyon Natin* 2040 and expands on the administration's 10-point socioeconomic agenda. The plan focuses on strategic trade and agricultural policy, as well as efforts to maximize the demographic dividend and promote macroeconomic and financial stability and fiscal prudence. With the passage of the PDP, the government has committed itself to policies that promote equitable tax reform, enhanced market competition, and improvements in the ease of Doing Business in the context of a sustainable buildup of public infrastructure investment and increased spending on social services.

Box 11 The Philippine Development Plan 2017-2022

The PDP 2017-2022 is founded on the pillars of *Malasakit, Pagbabago*, and *Patuloy na Pag-unlad*, roughly translated as "Care, Change, and Continued Progress." Under the first pillar (*Malasakit*), the government aims to reinforce citizen trust in public institutions. Strategies under this pillar include promoting transparency within the government, improving the efficiency of the public sector, and pursuing regulatory reforms. Under the second pillar of *Pagbabago*, or what the PDP refers to as inequality reducing transformation, the PDP aims to increase opportunities for output growth and income generation and improve access to human capital. Strategies under this pillar focus on enhancing access to quality basic education for all Filipinos, and increasing opportunities within the global market by streamlining bureaucratic processes for local and foreign businesses. Under the third pillar of *Patuloy na Pag-unlad*, the government aims to increase the Philippine economy's growth potential by maximizing the country's potential demographic dividend and advancing science, technology, and innovation. Strategies under this pillar include maintaining macroeconomic, fiscal, and financial stability as the country undertakes critical tax reforms.

NEDA is tasked with working with different government agencies to ensure the PDP's successful implementation. After the NEDA board approves the PDP 2017-2022, NEDA will formulate an Executive Order requiring that all government agencies support the PDP. To ensure the PDP's successful implementation, NEDA will work with various national-level government agencies to prioritize policies and programs identified in the PDP.

47. Under the PDP, the government aims to transition the Philippines to upper-middle-income status and significantly reduce poverty by 2022 while maintaining the country's strong pace of economic growth. The current administration has outlined three key targets it hopes to achieve by the end of its term: (i) sustained a 7-8 percent GDP growth rate over the medium-term; (ii) a 7.6 percent reduction in the poverty rate from 21.6 percent in 2015 to 14.0 percent by 2022, as well as a decrease in the rural poverty rate from 30.0 percent in 2015 to 20.0 percent in 2022; and (iii) a further reduction in the unemployment rate from 5.5 percent in 2016 to a target range of 3-5 percent in 2022.

PART III:

TRADE COMPETITIVENESS AND GLOBAL VALUE CHAINS IN THE PHILIPPINES[62]

The Philippine economy has grown at a robust pace in recent years, yet problematic trends have emerged in key areas of trade competitiveness, global value chain integration, and product-space evolution. The Philippines has increasingly focused on the export of intermediate products, extending its economic distance from the final consumer. In the process, Philippine firms have become less able to influence global value chains and have failed to penetrate new markets. As a result, the Philippines has lost some elements of global value chains to regional competitors, reorienting production toward less sophisticated goods and services, and its economy is now more exposed to global demand fluctuations. Furthermore, the diversification of the Philippine export basket has concentrated on primary commodities, natural resources, and other goods at the periphery rather than the center of the product and service space. The Philippines has also shifted focus away from its traditional comparative advantage in sophisticated products, making future value-chain upgrading and innovation at the center of the product and service space even more difficult. Most importantly, while the expansion of services, and especially business-process outsourcing, has driven recent growth in the Philippines, linkages between the services sector and more traditional activities such as manufacturing have remained tenuous and underdeveloped. The Philippines could better maximize the benefits of global connectivity and leverage the growth of the services sector to increase domestic value addition and accelerate the creation.

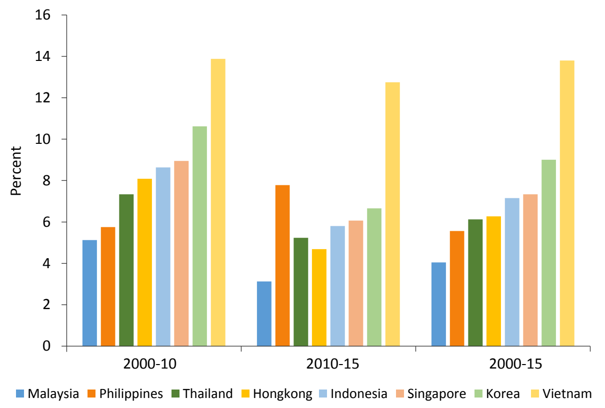
[62] This special focus note was prepared by Birgit Hansl. The analysis is based on a World Bank Background Document (2017): *Making GVCs Work for the Philippines* by Olivier Cattaneo (Senior Economist), Deborah Winkler, Mauro Boffa, Victor Kümmritz, Gianluca Santoni and Na Zhang (Consultants) from the Trade & Competitiveness GP, Masud Cader (Senior Portfolio Officer) and Kirstin Roster (Consultant) from Country Economics and Engagement at IFC.

3.1 Introduction

48. In recent years, the Philippines has ranked among the world's fastest-growing economies, with an annual real GDP growth rate averaging 4.5 percent since 2000. In 2015, it was among the top 30 fastest-growing economies worldwide. Like many other countries in the East Asia region, the Philippines has benefited from the rapid growth of the Chinese economy, which has expanded at an average growth rate of close to 10 percent since 2000, as well as regional and global trade integration and value-chain development.

49. However, the Philippines lagged its regional peers in terms of export growth in the 2000's, catching up in the 2010's (Figure 32). Moreover, an analysis of trade and competitiveness indicators suggests that the Philippines has not fully harnessed the opportunities presented by its growing economy, and that it has performed relatively poorly in terms of industrial development and global value chain (GVC) integration. In other words, rapid short-term growth could obscure an underlying decline in economic productivity. The Philippines appears to be gradually moving away from the sophisticated high-tech products in which it has a comparative advantage and is instead shifting focus toward primary commodities and resource-based goods. Moreover, the Philippines is excessively reliant on a limited number of products and services, and the country is experiencing a rapidly growing trade deficit in a context of low returns on foreign investment and limited trade participation. While the Philippines retains many of its traditional comparative advantages, it is failing to adjust to the demands of a dynamic global economic environment.

Figure 32: Annual growth of total exports, Philippines and peers, 2000-2015



Source: WDI

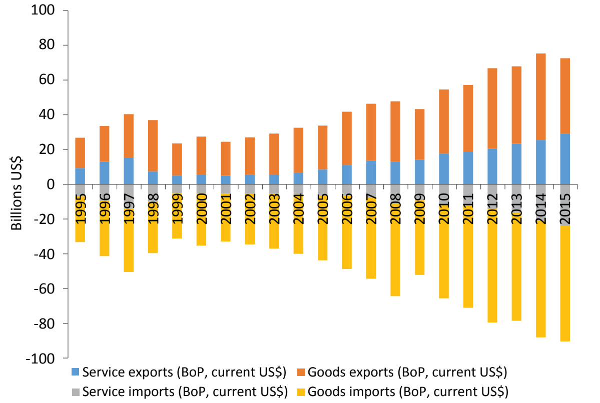
50. This note examines the evolution of product and service space in the Philippines and the country's integration into GVCs. It assesses the diversification and sophistication of Philippine exports, examines the country's position and role in major global production networks, and estimates the economic benefits it derives from its participation in GVCs. It also discusses whether the country is prepared for the 4th Industrial Revolution and what the future of manufacturing in the Philippines could look like. The note aims to inform the development of an effective policy framework for revitalizing the manufacturing sector and realizing the country's long-term growth potential.

3.2 Trade Competitiveness and Exports

51. While the Philippines has benefitted from the rapid growth of services exports since 2000, its overall trade deficit has grown, and its global connectivity has declined. Between 1999 and 2015, total exports from the Philippines grew from about US$23.6 billion to US$72.5 billion. While goods represented 59.6 percent of total exports in 2015, the share of goods in total exports continuously declined during the period, and services drove export growth (Figure 33). Moreover, import growth has outpaced export growth, widening the trade deficit to 17.7 billion in 2015 (Figure 34). The increase in the deficit was entirely due to trade in goods, as the Philippines maintained a trade surplus in services over the period. Export growth has not kept pace with both import and GDP growth, and trade's contribution to GDP has declined (Figure 35). Between 2004 and 2015 the contribution of merchandise trade to GDP fell from 93.9 to 44.0 percent, while the contribution of services trade increased from 13.8 to 18.2 percent. This suggests that the Philippine manufacturing sector has become less integrated into global trade networks, and that firms may be preoccupied with reaping the benefits of a fast-growing domestic consumer market rather than strengthening their international connectivity.

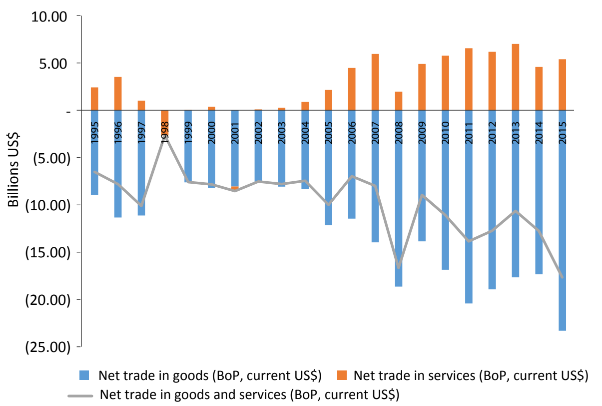
52. The sharp decline in trade integration in the Philippines in the 2000s largely reflected a "lost decade" for manufacturing, or the syndrome of a "premature deindustrialization" increasingly alluded to in the economic literature. From 2000-2011, exports of manufactured goods grew by 4.7 percent, while service exports grew by 12.9 percent (Figure 36). However, electronics—the Philippines' main manufacturing export—grew by just 1.9 percent, compared to a remarkable 25.5 percent growth rate in Vietnam and a 23.1 percent growth rate in China (Figure 37). This suggests that the Philippines has missed an important opportunity to accelerate the growth of its most important export sector. Since 2013, the growth of manufacture exports in the Philippines has modestly increased, indicating that a broader revival of sectoral development is possible.

