

# Philippine Economic *Outlook*

MAY 2006

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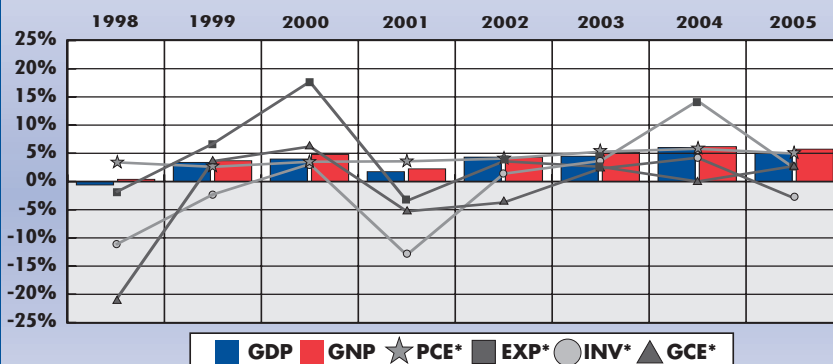
## Summary and Introduction



The Philippines faced a challenging economic environment domestically and externally during 2005: high and volatile world oil prices; unfavorable weather conditions; slower growth in export markets; and upward pressure on foreign interest rates. Political challenges — including allegations of election fraud, attempts to unseat or impeach President Arroyo, and the resignation of key Cabinet officials — added to the uncertainty. Under those circumstances, the Philippines nevertheless ended 2005 with a respectable 5.1% GDP growth rate; a heftier-than-expected balance of payments surplus; stronger portfolio capital flows; record-high overseas worker remittances, international reserves, and tourist arrivals; and narrower risk premiums for foreign-denominated bonds. The peso and stock markets also closed 2005 among the region's best performers. In the banking system, the average ratio of non-performing assets to total resources — although still above pre-Asian crisis levels — has reverted to single-digits, helped by the 2002 Special Purpose Vehicle law that provided time-bound fiscal and regulatory incentives to encourage the disposition of non-performing assets through private asset management companies.

Determined efforts to avert a fiscal crisis by curbing the public sector deficit, improving the financial condition of the cash-strapped and debt-saddled National Power Corporation, and pursuing congressional amendments to the Value Added Tax (VAT) law — the Arroyo Administration's centerpiece revenue legislation — played a crucial role in lifting confidence despite the polit-

REAL YEAR-TO-YEAR GDP AND GNP GROWTH  
By Expenditure Share



\*PCE (Personal Consumption Exp.); GCE (Gov't Consumption Exp.);  
INV (Fixed Capital Investments); EXP (Exports of goods and non-factor services)

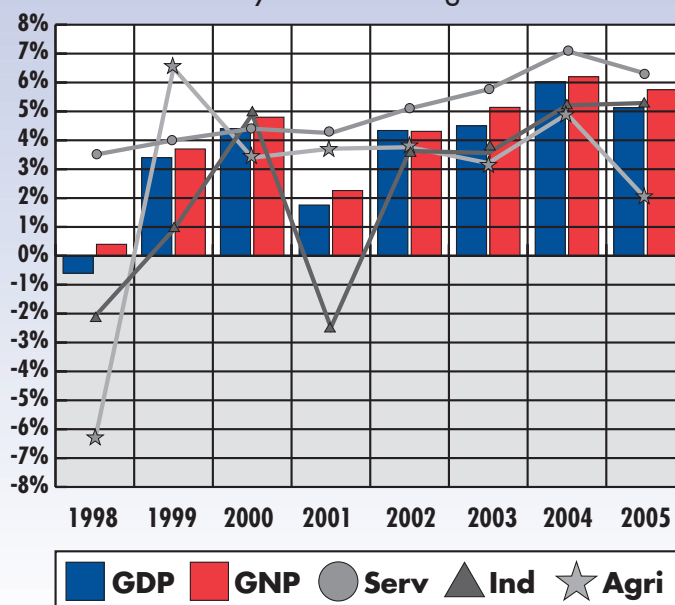
ical turbulence. Deficit reduction also has begun to slow the rapid pace of debt accumulation. After hurdling legal challenges, the Government began implementing the amended VAT law in November 2005. Starting 2006, the Government hopes to improve the quality of fiscal consolidation by using part of the additional VAT revenues to ease the severe spending compression of previous years.

The year 2006 opened on an upbeat note following generally positive economic news and improved fiscal prospects. The cautious optimism appears to have survived the resurgence of political challenges, including a reported coup plot that prompted President Arroyo to declare a State of National Emergency from February 24 to March 3, 2006. The peso, stock market, and foreign-debt risk premiums recovered quickly after initial knee-jerk losses. This suggests stronger confidence in economic fundamentals and progress made over the past year and also underscores the importance of sustaining the reform momentum as a buffer for sporadic political tensions.

Government economic managers now face the challenge of sustaining the current optimism and translating it into higher growth, more jobs, and less poverty by efficiently implementing new tax measures and undertaking vigorous, parallel efforts to strengthen tax collection and administration. Although improving of late, the public sector debt level remains high at over 100% of GDP, rendering the Philippines vulnerable to domestic and external shocks. Difficulties in privatizing the assets of the National Power Corporation remain a concern because of its important role in achieving the long-term stability of public sector finances, competitive electricity rates, and stable power supply. Creating a more conducive business climate for domestic and foreign investors remains critical to achieving developmental goals, improving the inadequate state of Philippine infrastructure, and sustaining a higher rate of economic expansion.

Domestic savings and investment rates are among the lowest in the region and the Philippines has been struggling with low international competitiveness and corruption rankings in a global environment of increasingly fiercer competition for trade and capital. Sustained reforms are needed to further develop the capital market, which is dominated by Government securities. The Central Bank continues to push for important legislative amendments that will strengthen its powers to take prompt corrective action and protect its officials and examiners from legal action.

## REAL YEAR-TO-YEAR GDP & GNP GROWTH By Industrial Origin



## Economic Growth and Inflation

Full-year 2005 Philippine Gross Domestic Product (GDP) — which expanded by 6.0% in real terms (a fifteen-year high) during 2004 — slowed to 5.1% growth during 2005, just shy of the Government's 5.3% target. Real Gross National Product (GNP) slowed less markedly than GDP, from 6.2% (2004) to 5.7% (2005), cushioned by robust remittances from overseas Filipino workers (OFWs). Record-high world oil prices, drought-affected agricultural harvests, and weaker export growth and consumer spending tempered economic expansion. The economy's performance nevertheless exceeded private sector expectations, especially in the wake of attempts to unseat President Arroyo following allegations of election fraud and the related resignation of key members of the Arroyo Cabinet.

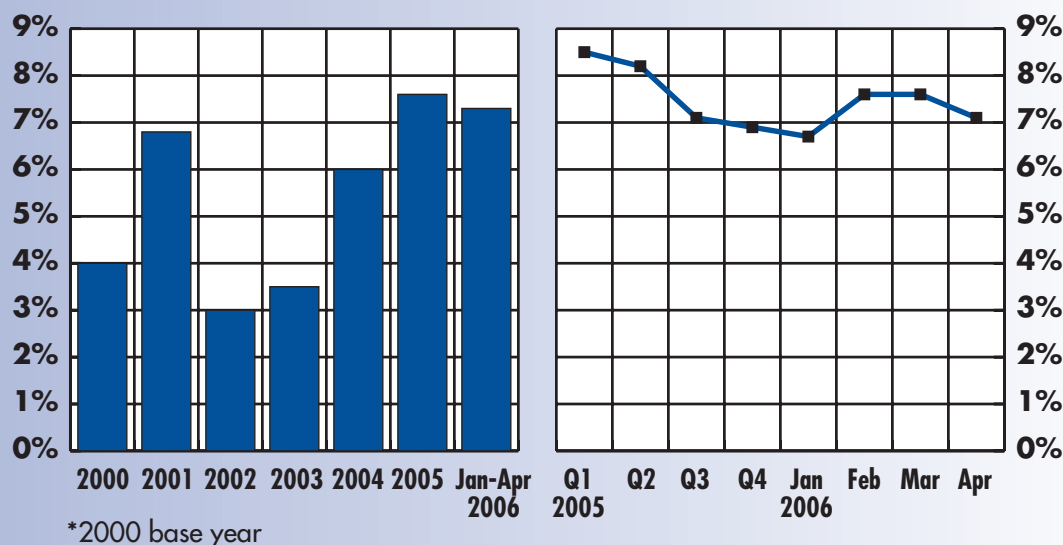
Personal consumption, the economy's major growth driver, slowed from 5.8% growth (2004) to 4.9% growth (2005) as consumers grappled with higher prices of goods and services. Remittances from OFWs, up by 13.2% year-on-year in real peso terms, helped cushion a sharper slowdown in consumer spending. Reflecting the global economy's more moderate expansion, Philippine exports of goods and non-factor services increased by a modest 2.3% in real peso terms, a marked slowdown from 2004's 14.1% expansion.

Gross capital investments declined by 4.3% in 2005 after increasing by 9.5% in 2004 as expectations of weaker domestic and external demand, higher costs of business operations,

and political noise resulted in lower investments in durable equipment and inventories. Spending on durable equipment, up by 5.8% in 2004, declined by 7.9% in 2005. Business enterprises limited inventory build-up to 60% of the 2004 level. Spending on construction slowed from 3.0% (2004) to 2.2% (2005). On a positive note, better-than-expected government revenues allowed a modest 2.6% expansion in pub-

The service sector, which contributes nearly half of Philippine GDP, decelerated from 7.1% growth in 2004 to 6.3% growth in 2005. Only the finance sub-sector put in a higher rate of expansion (15.4%) relative to 2004 (8.4%), driven mainly by banks' aggressive efforts to pursue non-interest and fee-based revenue sources (including trading gains from government securities). The trade sub-sector, which contributes a third of

### CPI YEAR-TO-YEAR CHANGE\*



lic sector construction outlays, after zero growth during 2004. However, private sector construction spending expanded at a weaker 2.0% pace relative to 2004's 4.8% increase, pulling down the overall growth in construction expenditures.

On the supply side, the drought-affected agricultural sector grew by 2.0%, lower than its historical growth trend of between 3.0% to 4.0% and 2004's above-trend performance of 4.9%. Had agricultural sector output increased at the usual pace, overall GDP growth in 2005 could have been higher by 0.2 to 0.4 percentage points. Industrial sector production (up by 5.3%) just about matched its 2004 performance (5.2%) as higher rates of expansion for mining/quarrying (9.3%) and manufacturing (5.6%) offset slower growth rates posted by the construction and electricity, gas, and water sub-sectors. From 2.6% in 2004, mining and quarrying sub-sector output increased by 9.3%, spurred by high mineral prices and positive sentiment from a Supreme Court decision upholding the legality of up to full foreign participation in large-scale mining projects. Although the manufacturing sub-sector's overall output expanded at a faster pace than 2004's 5.1% growth, performance within this sub-sector was mixed. Of 20 manufacturing groupings, 11 logged negative growth and five posted lower positive growth rates.

overall service sector output, grew by 5.8%, a percentage point weaker than 2004's 6.8% increase, consistent with the slowdown in consumer spending. The transport and communications sub-sector also logged slower growth (7.1%) vis-à-vis 2004's double-digit expansion (11.2%). Communications, up nearly 15% in real terms, continued to grow robustly on aggressive marketing efforts and continued demand for mobile communications, as well as from the rapid expansion of call centers and business process outsourcing (BPO) services. However, transport services shifted from 6.9% growth in 2004 to a 1.0% year-on-year decline in 2005 following fuel price hikes and fare adjustments.