Figure 33: The evolution of exports and imports, Philippines, 1995-2015



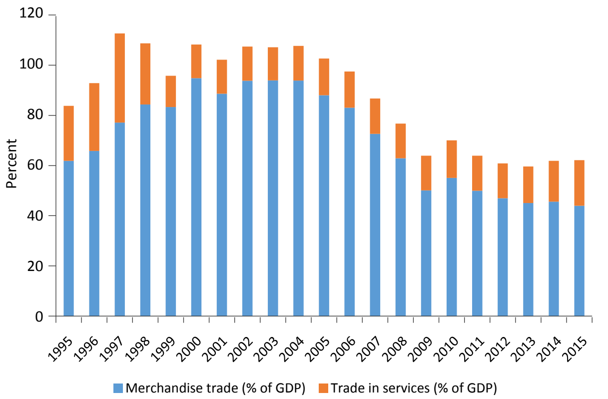
Source: IMF, Balance of Payments

Figure 34: The evolution of net trade in goods and services, Philippines, 1995-2015



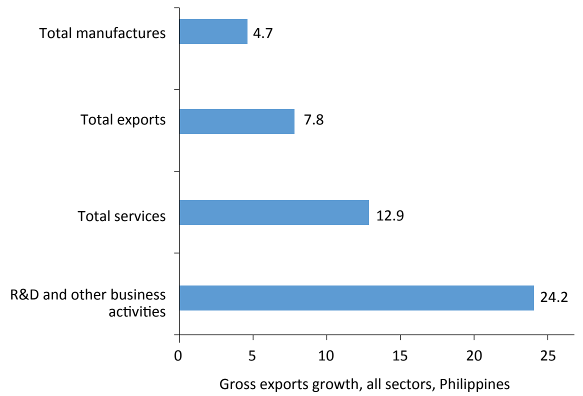
Source: IMF, Balance of Payments

Figure 35: Merchandise and services trade as a percentage of GDP, Philippines, 1995-2015



Source: IMF, Balance of Payments

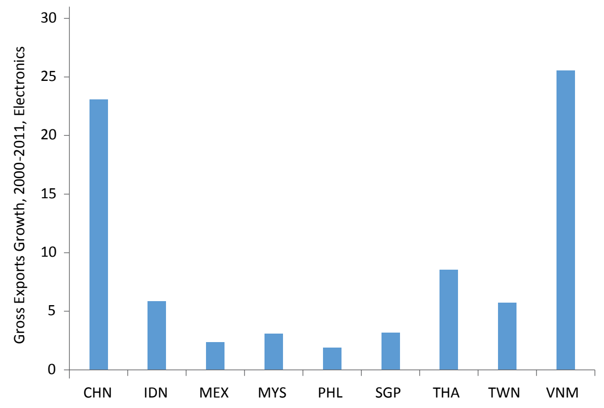
Figure 36: Export growth by sector, Philippines, 2000-2011



Source: OECD-WTO TiVA database, WB staff estimates

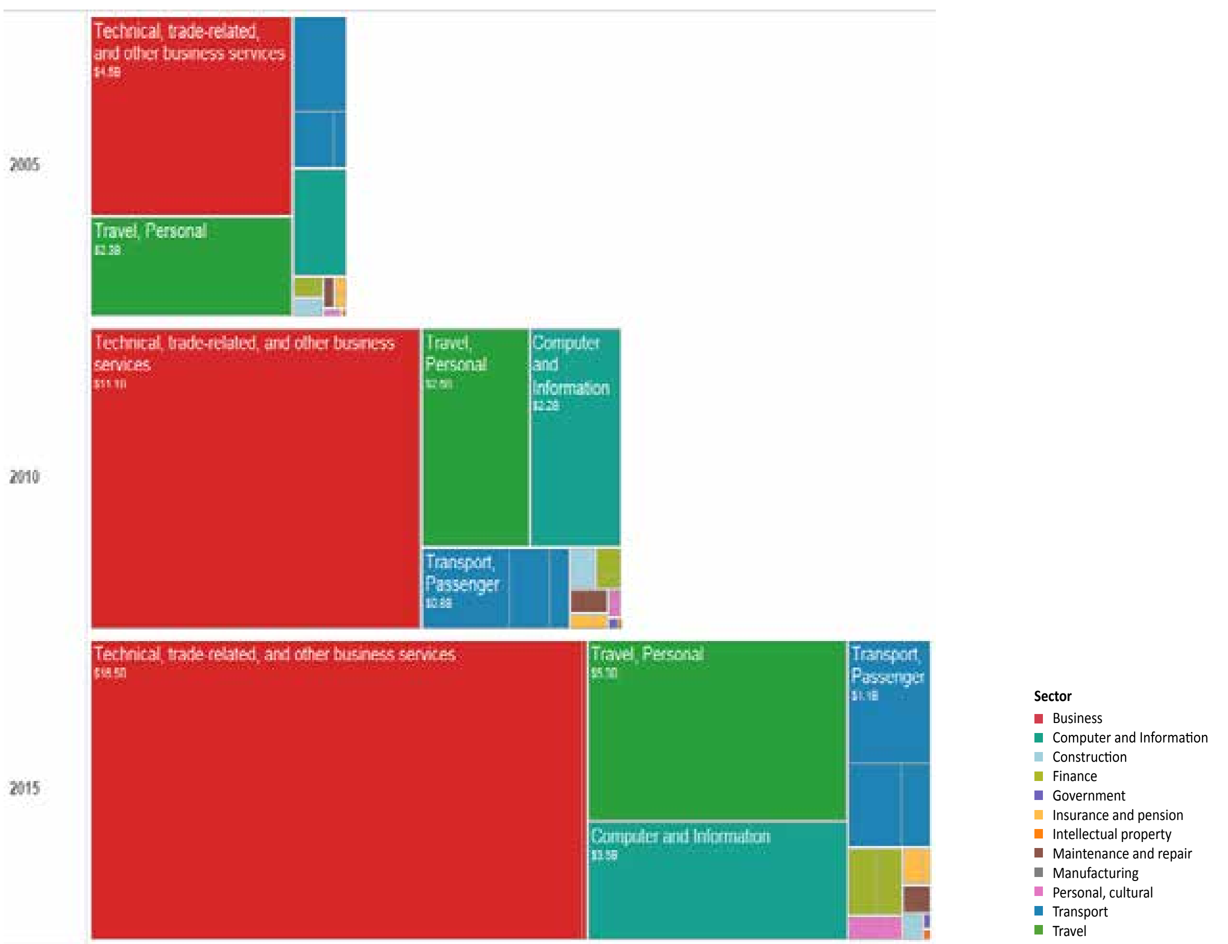
53. In services exports, some services subsectors have grown faster than others. Business-process outsourcing (BPO) has driven export growth in the Philippines since 2000. In 2015, the BPO subsector represented 64.7 percent of total services exports. Transportation and telecommunications also made substantial contributions to export growth during the period (Figure 38).

Figure 37: The growth of electronics exports, Philippines and comparators, 2000-2011



Source: OECD-WTO TiVA database, WB staff estimates

Figure 38: Evolution of services exports from the Philippines by sector, 2005-2015



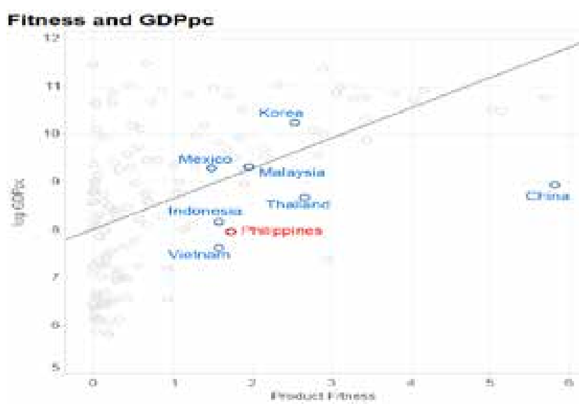
Source: IFC

3.3 The Philippines' Comparative Advantage in Sophisticated Exports

54. The Philippine export market is characterized by a significant degree of specialization in high-tech products[64], particularly electronics. More than 60 percent of Philippine exports were classified as high-tech in 2013, a much larger share than in China (42 percent) and all other peer countries (Figure 39). Due to the Philippine economy's heavy dependence on the performance of its high-tech sector, it is more vulnerable to demand shocks in high-tech value chains than other comparable countries. Comparing the Philippines' "fitness" to that of other countries further underscores its comparative advantage in high-tech products, as the Philippines exports more sophisticated products than other countries at a similar income level. However, per capita GDP in the Philippines is low relative to the sophistication of its exports (Figure 40), suggesting that the Philippines is not leveraging the full benefit of its participation in international trade and GVCs. This could be explained by the position of the Philippines in the value chain: while the end product is high-tech, the tasks performed in the Philippines are fairly basic (assembly of components), adding little value.

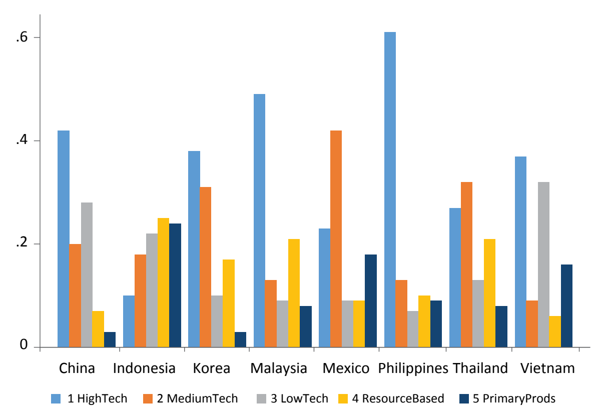
55. The share of high-tech products in the Philippines' export basket has declined since 2000. High-tech products fell from a peak of 75 percent of manufacturing exports in 1999 to 46 percent in 2011 before rebounding slightly to 53 percent in 2015. While increased export diversification reduced dependence on a narrow range of products, the decline in high-tech exports has been accompanied by an increase in primary commodities and resource-based products, both of which doubled their share of exports during the 2000-2013 period, led by minerals, metals, and fuels (Figure 41). This indicates that the Philippines may have strayed too far from its traditional sources of comparative advantage. Moreover, it is unclear to what extent recent