Private sector services also slowed from 6.7% growth in 2004 to 4.5% growth in 2005. Real estate services expanded by 5.1%, approximating its 2004 growth performance, helped in part by the strong demand for office spaces by the booming call center/BPO industry.

The Government is targeting GDP growth of 5.5% to 6.2% for 2006 based on the recovery of the agricultural sector, stronger exports, and a larger budget for infrastructure spending following the implementation of the Philippines' amended VAT law since November 2005. Government economic

planners also expect the service sector to benefit from booming BPO and IT-related activities, all-time high tourist arrivals, and new investment opportunities for telecommunications and mining. Downside risks to achieving the targeted economic expansion include sustained high oil prices, added inflationary pressures from implementation of the amended value added tax law, an erosion in export competitiveness from a stronger local currency, detrimental weather conditions on agriculture from the La Niña phenomenon, and sporadic political instability that could affect new investment flows. Delayed passage of the 2006 budget (which was still pending congressional approval as of end-April 2006) also will affect the Government's envisioned pump priming efforts, as will the Government's ability to collect the envisioned taxes from the amended VAT law. The current consensus is for 2006 GDP growth of around 5%.

Consumer price inflation accelerated from 6.0% in 2004 to 7.6% in 2005, a seven-year high. Drought-affected food harvests, successive fuel price hikes, electricity rate adjustments (resulting from pricing reforms to reflect the true cost of power), and subsequent wage rate and transport fare increases pushed up inflation. The fuel, light and water index and the services index (which includes transport-related services) jumped by 18.1% and 11.8%, respectively, and together accounted for nearly 70% of the 1.6 percentage point acceleration in the annual inflation figure between 2004 and 2005. Improved agricultural harvests (barring severe torrential rains from La Niña), a stronger local currency, and dampened purchasing power may help temper price increases in 2006 but the implementation of the amended VAT law and follow-through pressures from high global energy prices (including potential minimum wage, transport fare, and electricity rate increases) will prevent average inflation from slowing significantly.

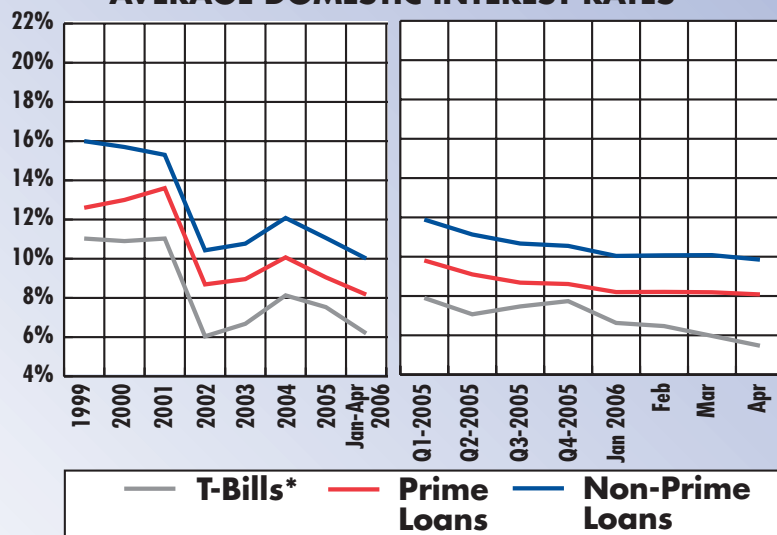
cantly. Consumer price inflation averaged 7.2% during the first four months of 2006. On balance, consumer price inflation for the full year may average from 7.3% to 7.8%.

## Labor and Employment

The Philippine labor market continued to improve moderately as employment posted an average growth rate of 2.2% in 2005. The total employment level reached 32.4 million in January 2006, a growth of 2.4% compared to 31.6 million in January 2005. The quarterly surveys conducted by the National Statistics Office showed an average unemployment rate of 11.4% for 2005, slightly lower from 11.8% in 2004. The unemployment rate decreased by 0.6 percentage points, from 11.3% in January 2005 to 10.7% in January 2006. (Note: The unemployment rate used is based on the old definition of unemployment, which took into account only those without work and seeking work. In April 2005, the National Statistical Coordination Board adopted a resolution redefining unemployment based on the International Labor Organization concept, taking into account those without work, currently available for work, and seeking work. Using the new concept, the unemployment rate for January 2006 is 8.1%.)


The main source of employment gain in 2005 was the service sector, which grew by 2.8% over the year to nearly 15.7 million workers and accounted for 48.5% of the total employed. The agriculture, fishery and forestry sectors followed with an average growth of 2.2%, while the industry sector recorded 0.5% growth in 2005. Wage and salary employment declined by 0.9% in 2005 after posting a 7.3% growth rate in 2004. The number of unpaid family workers increased dramatically to 10.4% over the year (there was a recorded decline of 6.3%

**AVERAGE DOMESTIC INTEREST RATES**



\* Weighted average for all maturities.





and 23% in the past two years). Full-time employment (those who worked for 40 hours or more), increased by 4.2% over the level recorded in 2004. Part-time employment recorded a slight increase of 0.3% from 2004.

The total labor force in January 2006 was estimated at 35.2 million, with a labor force participation rate of 63.8%. Labor force participation for the same period last year was 63.2%. A rise in underemployment accompanied the increase in the volume of employment. Average underemployment in 2005 amounted to 6.8 million compared to 5.6 million in the previous year, posting an increase of 21.8%. Most employed persons wanting more hours of work came from the agriculture, forestry and fishing, and the services sectors, particularly those in wholesale and retail trade.

The National Conciliation and Mediation Board registered 26 actual strikes or lockouts declared in 2005, only one higher than those declared in 2004. This year's strikes involved fewer workers (8,496) than in 2004 (11,197). The number of notices of strikes filed declined by 16.7%, from 558 in 2004 to 465 in 2005.

The Department of Labor and Employment (DOLE) noted that the business climate remains vibrant and favorable in the Philippines as the country continues to enjoy a low strike rate and a stable industrial peace. DOLE and the Philippine Economic Zone Authority (PEZA) entered into an agreement in March 2006 to facilitate the settlement of labor disputes and ensure employers' compliance with labor laws in over a thousand firms situated in the country's economic zones. Labor and Employment Secretary Patricia Sto. Tomas said the agreement was intended to ensure an environment conducive to investments and the preservation and generation of jobs for workers.

## Financial Markets


The Philippine Monetary Board — the highest policy-making body of the Bangko Sentral ng Pilipinas (BSP, the Central Bank) — raised policy rates three times during 2005 (in April, September, and October) by a total of 75 basis points. The BSP's overnight borrowing rate and lending rate stood at 7.5% and 9.75%, respectively, as of end-April 2006. In July 2005, the Monetary Board also increased reserve requirements on peso deposit liabilities and trust funds by a total of two percentage points to 21% — raising “regular” reserves (which earn little to no interest) to 10% and “liquidity” reserves (which earn market-based rates) to 11%. July 2005's relatively more aggressive monetary-tightening move mainly reflected efforts to stem inflationary threats from foreign exchange speculation as political jitters

mounted with the resignation on July 8 of key members of the Arroyo Cabinet. The September and October policy rate increases hoped to temper higher-than-expected domestic liquidity growth resulting mainly from strong foreign exchange flows. Overall, BSP policy rate adjustments have been modest thus far relative to the 16 increases (totaling 400 basis points) in the target federal funds rate by the United States Federal Open Market Committee between June 2004 and May 2006. Citing soft spots on the demand side (among them slower consumer spending growth, remaining spare capacity in the manufacturing sector, and modest credit expansion), the Monetary Board has argued that supply-side, cost-push factors have mainly spurred inflation to defend its moderate monetary policy stance. Monetary officials also noted that domestic liquidity growth has slowed in recent months and the peso has strengthened despite narrowing interest rate differentials.

Bid rates for Government securities softened during 2005 despite higher inflation, reflecting improved sentiment over fiscal prospects, slower economic growth, and strong competition for relatively risk-free investment alternatives as credit expansion remained moderate. The loan-benchmark 91-day Treasury bills averaged 6.36%, down by 98 basis points from 2004. Rates softened further during the first four months of 2006 and averaged 4.96%. Real interest rates (i.e., nominal rates less inflation) for the 91-day bills have been negative since November 2004 and averaged -1.24% during 2005 and -2.29% during January to April 2006.

Prime loan rates offered by the banking sector averaged 9.05% during 2005, down 102 basis points year-on-year. Average loan rates for non-prime customers tapered by 102 basis points to 11.06%. Nominal lending rates softened further during the first four months of 2006, with nominal prime loan rates averaging 8.17% and non-prime rates 10.01%. Average real interest rates tightened from 4.07% (2004) to 1.45% (2005) for prime borrowers and from 6.08% to 3.46% for non-prime borrowers, as lower nominal interest rates combined with higher inflation. Average January to April 2006 real interest rates tapered further to 0.88% and 2.72% for prime and non-prime clients, respectively.

Interest rate differentials have narrowed dramatically, reflecting a combination of higher foreign interest rates and softer domestic rates. The gap (net of tax) between the Philippine Government's 90-day Treasury bill and the United States' 90-day paper tightened from nearly 400 basis points to less than 15 basis points between December 2004 and December 2005, respectively. By January 2006, the yield differential had reversed to favor the U.S. debt paper, with that differential averaging about 65 basis points during the first four months of the year. Looking forward,



narrowing differentials vis-à-vis international interest rates (which pose risks of investments shifting from peso to foreign assets), tightening real yields, and prospects of further U.S. policy rate adjustments suggest that domestic interest rates, especially for the shorter-end of the yield curve, may be bottoming out. Barring severe political challenges and inflationary pressures, however, improved public sector finances and moderate demand for credit are expected to temper upward interest-rate pressures.

Outstanding loans of the commercial banking system (net of inter-bank credits) increased by a lethargic 0.3% year-on-year in 2005, slowing from the 3.3% year-on-year expansion posted at the end of 2004. As of February 2006, year-on-year loan growth had accelerated to 2.4% but remained far from the robust two-digit rates before the Asian financial crisis. The modest credit expansion reflected a combination of weak loan demand, banks' aversion to credit risks, and the preference for government securities. Although improving, the overhang of non-performing assets (NPAs, the sum of non-performing loans and foreclosed assets) and the accompanying need to beef up loan loss reserves continued to inhibit more aggressive credit expansion.

The Special Purpose Vehicle (SPV) Act of 2002, which provided time-bound fiscal and regulatory incentives to encourage the resolution of NPAs through private sector asset management companies, has helped bring down NPA levels. Banks had until April 12, 2005 to conclude notarized agreements to sell NPAs outstanding as of June 2002 — 61% of which consisted of non-performing loans (NPLs) and the balance foreclosed properties — to qualify for incentives under the law. Total NPAs disposed by the Philippine banking system under the SPV Act totaled P97 billion, equivalent to about one-fifth of the P520 billion in banking system NPAs as of end-June 2002. Over 90% (P88 billion) of NPAs unloaded under the SPV Act consisted of non-performing loans as pricing disparities have thus far limited done deals for foreclosed assets.