Figure 40: Sophistication of exports and GDP, Philippines and comparators, 2013



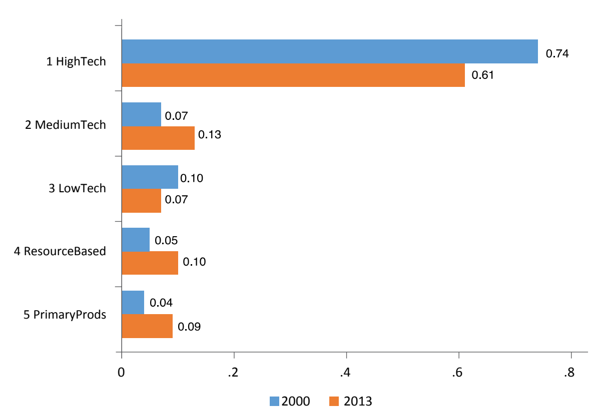
Source: IFC based on UN Comtrade

Figure 39: Technological classification of total exports, Philippines and comparators, 2013



Source: WITS, Trade outcomes indicators

Figure 41: Philippine exports by technological classification, 2000 and 2013



Source: WITS, Trade outcomes indicators

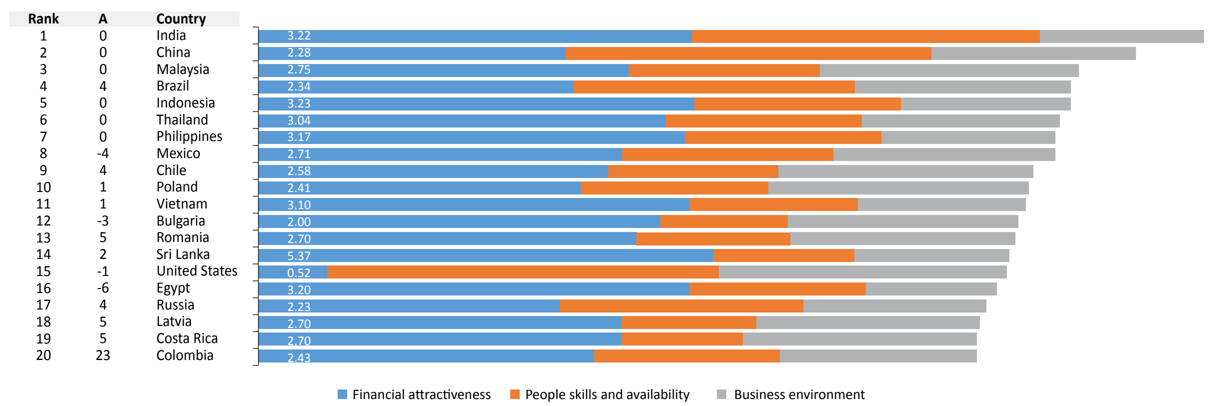
64 According to UN Comtrade, high-technology products are products with a high research and development intensity, such as computers, pharmaceuticals, scientific instruments, and electrical machinery.

65 Fitness refers to the level of capabilities present in the economy, with "fitter" countries being able to produce more sophisticated goods and services.

diversification has benefited the Philippines, as primary and resource-based sectors have thus far involved less local transformation, domestic value addition, and job creation.

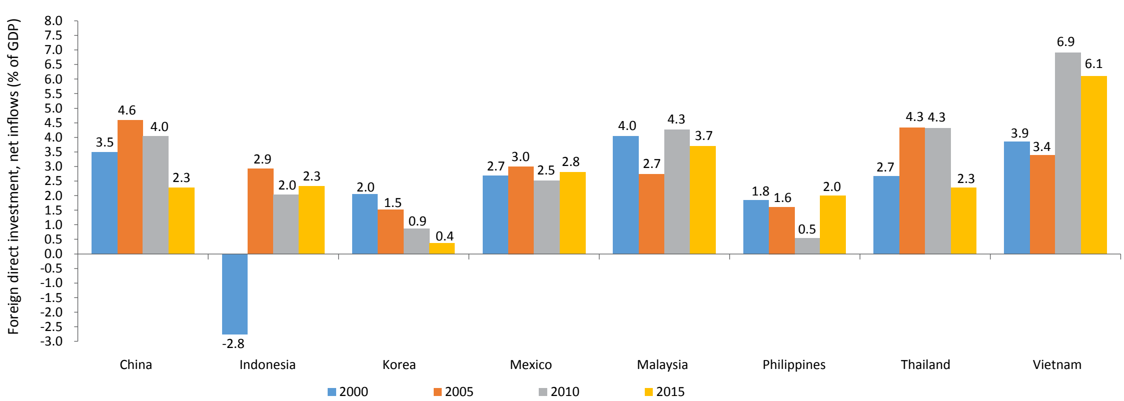
56. The Philippines underperforms peer countries in terms of the value and content of FDI. The AT Kearney Global Services Location Index suggests that the Philippines' main factor of attractiveness in the BPO sector is its low cost (Figure 42). Looking at the IBM Global Location Trends (2016) ranking of countries by average job value of investment projects. However, looking at the 2016 IBM Global Location Trends ranking of countries by average job value of investment projects, the Philippines disappears from the top. Ireland ranks first, while Singapore and Hong Kong are the only Asian countries in the top 10. In other words, while FDI has created numerous jobs in the Philippines, most of these were low-paid. Beyond the size and quality of employment creation, the value of FDI inflows can be assessed in terms of its contribution to infrastructure development and capacity building. FDI inflows represented only 1.4 percent of the Philippines' GDP in 2013, compared to more than 5 percent in Vietnam and more than 3 percent in China, Malaysia, and Thailand (Figure 43). This also suggests that the Philippines does not benefit as much as it could from trade integration and GVC participation.

Figure 42: AT Kearney global services location index, 2016



Source: AT Kearney, 2016

Figure 43: Net Foreign Direct Investment Inflows, Philippines and Comparators, 2000-2015



Source: WDI

3.4 Evolution of Exports and GVC Integration in the Philippines

57. The Philippines' export basket has not changed substantially over the past decade.[66] A product-space analysis reveals that the range of products exported by the Philippines has remained broadly constant over time (Figure 44). By contrast, China has successfully diversified its exports. The analysis also confirms the high concentration of Philippine exports in a limited number of areas—especially electronics, textiles and apparel, agricultural products and foodstuffs, and electronics—whereas China exports a much wider range of products.

58. Graphically, a successful economic development and diversification pattern leading to greater export sophistication and value-addition would be represented by a move toward the center of the product space. Products at the center of the product space are more similar, increasing the ease with which production can shift from one product to another. This reduces a country's potential exposure to external shocks and increases the resilience of its economy. The process of moving towards the center of the product space could entail an economic upgrading and a movement down the value chain, allowing the country to capture more value addition locally.

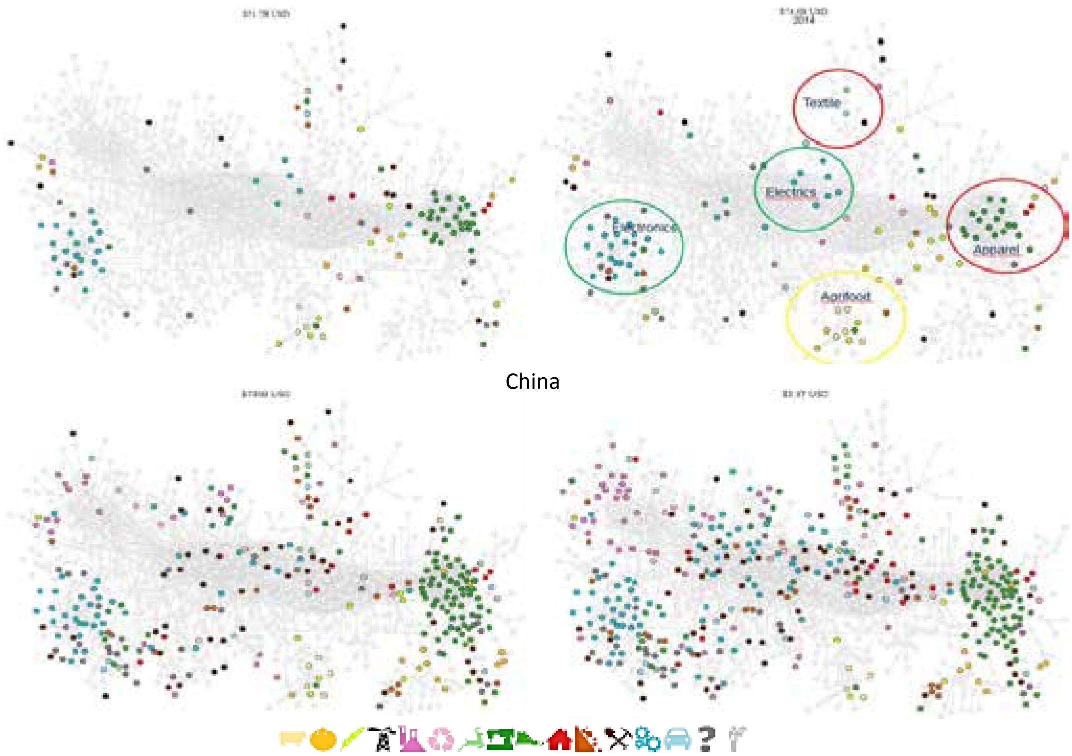
59. The Philippines is not decisively moving toward the center of the product space. Only a few new products have appeared on the upgrading path, reflecting limited innovation in the electrical products, apparel, and agriculture and food sectors. The electronics cluster has diversified, but without a clear movement towards the center. Nevertheless, the concentration of products in the middle of the cluster has increased. While new products appeared at the center of the product space that were not connected to existing products further toward the periphery, these disappeared almost immediately, suggesting that the companies producing them did not survive. However, several new products have appeared and persisted in resource-based sectors (e.g., metals and minerals) at the periphery of the product space, contrary to the "normal" upgrading path. This again stands in contrast to the pattern observed in China, where new products appeared toward the center of the product space while others closer to the periphery disappeared, indicating economic upgrading (Figure 44).

60. Some elements of the Philippines' product space have changed over time. Over the past decade, the Philippines has seen (i) a sharp decline in the range of textile exports and a moderate decline in the range of apparel exports; (ii) a fairly stable distribution of exports in the agriculture and food, electronics, and electrical products sectors, with only a few new exports emerging in each sector; and (iii) few innovations in resource-based sectors at the periphery of the product space. These findings are confirmed by an analysis of the Philippine export basket presented in Annex 1. An analysis of the International Trade Center's "Trade Map" also suggests that the Philippines has lost market share in growing sectors, such as agriculture and food, apparel, and machinery, and moved toward resource-based products with lower growth potential (Figure 45).