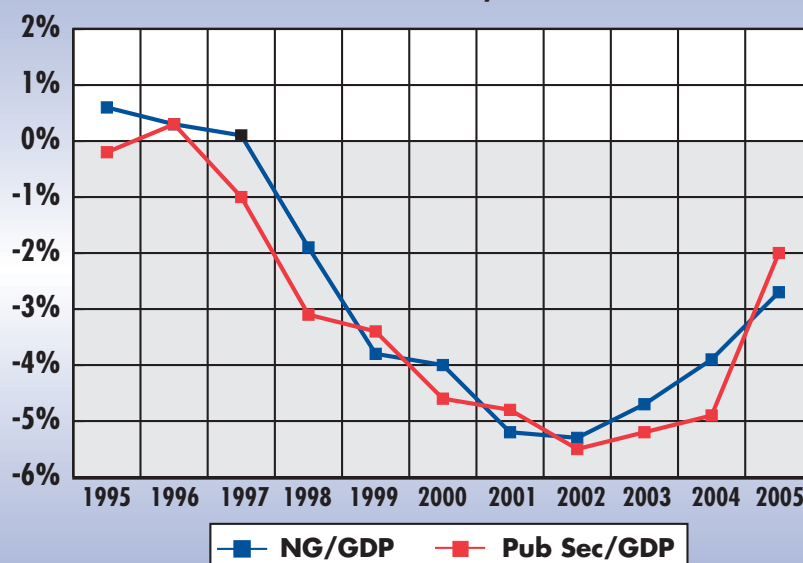
Helped by the SPV law, commercial banking system NPL and NPA ratios — which peaked at 18.8% (October 2001) and 15.1% (May 2002), respectively — have reverted to single-digits since June 2005. As of February 2006, commercial banking system's NPAs had declined by 15.6% (P63.8 billion) year-on-year to P346.1 billion and the NPA ratio from 10.4% to 8.7% over the same period. Non-performing loans (NPLs), estimated at P158.7 billion as of February 2006, contracted by nearly 30% (P55.6 billion) year-on-year, and the NPL ratio fell from 11.8% as of February 2005 to 8.3% as of February 2006. On April 24, 2006 President Arroyo signed into law congressional amendments to the SPV Act

that gives banks another two years of incentives to sell outstanding mid-2002 NPAs remaining in their portfolios to asset management companies. The BSP hopes the extension will bring down non-performing assets by at least another P100 billion to an NPA ratio of about 6.5%, closer to the pre-Asian crisis level of 4%.

Computed according to the Basel Capital Accord formula, the BSP's latest estimate placed the Philippine banking system's average capital-adequacy ratio (i.e., the ratio of capital to risk assets) at 17.6% on a consolidated basis as of September 2005, better than the BSP's statutory floor and the 8% internationally accepted standard. Commercial banks' capital-adequacy ratio averaged 17.7%; thrift banks 17.6%; and rural/cooperative banks 16.0%. The commercial banking system's provisions for probable losses increased from 37.5% of NPAs as of end-February 2005 to 42.5% as of end-February 2006. However, significant troubles at any major commercial bank could lead to a swift reversal of depositor sentiment, and the resulting strain on the system to service withdrawals could be substantial. More than 380 banking institutions (including 11 commercial banks) are saddled with NPA ratios exceeding the industry average. Several banks (nine commercial banks, 30 thrift banks, and 156 rural and cooperative banks) remain short of BSP-prescribed minimum capitalization levels. More than 160 banking institutions (including three commercial banks) have yet to comply with the BSP's 10% capital adequacy ratio.

The BSP continues to encourage consolidation in the banking system through time-bound incentives and a temporary moratorium (since September 1999) on the issuance of new bank licenses. During 2005, there were seven approved and/or completed consolidation/mergers involving three commercial banks, three thrift banks, and nine rural/cooperative banks. As of end-March 2006, the BSP had approved 63 acquisitions, mergers and/or consolidations thus far since the Asian crisis (involving 30 commercial banks, 25 thrift banks, 39 rural banks, 11 non-bank financial intermediaries, and two offshore banking units). Lower-capitalized thrift and rural banks, which constitute less than 10% of overall banking system assets, have been more severely affected by the shakeout since the Asian crisis. Nine banks (two thrift bank and seven rural bank) were closed during 2005 and another five banks were closed during the first three months of 2006 — for a total of 170 bank closures since mid-1997 (involving two commercial, 19 thrift, and 149 rural and cooperative banks). The inability of a number of banking institutions to meet minimum capitalization levels and capital adequacy ratios suggests there is room for further consolidation. As of March 2006, seven consolidation and/or merger proposals were pending BSP approval.

## PUBLIC SECTOR & NG SURPLUS/DEFICIT AS % OF GDP




The Central Bank (BSP) is working to fully adopt Basel 2 standards by 2007, which, inter alia, would expand coverage from credit and market risks to operational risks, as well as enhance the risk-weighting framework. The BSP also issued a new financial reporting package for banks and other supervised institutions in March 2006, aligning accounting and reportorial requirements with revised Philippine financial reporting and accounting standards patterned after those set by the International Accounting Standards Board. Nevertheless, the circumstances surrounding bank closures highlight remaining impediments to more effective bank supervision and timely intervention — including stringent bank secrecy laws, obstacles preventing bank regulators from examining banks at will, and inadequate legal protection for BSP officials and bank examiners. Although progress in the Philippine Congress has been slow thus far, the BSP continues to push for legislative amendments to its charter to strengthen its regulatory, supervisory, and prompt corrective action powers — including authority to compel weak banks to infuse additional capital, accept new investors, or merge with stronger financial institutions.

In October 2005, President Arroyo certified as urgent proposed anti-terrorism legislation to demonstrate her Administration's commitment to combating money laundering and terrorist financing, following the Philippines' removal in February 2005 from the Financial Action Task Force's (FATF) list of Non-Cooperating Countries and Territories (NCCT) and admission in June 2005 to the prestigious Egmont Group (the international network of financial intelligence units). As of late April 2006, the House of Representatives had approved anti-terrorism legislation and the bill was still pending on second reading in the Senate.