61. The evolution of the Philippine's product space and export basket suggests that the country did not pursue an appropriate diversification strategy. Having diversified only at the periphery, where products are less sophisticated and have less potential for transformation, the Philippines is less able to capture value addition and leverage transformative activities to create jobs and increase income. Moreover, the country's diversification away from its traditional sources of comparative advantage makes it harder for exporters to compete internationally. Meanwhile,

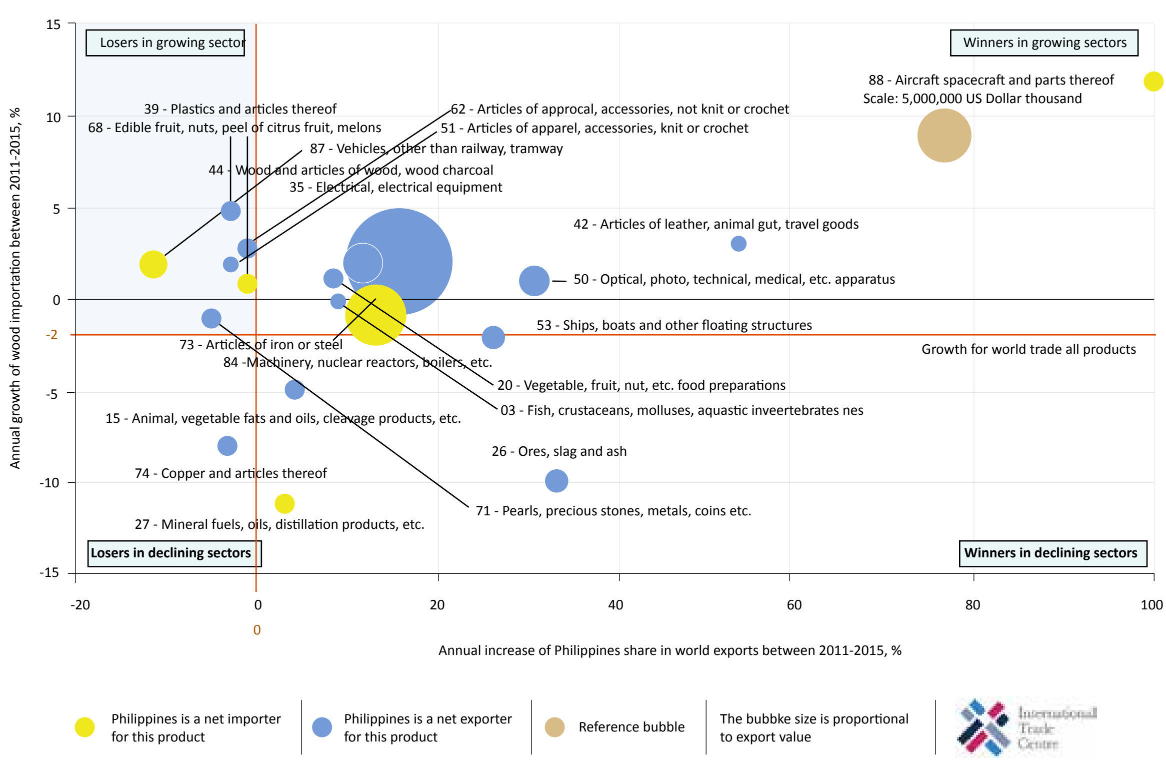
[66] The product space quantifies the relatedness of products with a measure called "proximity". Proximity formalizes the intuitive idea that a country's ability to produce a product depends on its ability to produce other products. For example, a country that exports apples probably has the necessary conditions, equipment, and regulations in place to relatively easily begin exporting pears, e.g. the appropriate soil and climate, packing equipment, refrigerated trucks, agronomists, phytosanitary laws, and working trade agreements. These inputs would not be useful, however, in producing a dissimilar product such as copper wire or home appliances.

Figure 44: Product-space evolution, Philippines and China, 2004 and 2014



Source: Atlas of Economic Complexity, Harvard University

Figure 45: The growth of domestic supply and international demand for products exported by the Philippines, 2015

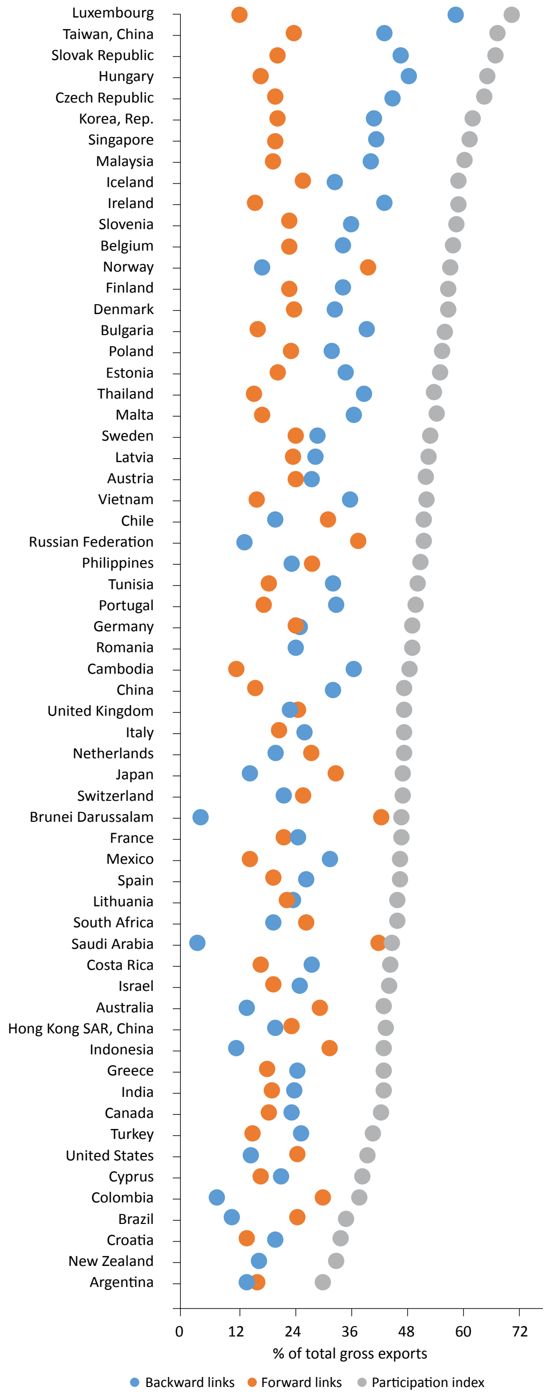


Source: Trade Map, International Trade Center the "complexity gap" discourages isolated innovation at the center of the product space.[67] As a result, the Philippines is more exposed to both demand-based external shocks, as it is harder to quickly reallocate labor and capital to related products, and price volatility, as there are few intermediate industries to buffer the impact of volatile commodity prices. Finally, the Philippines has become more of a GVC taker, meaning that it is increasingly exposed to the decisions of actors down the value chain, and less of a GVC maker, where it is directing the market.[68]

62. A country's position in GVCs determines its trade prospects and the economic benefits generated by foreign investment and trade. This includes the number and quality of jobs created, as well as technology transfer, workforce-skills upgrading, and positive spillover effects from capital and infrastructure investment. The amount of value that a country generates through its participation in GVCs depends on its position in the value chain, the types of tasks it performs, and backward and forward linkages in the domestic economy.[69] The Philippines ranks in the middle of the GVC Participation Index, behind many of its regional peers and other emerging economies (Figure 46).

63. GVC integration is heterogeneous across sectors. The level of GVC integration in the electronics sector declined significantly between 2000 and 2011, underscoring the extent to which this was a "lost decade" for manufacturing (Figure 47) that is also reflected in lagging productivity growth. The decline in GCV integration was driven by a reduction in backward linkages as producers in the Philippines became further removed from final products and consumers. By contrast, backward linkages have increased GCV integration in the services sector, which may reflect the different relative position of the Philippines in the BPO value chain and its closer proximity to consumers.

Figure 46: Technological classification of total exports, Philippines and comparators, 2013



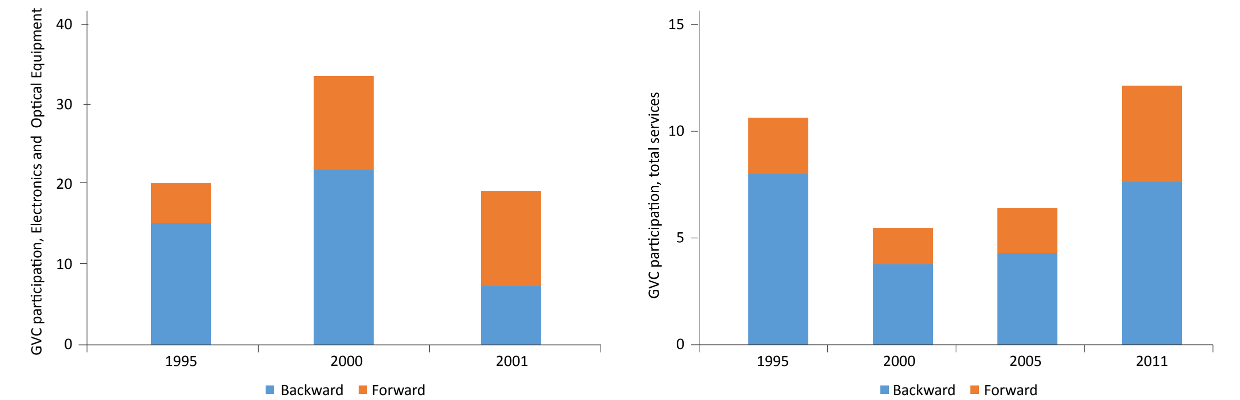
Source: Adapted from OECD-WTO TiVA database, 2015

[67] A linear movement towards the center of the product space is more secure than a stochastic one: The survival rate of companies isolated at the center of the product space is lower than that of companies closer to existing exporters.

[68] These terms distinguish between firms which make decisions that influence the value chain (GVC makers) and firms that are subject to those decisions (GVC takers). See: Sturgeon and Gereffi (2008).