The Philippine Stock Price Index (Phisix) closed 2005 at 2,096, up 15% year-on-year from the end of 2004, Southeast Asia's second best performer. The Phisix closed at a 5-1/2 year high on March 7 (2,166) as a number of attractive Initial Public Offerings (IPOs) and a succession of good news — such as the passage of revenue measures (i.e., excise tax hikes for tobacco and liquor products and a lateral attrition program for revenue collectors), a Supreme Court decision upholding full foreign participation in mining ventures, and the Philippines' removal from the FATF money laundering watch list — outweighed credit rating downgrades. By July 6, however, the Phisix had sputtered to 1,813, its lowest closing level since late December 2004. Heightened political jitters — which saw key members of the Cabinet resign and the Opposition lodge an impeachment complaint against President Arroyo for alleged election fraud — combined with legal obstacles to the implementation of the amended value added tax (VAT) law and worries over soaring oil prices erased the Phisix's earlier gains. A calmer political climate following the failure of the impeachment effort, favorable corporate profit results, determined government efforts to curb the fiscal deficit, and the resolution of legal challenges to the amended VAT law pushed up the Phisix during the fourth quarter of 2005.

The Phisix has since risen further, cheered by a string of encouraging economic news such as a hefty 2005 balance of payments surplus; record-high OFW remittances, international reserves, and tourist arrivals; sustained fiscal deficit reduction efforts; credit rating outlook upgrades; softer domestic interest rates; and encouraging corporate earnings prospects. The market rebounded quickly from the one-week state of national emergency (February 24 to March 3, 2006)



that President Arroyo declared in response to an alleged coup plot. The Phisix has since surged to seven-year highs before shaving off some gains on profit-taking. It closed May 15 at 2,439, up 16.4% from the end of 2005.

## Fiscal Performance

For a third consecutive year in 2005, the National Government (NG) fiscal deficit declined. From 2002's record P210.7-billion (5.3% of GDP) level, the NG deficit had narrowed to P146.5 billion (2.7% of GDP) by 2005, P33.5 billion below the P180 billion (3.4% of GDP) ceiling programmed for the year. Revenues increased by 13.7% (P95.9 billion) year-on-year to P795.7 billion and surpassed the 2005 revenue goal by P12.5 billion (1.6%). On the other hand, expenditures (P942.2 billion) increased by a more modest 6.2% and ended 2005 below the programmed level by P21 billion (2.2%). About 65% of 2005's lower-than-expected disbursements reflected interest savings from lower-than-forecasted borrowing rates and a stronger local currency.

Although total revenues surpassed expectations, that performance was achieved because higher-than-anticipated non-tax inflows — primarily windfall returns on Treasury investments — more than offset a P21.8 billion (3.1%) shortfall in tax collections. Bureau of Customs (BOC) collections, up 15.7% year-on-year to P141.7 billion, missed the 2005 target by P9.5 billion. Bureau of Internal (BIR) collections, up 14.2% to P534.5 billion, missed the target by P12.4 billion. Tax effort (the ratio of tax revenues to GDP) improved from 12.4% of GDP in 2004 to 12.7% of GDP in 2005 but missed the Government's 13.2% target despite passage of a law that increased excise taxes on tobacco and alcohol products and unprogrammed inflows from the implementation of the amended VAT law since November 2005. (Note: Opting to be conservative pending congressional passage of the controversial measure, the Government did not assume any revenues from the amended VAT law in its 2005 revenue target.) The Government collected barely a fifth of the P15 billion in incremental revenues (equivalent to roughly 0.3% of GDP) that it expected from legislation that increased tobacco and alcohol excise taxes. According to Department of Finance officials, tobacco and liquor manufacturers frontloaded removals from their factories before the higher excise taxes went into effect. The Department of Finance (DOF) estimated the agency's November-December incremental collections from the amended VAT law at P4.4 billion, equivalent to about 0.1% of 2005 GDP.


While the Government has demonstrated resolve to curb its budget deficit since 2003, this was achieved mainly

through expenditure compression following the decline in the Philippines' tax effort from 1997's peak rate of 17%. Non-debt expenditures, equivalent to 16.2% of GDP in 1997, had declined to 14.9% of GDP by 2002 and, by 2005, had dropped even more precipitously to 11.9% of GDP. Spending compression has had serious repercussions on the state of Philippine infrastructure, which investors consider one of the most serious impediments to doing business in the country. National Government spending for capital investments slipped from 3.3% to 1.7% of GDP between 1997 and 2005. Combined outlays for education and health declined from 4.5% to 2.7% of GDP over the same period.

For 2006, the National Government plans to reduce its budget deficit further to P124.9 billion (2.1% of GDP) while beginning to reverse the spending compression of previous years. The 2006 target calls for increasing the tax-to-GDP ratio from 12.7% (2005) to 14.6% (2006), which depends heavily on collecting the P75 billion to P80 billion in revenues (equivalent to 1.4% of GDP) estimated from the implementation of the amended VAT law (signed in May 2005), the Arroyo Administration's centerpiece revenue-raising legislation. The Government began implementing the amended VAT law on November 1, 2005 — four months behind the original July 1 schedule, after hurdling legal challenges brought before the Supreme Court. The initial phase of reforms mainly involved the removal of VAT exemptions on various goods and services — including those previously enjoyed by the fuel and electricity sectors. President Arroyo subsequently raised the VAT rate from 10% to 12% in February 2006 after the Government met both of two alternative conditions stipulated under the law (i.e., a 2005 deficit-to-GDP ratio above 1.5% and VAT-to-GDP ratio above 2.8%). Incremental revenues from the amended VAT will go jointly to increases in capital/social spending and deficit reduction, with the share of the former successively increasing from 30% in 2006 to 50% by 2005. With implementing rules and regulations nearing finalization, the Government also hopes to begin benefiting this year from a lateral attrition law signed in January 2005 that institutes a reward and punishment system in revenue collection agencies.

Banking on higher revenues, the National Government's proposed 2006 budget envisions a 32% (P29.3 billion) year-on-year hike in infrastructure/capital spending. It hopes to increase the budget for social expenditures (including spending on health and education) by 15.6% (P39.6 billion). Overall, the Government's 2006 budget proposal would increase the ratio of non-debt expenditures to 12.6% of GDP (from 11.9% during 2005). However, the Government has been operating on a "re-enacted" 2005 budget (the equivalent of a continuing resolution) since January 2006 that, as a general principle, limits expenditures to 2005 levels. The House





of Representatives approved the 2006 budget before adjourning for an April 8 to May 13 congressional recess. The Senate hopes to complete action after the congressional break, after which a bicameral conference committee will need to resolve any differing provisions before ratification by both houses. Under current circumstances, a new budget may not be passed until June 2006, at the earliest.