[69] Backward linkages are established when an investment creates demand for inputs from the local economy, while forward linkages are created when the investment's outputs become inputs elsewhere in the domestic economy.

Figure 47: Change in GVC participation and backward and forward linkages, electronics (left panel) and services (right panel), 1995-2011



Source: OECD-WTO TiVA database, 2015; World Bank staff estimates

64. Firm-level data confirm the Philippines' relatively poor integration into GVCs.[70] Just 6.9 percent of domestic firms and 25.5 percent of foreign firms in the Philippines directly or indirectly export goods and services, far fewer than in peer countries. Up to 61.1 percent of domestic firms in Thailand are exporters, while 78.7 percent of foreign firms in Vietnam, 84.1 percent in Malaysia, and 93.2 percent in Thailand directly or indirectly export. The share of total sales exported directly or indirectly by foreign firms in the Philippines is similarly low at 16.3 percent, compared to 56.7 percent in Malaysia and 54.8 percent in Vietnam. Domestic firms in the Philippines export only 3.5 percent of their output, compared to 26.0 percent in Malaysia and 25.7 percent in Thailand. However, only 60.4 percent of foreign firms and 39.0 percent of domestic firms in the Philippines import inputs, and 77.8 percent of the total inputs of domestic firms are locally sourced.

3.5 Entering the 4th Industrial Revolution: Servicification and the Future of Manufacturing

65. As the world enters the 4th Industrial Revolution, distinctions between goods and services have become increasingly obsolete. About half of all services are traded indirectly and embedded in goods.[71] In the Philippines, services represent more than 17 percent of the domestic value added to gross computer exports. The increased dependence of manufacturing activities on services, or "servicification," implies the globalization of both manufacturing and services.[72] This process presents a critical opportunity to increase commerce, promote local sourcing, and enhance value addition. Servicification also plays an important role in attracting FDI, as firms willing to invest in emerging sectors in the Philippines will require an adequate supply of the necessary services.

66. Servicification is the future of manufacturing. Policies designed to support a resurgence in manufacturing must have a services-development component. Without efficient services, the Philippines will not be able to compete internationally or establish new ties to global production networks. Key sectors such as apparel are experiencing a GVC consolidation, as GVCs are becoming shorter and involving fewer actors.[73] Meanwhile, an expanding range of sectors require services as a necessary condition for investment. Moreover, innovation

70 Based on Enterprise Surveys, World Bank 2015. Data for the Philippines and Vietnam are from 2015, while data for Malaysia and Thailand are from 2007 and 2006, respectively.

71 OECD-WTO Trade in Value-Added (TiVA) database.

72 "Servicification" refers to the progressive increase in the services content of production observed over time, whether the services are used as inputs in production or to augment final products. See: National Board of Trade, 2010.

74 See: Cattaneo et al., 2010.

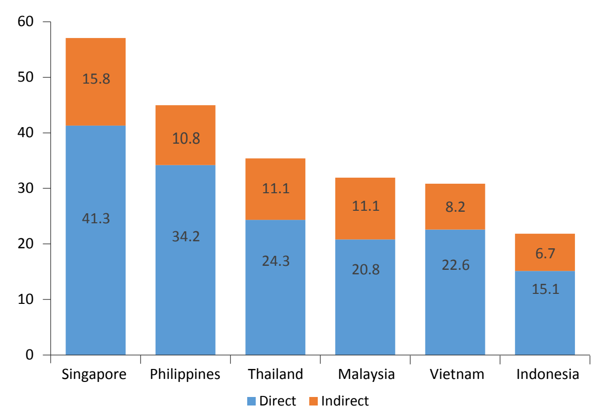
in the services sector is vital to compete in the crowded middle ground of the product space. In this context, it is no longer possible for a country to specialize exclusively in manufacturing. The development of a robust services sector, coupled with the adoption of new technology, can enable countries to enter new value chains and compete in new industries.[74]

67. Philippine policymakers should view the product space in three-dimensional terms, innovating and differentiating between products by adding more services to goods. For example, the Philippines is the primary producer of printers in the world; however, it is unclear how much value is being added in the printer value chain. As printing becomes more sophisticated, software, maintenance, and other services are representing a larger share of value addition relative to hardware manufacturing. The challenge for the Philippines will be to create linkages between sectors in which the country performs well, such as BPO services, with manufactures where resurgence is sought and innovation needed.

68. In the Philippines, the share of services in total export value-addition is high at 45.0 percent. The Philippines is second only to Singapore (57.1 percent) among comparable countries (Figure 48). However, this does not necessarily reflect the Philippines' success in using services to add value to goods, but rather the large share of services in Philippine exports, as the domestic value added through services exports is higher than that of goods exports. Moreover, some services suffer from limited efficiency and higher costs. For example, transport services appear among the highest-value-added service exports, but in reality affect the competitiveness of Philippine exporting firms. Ensuring that manufacturing firms have access to services requires a highly efficient domestic services sector and/or access to services imports. Given that three-quarters of services trade is in intermediate services, and that global networks play a key role in business development, expanding the local supply of services will not be possible without greater trade openness.

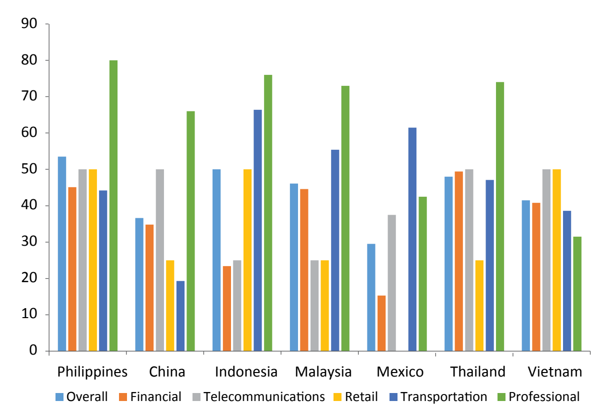
69. The Philippines imposes several important barriers to trade in services. The Philippines is the most restrictive country among its peers based on the Services Trade Restrictiveness Index, ranking highest in most indicators (Figure 49). Key service inputs for the manufacturing sector are tightly restricted, including telecommunications, transport, finance, and retail, and the domestic market for professional services is almost completely closed. Expanding access to services imports would be a major step toward reviving the growth of the Philippine manufacturing sector.[75]

Figure 48: Domestic value added in services exports as a share of total domestic value added exported, Philippines and Comparators, 2014



Source: WITS

Figure 49: Services trade restrictiveness index by sector, Philippines and comparators



Source: WB services trade restrictions database
Note: 2008 data for Southeast Asian countries; 2011 data for China and Mexico

[74] Zedillo et al., 2015.
[75] RASTI, World Bank 2014

70. The paradox of the Philippines is that the country is primarily driven by services exports, but poorly endowed with services that are necessary inputs in other sectors' value chains such as agriculture or manufacture (so-called "embodied" services). This is due to the high concentration of services exports and value addition in the BPO sector, which has limited ties to the domestic economy. However, the Philippines could leverage its strong performance in the BPO sector and the key skills required in this sector, such as proficiency in English, customer service, and IT capabilities, to expand into other service-based sectors like tourism, healthcare, and design. Tighter linkages with other sectors could both diversify the range of services offered and increase the value added in other sectors. For example, the Philippines could transition from solely producing printers to offering post-sale technical support, designing printing software, or even entering the printing market.

71. With the consolidation of GVCs and the demand for "task bundling" by industry-leading firms, the Philippines has an opportunity to move toward the center of the product space. The Philippines can upgrade and expand its participation in value chains by developing the services sector and by building linkages across sectors, and by adding more services to goods (so-called "embedded" services). Diversification is possible even within the BPO sector by moving into KPO and linking basic offshoring services with other more sophisticated services such as telemedicine, accounting, legal services, and other professional services. The core challenge is not to create sophisticated industrial and services sectors, but to align their operations and leverage complementarities between them.[76]

3.6 Policy Recommendations: Maximizing the Benefits of GVC Participation

72. The Philippines must devise a strategy to sustain the growth and diversification of its exports. The Philippines cannot effectively compete with lower-cost producers such as Vietnam, or in sectors that rely on economies of scale in mass production. Unless the government can support the growth of services and the adoption of new technologies, it will not be able to recapture some of the segments of manufacturing lost to global competition, such as textiles. The Philippines' main asset remains its high-quality and flexible workforce, which allows for timely production tailored to the needs of the client. Efficient international sourcing is more likely to engender success and improve the country's competitiveness than local sourcing, at least for low-cost inputs that require scale. The Philippines remoteness in value chains remains a key issue, and looking back at lost productions that were even further remote is not a solution.

73. The Philippines will need to improve domestic linkages not only between services and other sectors, but also among industrial subsectors. With the consolidation of GVCs, international firms increasingly expect suppliers to bundle services with industrial activities. Given the flexibility and skill level of its workforce, the Philippines could capitalize on this demand. Successful Philippine companies have already moved in this direction, developing one-stop shops for both products and services, such as design, marketing, or packaging, as well as tailored technological and logistical solutions. While the Philippines is not capable of competing with China in the mass production of relatively simple standardized goods, successful Philippine firms have specialized in technological or skills-based niches, limiting their direct competition with China. Policies supporting innovation and the development of micro, small and medium enterprises (MSMEs), production clusters, and cross-sectoral linkages would facilitate this process. Efficient international sourcing and innovation in the right areas of the product space will be key to success, allowing the government

[76] Using Usui's (2012) analogy expressing the need for the Philippines to "walk on two legs," the problem is not so much that the Philippines does not have two legs—an industrial and a modern services sector—but that the two legs are not attached to a single trunk and walk in opposite directions.

to focus on quality rather than quantity. On the long term, preserving this comparative advantage also means addressing human capital issues, and having an ambitious education and skills agenda. Indeed, recent work by Hidalgo et al. shows a link between inequality (which is also linked to primary education) and the complexity of the product space.

74. A common feature of successful companies in the Philippines is their specialization in either technological or skills-based niche markets. This is true across all economic sectors, including BPO, apparel, and furniture. Niche-market companies often produce higher-quality products, are more innovative than their competitors, and offer customized solutions to their clients. The success of these companies is in large part due to individual initiative and strategy and their ability to capitalize on technology and services, rather than specific government policies. Firms in the furniture sector are increasingly offering online solutions for customers, such as the ability to design customized pieces, while those in the apparel sector are bundling product development with services such as packaging and marketing.

75. Diversification through innovation will be key to the Philippines' success, particularly given the need to compete with lower-cost producers in the region. While the government has promoted innovation heavily and successfully, the types of innovations pursued have often failed to yield internationally competitive firms, resulting in a low export survival rate at the center of the product space. Using the GVC and product-space analysis, the Philippine government could identify priority areas for innovation to help the country upgrade, move up value chains, and make progress towards the center of the product space. Strategic innovation at key points in the value chain, supported by more focused policies, would facilitate this process. The analysis presented in Annex 2 could help identify prime areas for diversification. For example, the Philippines seems to have the necessary technology to produce and export transmitter-receiver devices, for which there is rapidly growing global demand.

76. MSME support should also be a key component of any manufacturing-resurgence or trade-promotion strategy. A full 99.6 percent of all firms in the Philippines are MSMEs, which together represent 61.2 percent of employment and 35.7 percent of total value added. While there has been some focus on MSME development, the level of support remains insufficient, and key constraints, such as access to finance, continue to slow their growth. As with innovation, the government could use the GVC and product-space analysis to better target MSME support programs.

77. A country's business environment and investment climate influence its attractiveness to lead firms and ultimately determine the extent and quality of its participation in GVCs. The Philippines ranked 99th in the 2017 Doing Business report (Table 8). To increase its attractiveness to investors, the Philippines will need to focus on improving its structural economic efficiency and competitiveness, rather than on lowering labor costs or providing investment incentives. Pro-investment policies should be tailored to specific sectors, as investor requirements often vary substantially between sectors.

78. To diversify its export basket and create better jobs, the Philippines must attract foreign investment in sectors beyond BPO. While the Philippines remains an attractive location for offshore production, FDI levels have been low and the quality of jobs created in the economy has been generally poor. Three out of every four companies that have established a presence in the Philippines do not export. As the Philippines does not have China's scale or the cost advantages of some its neighbors, it needs to attract the appropriate types of investors to capitalize on its GVC participation. The continued implementation of climate-smart policies and infrastructure and the reduction of sustainability risks related to GVCs could potentially attract greater FDI. Annex 3 examines how the Philippines could build on existing Ecozones and Negosio Centers to increase its attractiveness to lead firms that are conscious of their social

Table 8: Doing Business indicators for the Philippines, 2017

Topics	DB 2017 Rank	DB 2016 Rank	Change in Rank	DB 2017 DTF (% points)	DB 2016 DTF (% points)	Change in DTF (% points)
Overall	99	99	0	60.40	59.53	0.87
Starting a Business	171	164	7	68.86	68.56	0.30
Dealing with Construction Permits	85	103	18	69.45	67.71	1.74
Getting Electricity	22	30	8	86.90	83.76	3.14
Registering Property	112	109	3	57.54	57.53	0.01
Getting Credit	118	109	9	40.00	40.00	-
Protecting Minority Investors	137	136	1	41.67	41.67	-
Paying Taxes	115	120	5	65.74	62.19	3.55
Trading Cross Borders	95	93	2	69.39	69.39	-
Enforcing Contracts	136	136	-	49.24	49.24	-
Resolving Insolvency	66	64	2	55.24	55.35	0.01

Doing Business reform making it easier to do business = change making it more difficult to do business
Source: Doing Business, World Bank

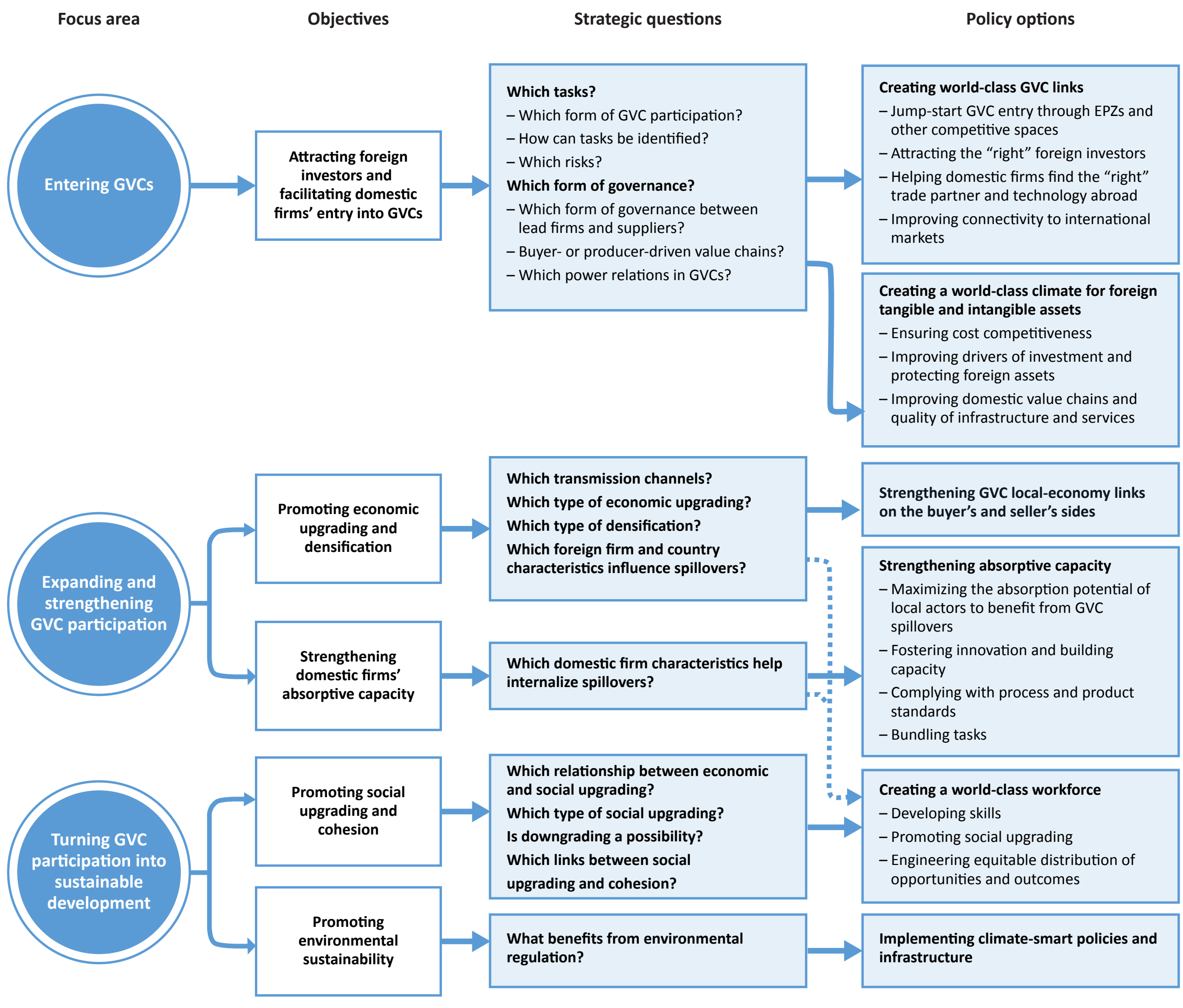
and environmental impact. Dedicated supplier development programs also proved effective in countries like Malaysia (oil industry), Ireland (electronics), Mexico (aeronautics) or the Czech Republic to make the investment location more attractive and create more jobs associated with GVC integration.

79. The World Bank has developed a GVC strategic policy framework that identifies reforms aimed at expanding and strengthening the Philippines' GVC participation, maximizing the benefits of participation, and enhancing the country's attractiveness to lead firms. The framework builds on the analysis presented above, as well as select performance indicators related to the regulatory and institutional framework for GVCs (Figure 50). It attempts to provide a holistic and coherent basis for reforms that reflects the following priorities:

- Improving the functioning of market institutions related to asset protection, domestic and foreign competition, the ease of Doing Business, access to finance, and political stability;
- Strengthening international and domestic connectivity, reducing import and export times, enhancing the timeliness of delivery, building infrastructure and logistics capacity, improving product tracking, and increasing internet coverage;
- Promoting economic upgrading, including strengthening backward and forward GVC linkages, and maximizing the potential of local firms to internalize GVC spillovers;
- Encouraging GVC participation in sustainable development by adopting policies targeting the social upgrading of local workers.

80. The Philippine government could improve the efficiency of its export-promotion policies and enhance the economy's international competitiveness through more targeted interventions. This includes efforts to support innovation, align exports with international standards, promote the growth of MSMEs, and better exploit domestic assets to develop the services content of manufacturing, improve logistics, and create cross-sectoral linkages. The right mix of policies would enable the Philippines to attract high-quality investment that will drive job creation and accelerate the country's social and economic development.