According to more recent estimates from the Department of Finance, the National Government's fiscal deficit as of March 2006 stood at P67.6 billion, P4.2 billion (5.8%) below the programmed three-month ceiling and on track towards achieving a balanced budget by 2008 (two years ahead of the Government's original schedule). That performance reflected larger-than-targeted revenues, which exceeded the P191.7 billion goal by P13.3 billion (6.9%) and more than offset higher-than-programmed expenditures (which overshot the target by P9.1 billion or 3.5%). Interest payments exceeded the programmed level by P7.8 billion because the Government frontloaded interest payments under a bond exchange program to rationalize and lengthen the maturity structure of domestic debt papers. On a positive note, both tax and non-tax revenues exceeded the respective three-month goals by P7.3 billion and P6.1 billion. BIR collections increased by 22.7% year-on-year and topped its January-March 2006 goal by P3.6 billion (2.7%). The Bureau of Customs collected 35.7% more year-on-year and exceeded its first quarter target by P3.7 billion (9.6%). According to preliminary estimates for the first two months of 2006, collections from the amended VAT law yielded P7.6 billion in incremental revenues, more or less meeting the Government's P7.7 billion two-month target.

The consolidated public sector deficit (CPSD) — which, in addition to the NG, includes the financial performance of government-owned financial and non-financial corporations, the BSP, local government units (LGUs), and state-run social security agencies — closed 2005 at P106.0 billion (2.0% of GDP), down 54.3% from 2004's consolidated deficit of P231.9 billion (4.9% of GDP). The 2005 CPSD was also well within the P180.3 billion (3.4% of GDP) ceiling programmed for the period. Like the National Government, the non-financial public sector also posted a much smaller deficit (P21.7 billion) during 2005 relative to 2004 (P85.4 billion) as well as the 2005 target (P42.5 billion). These combined with higher-than targeted surpluses posted by the rest of the public sector to pull down the consolidated deficit level.

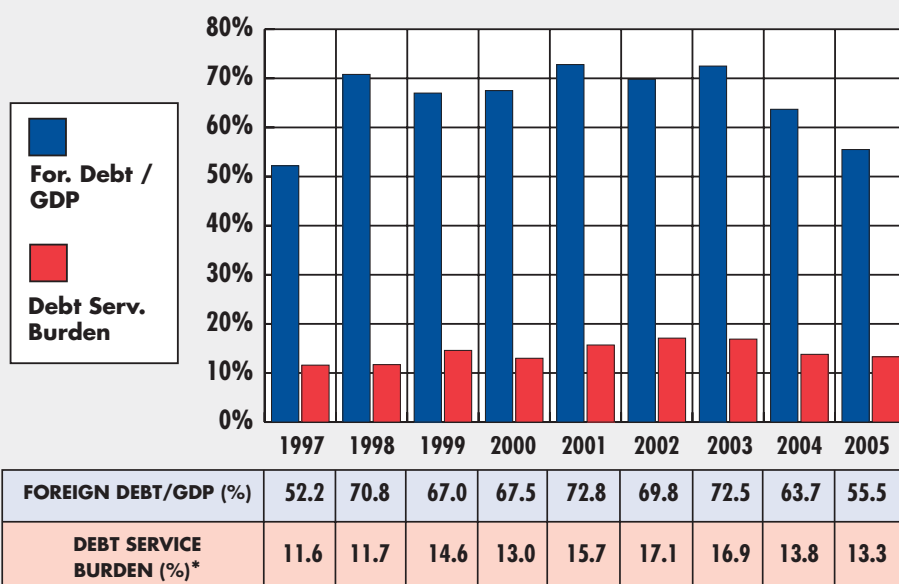
The narrower deficit logged by non-financial government firms partly reflected the improved performance of the National Power Corporation (NPC), which reversed from a P29.9 billion net loss (2004) to a P16 million net surplus

(2005), its first net profit since 1997. NPC officials cited a combination of rate adjustments; lower debt-service costs (stemming from the National Government's assumption of P200 billion of NPC obligations at the start of 2005 as provided under the Electric Power Industry Reform Act or EPIRA, as well as a stronger local currency); an improved generation mix (i.e., reduced dispatch from more costly oil-fired power plants); as well as cost cutting measures. On a more sober note, the lower deficit posted by the non-financial corporate sector also reflected restrained capital spending. Overall, total public sector capital expenditures (inclusive of National Government outlays) has declined from over 5% of GDP in the mid-1990s to about 3.3% of GDP in recent years. This suggests that underlying financial weaknesses remain, in many cases reflecting poor cost recovery due to politicized tariff/rate setting and, in other cases, waste and inefficiency.

The restructuring of the power sector and the privatization of NPC remain critical components of a sustainable fiscal consolidation plan. However, the privatization of generation assets — a crucial step towards open access and retail competition in the electricity market — is moving slowly, reflecting a myriad of issues that have dampened investor interest. These include the absence of transitional supply contracts with electricity distributors and regulatory uncertainties. As of end-2005, the Government had privatized 609 megawatts (and nearly all of that from a not yet finalized sale of a coal plant), representing only 12% of NPC's generation capacity, way below the goal of privatizing 70% of NPC's total capacity by the end of that year. This setback is also a grave cause for concern in a country whose power rates are the second highest in Asia and where inadequate investments threaten the reliability of power supply.