Figure 50: GVC strategic policy framework

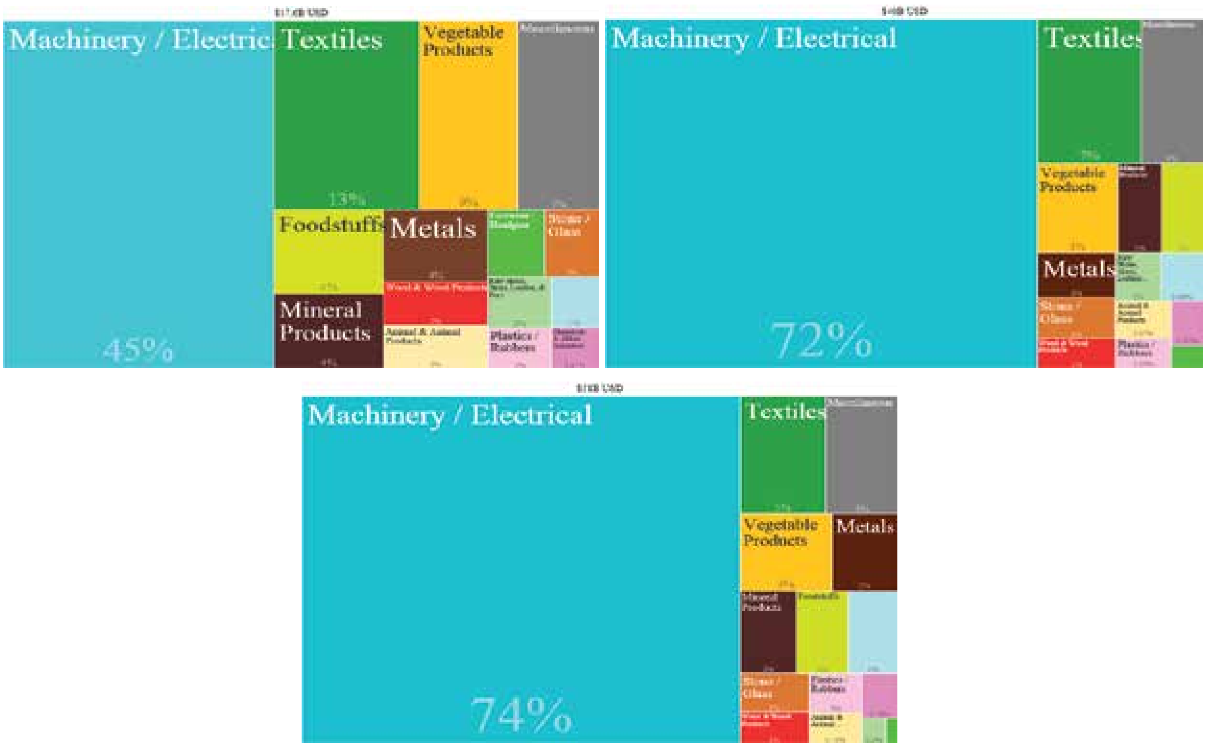


Source: Taglioni and Winkler, 2016

ANNEX 1: PHILIPPINE EXPORT BASKET

Over the past 20 years, the Philippines' basket of exports has undergone two phases of evolution in volumes/values. During the first period from 1995 to 2005, the Philippines shifted its production and exports from textiles, agri-food, and other natural resources to electronics and electrical products (Figure 51). Electronics and electrical products represented up to 74 percent of exports in 2005, compared to 45 percent in 1995. During the second period from 2005 to 2015, electronics exports declined, though they still represented 60 percent of total exports in 2014, and resource-based exports increased, with metals and minerals representing 12 percent of exports in 2014. (Figure 52)

Figure 51: The evolution of the Philippine export basket, 1995, 2000, and 2005



Source: Atlas of Economic Complexity, Harvard University

Figure 52: Evolution of Philippine export basket, 2010 and 2014

Source: Atlas of Economic Complexity, Harvard University

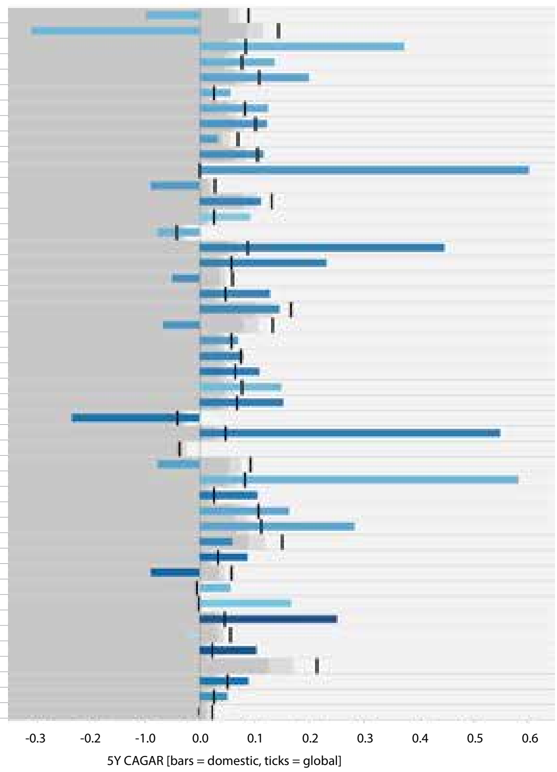
ANNEX 2: IDENTIFYING PRIME AREAS FOR DIVERSIFICATION

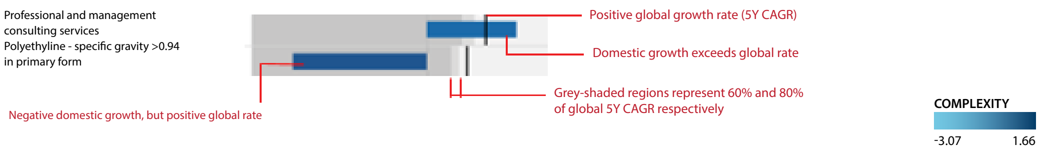
The Philippine government could better target its interventions and support innovations in industries with a higher chance of success. Figure 53 identifies export diversification opportunities in the Philippines based on the proximity of existing non-competitive and competitive exports and market trends. It shows the products most similar to the ones the Philippines currently successfully exports, which depend on similar technologies and inputs, and which enjoy growing market demand. The products are ranked by their distance from existing competitive exports. The color of the bars reflects the size of the complexity gap, with darker blue bars indicating greater complexity. The length of the bars shows export performance, and the black lines denote global growth rates for each type of product. Products for which the blue bar does not cross the black line represent opportunities for diversification.

Figure 53: Diversification opportunities within Philippines' reach

Non-competitive exports above $45 million
(sorted by distance to competitive export basket, shaded by complexity)

DESCRIPTION	DISTANCE	COMPLEXITY	EXPORT VOLUME 2014
Articles of iron or steel, nes	13.84	-1.72	$49,311,968
Transmit-receive apparatus for radio, TV, etc.	14.20	-1.72	$57,776,190
Non-alcoholic beverages nes, except fruit, veg juices	14.51	-1.69	$53,514,301
Sauces nes, mixed condiments, mixed seasoning	14.78	-1.57	$48,667,236
Electric conductors, 80-1,000 volts, no connectors	14.78	-1.30	$53,505,214
T-shirts, singlets and other vests, of cotton, knit	14.99	-1.56	$51,905,441
sacks & bags (including cones) of polymers of ethyl..	15.14	-1.42	$57,520,428
Electrical switches for < 1,000 volts, nes	15.19	-1.02	$58,561,511
Toys nes	15.47	-1.15	$51,945,376
Parts of taps, cocks, valves or similar appliances	16.31	-0.86	$45,349,073
Waste or scrap containing gold as sole precious metal	16.62	-1.04	$53,630,692
Womens, girls trouser & shorts, of cotton, not knit	16.69	-1.15	$59,782,653
Parts of seats	16.78	-0.64	$49,694,265
Transport, other, credit	16.85	-2.37	$256,648,975
Cargo vessels other than tanker or refrigerated	16.88	-1.59	$51,473,780
Gearing, ball screws, speed changers, torque conver..	17.08	-0.51	$49,245,529
Needles, catheters, cannulac etc. (medical)	17.35	-0.53	$48,317,206
Brassleres and parts thereof	17.57	-0.85	$46,598,830
Aerials and aerial reflectors	17.63	-0.65	$51,317,231
Womens, girls dresses, synthetic fibres, not knit	17.68	-0.77	$54,764,659
Nitrogen-phosphorus-potassium fertilisers, pack >10..	17.89	-0.97	$47,274,855
Womens, girls trousers, shorts, synth fibres, not knit	18.00	-1.08	$50,549,736
Personal deodorants and antiperspirants	19.21	-0.61	$57,719,414
Locks of base metal, nes	19.87	-0.27	$54,855,408
Transport, freight	20.12	-1.88	$585,997,977
Bicycles, other cycles, not motorized	20.26	-0.41	$54,311,229
Indicator panels incorporating electronic displays	20.36	0.03	$58,881,303
Games, coin or disc operated	20.96	-0.36	$51,493,991
Tankers	22.96	-0.73	$60,257,766
Construction	22.98	-1.30	$60,622,408
Other personal, cultural, and recreational services	24.10	-1.73	$97,797,740
Bathe, shower-bathe and wash basins, or plastics	24.79	-0.15	$52,256,408
Audiovisual and related services	24.81	-1.36	$53,734,451
Crabs, not frozen	24.87	-1.33	$54,775,193
Maintenance and repair services n.i.e.	24.89	-0.67	$92,361,813
Electric capacitors, fixed, nes	25.29	0.19	$52,148,315
Parts and accessories of optical appliances nes	25.51	0.45	$51,814,336
Basketwork, wickerwork products of vegetable mater..	25.78	-1.81	$45,653,475
Reinsurance	26.10	-2.21	$89,000,157
Other Business Services, Research and development..	26.94	1.12	$59,288,982
Explicitly charged and other financial services	28.97	-3.07	$62,846,199
Thyristors/diacs/triacs, except photosensitive device	29.63	0.98	$49,224,912
Casings, circular, iron/steel, oil/gas drilling <406mm	30.01	0.27	$51,237,405
Financial intermediation services indirectly measure..	30.80	-0.04	$127,017,777
Leather, composition sports gloves, mittens and mitts	33.40	-0.86	$46,127,501
Lawn-tennis balls	52.02	1.66	$47,140,810

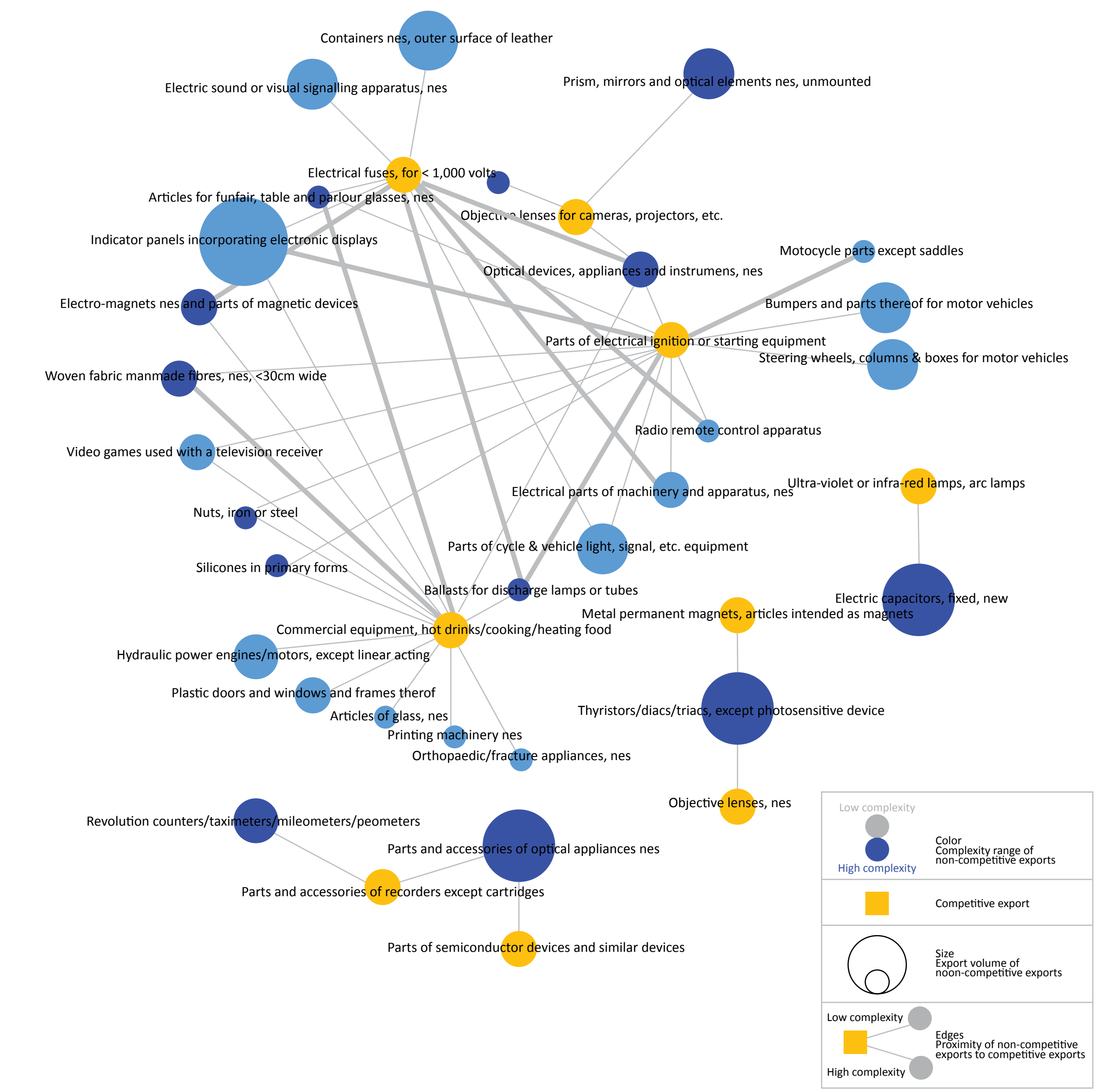




Source: IFC based on IMF and CEPII

Similar analyses could be done at the sectoral level to identify unexploited opportunities in the product space. Figure 54 examines the electronics and machinery sector. The relative thickness of the lines measures the proximity of non-competitive and competitive exports (the thicker the line, the closer the products are in the product space), while the color measures the complexity range (darker colors reflect greater complexity). Prime areas for diversification, with high proximity and low complexity levels, include "electro-magnets and parts of magnetic devices" and "electrical starts of machinery and apparatus."

Figure 54: Exploiting the Philippines' comparative advantage in complex products, electronics and machinery



Source: IFC based on IMF and CEPII

ANNEX 3: APPLYING THE CONCEPT OF ECO²ZONES TO THE PHILIPPINES

Investment incentives should focus on qualitative rather than quantitative dimensions. From the perspective of countries willing to attract FDI and actively participate in global production and trade (GVCs), it is about ending a race to the bottom for FDI attraction, becoming more selective, and rewarding investors with the largest development footprint, i.e. investors who contribute most to the socioeconomic upgrading of the country through intra-value chain transfers of all kinds, ranging from access to finance and technology to knowhow and skills. It is also an acknowledgment of the limits of the old SEZ model that based attractiveness on production costs (low wages and taxes) and could have little or limited impact on the domestic economy, sometimes creating a dual economy to the detriment of domestic forward and backward linkages. Recent surveys and analyses show that the main reason driving a lead firm's decision to include (or not) a specific country in its GVC is its local firms' (mainly SMEs) ability to meet its production standards.[77]

Attracting the right investors, creating the right incentives, and maximizing the development impact of GVC participation begins with increased transparency about production methods. Sustainability reporting can reduce firm liability along GVCs, allowing products to be more easily traced and risks to be more effectively mitigated along the value chain. This would be a first but important step towards more inclusive and sustainable GVCs. SSEZs or Eco²zones would serve as safe production areas for lead firms. Local firms in the zones would be required to fill sustainability reports with support from the government, donors, NGOs, and lead firms. The zones would help attract investors that are conscious of development issues and willing to reduce sustainability risks along GVCs. However, the zones should be conceived in such a way so as not to affect the competitiveness of SMEs. The Philippine model addresses this by assigning Eco²zone status to firms themselves rather than to geographic areas.

The development of Sustainable Special Economic Zones (SSEZs), or Eco²zones, was facilitated by a shift in the trade and investment paradigm. The globalization of value chains has increased the risk of non-compliance with corporate social responsibility principles and environmental, labor, health, and safety standards. Companies headquartered in the US and the EU are now liable for risks all along their value chains, and they must respond to allegations that their subsidiaries are engaging in prohibited practices, such as the use of child labor. As a result, firms are increasingly seeking increased transparency along value chains to reduce their liability and ensure the quality of end products.

Eco²zones represent a large share of exports in the Philippines. The Eco²zones could help to promote more equitable and sustainable GVCs. SME training, the development of tailored reporting instruments, and the diffusion of information and materials could build on existing Negosio centers. Given the innovative character of this approach, one could also invest in the promotion of a national "risk-free GVC" brand and concepts of SSEZs or Eco²zones. This would be an integral part of the country's strategy to attract the right investors and create more and better jobs through GVC integration.

The Swiss State Secretariat for Economic Affairs' Corporate Sustainability and Reporting for Competitive Business program, which was launched in partnership with the Global Reporting Initiative in Colombia, Ghana, Indonesia, Peru, South Africa, and Vietnam, aims to improve sustainability reporting and enhance the competitiveness of sustainable businesses, with a focus on SMEs. The program seems to have been largely successful based on preliminary evaluations, and a second phase was recently launched to build on the initiative. Among other activities, simplified reporting questionnaires and methodologies are being developed that target the specific needs

[77] OECD-WTO, Aid for Trade at a Glance, 2013.

and capacities of SMEs. The program is currently being analyzed to assess whether SMEs that have complied with sustainability requirements have become more competitive and better integrated in GVCs, as well as the extent to which sustainability reporting has helped to link local SMEs with lead firms and production networks.

Companies and investors around the world are increasingly using sustainability reporting to evaluate business performance. A number of countries have established laws requiring that companies report on non-financial activities to better assess the environmental and social impact of their business operations. Greater transparency should promote more sustainable business practices and help governments better target regulatory reforms.

Sustainability reporting is just a first step towards more inclusive and sustainable GVCs. Increased transparency could help identify bottlenecks and improve the sustainability and performance of local firms. Programs to facilitate the upgrading process could be put in place with the support of the government, the international community, the private sector, and civil society. The World Bank and the IFC, in particular, are implementing a number of programs aimed at building the capacity of SMEs. Based on reporting, one could identify the best performers, the lagers, the gaps (e.g. absence of answers on a dimension like gender or health), etc. and put in place the adequate support.

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APPENDIX

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

	2015	2016	2017	2018	2019
	Actual		Projected		
Growth and inflation	*(in percent of GDP, unless otherwise indicated)*				
Gross domestic product (percent change)	5.9	6.8	6.9	6.9	6.8
Inflation (period average)	1.4	1.8	3.3	3.0	2.8
Savings and investment					
Gross national savings	24.3	24.0	26.0	27.7	31.8
Gross domestic investment	21.4	23.8	25.8	27.2	31.1
Public sector					
National government balance (GFS basis)[1]/	-1.0	-2.5	-3.1	-3.4	-3.6
National government balance (gov't definition)	-0.9	-2.4	-3.0	-3.3	-3.5
Total revenue (government definition)	15.8	15.2	15.0	15.2	15.7
Tax revenue	13.6	13.7	13.8	14.4	14.8
Total spending (government definition)	16.8	17.6	18.0	18.5	19.1
National government debt	44.8	42.1	40.4	39.2	38.5
Balance of payments					
Merchandise exports (percent change)	-13.1	3.8	6.5	8.5	10.5
Merchandise imports (percent change)	-3.2	16.5	17.3	18.0	18.5
Remittances (percent change of USD remittance)	4.6	4.9	5.1	5.4	5.6
Current account balance	2.9	0.2	0.2	0.5	0.7
Foreign direct investment (billions of dollars)	5.7	7.9	8.1	8.7	9.7
Portfolio Investment (billions of dollars)	-0.6	0.4	0.5	1.0	1.5
International reserves					
Gross official reserves[2]/ (billions of dollars)	80.7	81.1	82.4	83.8	85.3
Gross official reserves (months of imports)[3]/	10.1	9.2	9.3	9.4	9.5
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) (2015-2017)

	2015	2016	2017
	Actual	Estimate	Budget
	(in percent of GDP, unless otherwise indicated)		
Revenue and grant	15.8	15.2	15.6
Tax revenue	13.6	13.7	14.5
Net income and profits	6.4	6.3	6.9
Excise tax	1.2	1.2	1.2
Sales taxes and licenses	2.8	2.9	3.0
Others	0.5	0.5	0.5
Collection from customs	2.8	2.7	2.9
Nontax revenue[1]/	2.2	1.5	1.0
Grant	0.0	0.0	0.0
Total expenditure	16.8	17.6	18.6
Current expenditures	13.4	13.2	13.9
Personnel services	5.0	4.8	5.3
MOOE	3.0	3.3	3.1
Allotment to LGUs[2]/	2.3	2.3	2.7
Subsidies	0.6	0.5	0.5
Tax expenditures	0.1	0.1	0.1
Interest payment	2.3	2.1	2.1
Capital outlays	3.3	4.4	4.6
Net lending	0.1	0.1	0.1
Balance (GFS definition)	-1.0	-2.5	-3.1
Balance (GOP definition)	-0.9	-2.4	-3.0
Primary balance (GFS)	1.4	-0.3	-0.9
Memorandum items			
Privatization receipts (PHP billions)	62.8	2.0	2.0
Nominal GDP (PHP trillion)	13.3	14.4	15.9

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]/ For 2015, revenue and components are based on World Bank staff estimates due to unavailability of final data

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