Declining fiscal deficits helped slow the pace of debt accumulation over the past two years. The National Government's outstanding debt increased by a modest 2% during 2005 to P3.9 trillion, the first single-digit growth rate logged since 1997. That debt level was equivalent to 72.3% of GDP, down from 78.7% in 2004, and also marked the first year-on-year decline in the NG debt-to-GDP ratio since 1997. The slower year-on-year expansion also reflected a 4.8% (P87 billion) decline in the peso equivalent of the NG's foreign debt obligations, reflecting the appreciation of the peso and other foreign currencies versus the US\$. (Note: Adding back the estimated impact of currency revaluation adjustments, the National Government's total end-2005 debt level would have expanded by roughly 6.7% year-on-year and equaled 75.7% of GDP). Nevertheless, the National Government's debt-to-GDP ratio remains well above the 53.2% pre-crisis level.

## FOREIGN DEBT RATIOS



\*Ratio of debt service payments to merchandise exports and receipts from services and income.


The outstanding debt of the consolidated public sector stood at P5.5 trillion as of end-September 2005, equivalent to 105.3% of GDP. That debt-to-GDP ratio reflected an improvement from 2004 (109.8% of GDP) and from 2003's peak (118.2% of GDP). Despite recent progress, however, debt levels remain high and the Philippines remains vulnerable to domestic and external shocks. As of September 2005, 67.7% of public sector obligations represented foreign-denominated loans. By 2010, the Government hopes to have brought down the NG debt-to-GDP ratio to below 50% and that of the public sector to below 60%.

In July 2005, major credit rating agencies (Fitch, Moody's, and Standard & Poor's) cut their credit-rating outlook for Philippine sovereign debts from "stable" to "negative," suggesting possible near-term downgrades in the ratings themselves. The rating agencies' action followed legal challenges that prevented the implementation of the amended VAT law on July 1 and worries that political distractions would endanger the country's ability to sustain fiscal consolidation and reduce precariously high debt levels. Fitch and Standard & Poor's restored their credit rating outlook to "stable" during the early months of 2006 following implementation of the amended VAT law and a string of positive 2005 economic indicators. Moody's has not changed its "negative" outlook. The credit ratings themselves have not improved and remain two to three notches below investment grade pending clearer indications of a sustained fiscal and debt turnaround, although the Government recently has been able to borrow from international credit markets at markedly narrower spreads.

The challenge for the Government will be to improve the quality of fiscal consolidation by collecting the targeted revenues from unpopular tax measures and delivering the promised results in terms of improved infrastructure, better public service delivery, higher economic growth, and more jobs. Determined, parallel efforts to boost revenue collection efficiency remain critical to a sustainable fiscal consolidation program, especially considering strong resistance to new and/or higher taxes because of public disenchantment with weaknesses in tax administration, waste, and corruption. Absent new major tax measures, the average 0.6 percentage point year-to-year improvement in tax effort required from 2007 to 2010 (the end of President Arroyo's term) just to recover to the 17% pre-Asian crisis tax-to-GDP peak will fall squarely on improving revenue collection efficiency. Long-term fiscal viability will also require persistent, parallel efforts to address high tax evasion and leakage rates.

## Foreign Debt and Debt Service

By September 2005, the National Government had raised \$3.25 billion from overseas bond markets and had completed its \$3.1 billion commercial borrowing program for the 2005 full year. It also had tapped \$695 million in official development assistance (ODA) loans, about 74% of its targeted full-year 2005 ODA borrowings of \$973 million. The National Government's 2006 fiscal program targets external borrowings of just under \$4 billion — slightly lower than 2005's \$4.1 billion program — to service maturing principal payments and to fund its budget deficit. Of that amount, the National



Government envisions raising \$3.1 billion from commercial sources and the remaining \$850 million from official bilateral and multilateral lenders. The 2006 foreign financing program envisions a larger share (21%) of multilateral and bilateral loans than in 2004 (17%), partly reflecting additional budgetary resources for government counterpart funding under the proposed 2006 budget.

In January 2006, the National Government issued \$2.1 billion of global bonds in the international capital market (\$1.5 billion of 25-year maturities and \$600 million of 10-year maturities), representing about 68% of its full-year 2005 foreign commercial borrowing goal. Positive sentiment over improved fiscal prospects boosted investor demand, reduced borrowing costs, and narrowed risk premiums over comparable U.S. Treasury papers. The 25-year bonds carried a yield of 7.875% or an equivalent of 335 basis points over benchmark U.S. Treasuries, down from a yield of 9.7% and a spread of 505 basis points when the Government last floated 25-year bonds in January 2005. The 10-year bonds were sold to yield 6.375% or an equivalent of about 310 basis points over benchmark U.S. Treasuries, down from the 8.25% yield and 410 basis-points spread when the Government last floated the 10-year paper in September 2005.

The Philippines' recorded external debt (based on public and private sector foreign credits approved and/or registered with the Bangko Sentral ng Pilipinas) stood at \$54.2 billion as of end-2005, lower by 1.2% (\$660 million) year-on-year. That decline reflected net repayments of public sector foreign obligations as well as foreign currency revaluation adjustments from the appreciation of third-currency debt vis-à-vis the U.S. dollar. The public sector's outstanding external liabilities declined by \$1.4 billion (3.7%) between the end of 2004 and the end of 2005 while that of the private sector increased by \$734 million (4.3%). The public sector owed 67.4% of the Philippines' outstanding external liabilities as of 2005 (down from 69.1% share as of 2004). Medium- to long-term (MLT) loans comprised the bulk (88%) of the country's total foreign debt portfolio. The MLT obligations had an average weighted maturity of 17.4 years, with public sector loans carrying a longer average term (nearly 20 years) relative to private sector debts (10.4 years).

By type of creditor, 39.9% of the Philippines' external obligations were owed to official lenders (defined as multilateral and bilateral lenders and their export credit agencies) at generally more concessional terms. Bondholders accounted for 31.7%, banks and other financial institutions for 23.8%, and other creditors (mainly suppliers) for 4.6% of the country's external debt stock. The share of debt owed to official lenders generally has been declining over the years from 55.3% as of

end-1996, just before the onset of the Asian crisis. Conversely, the cumulative share of commercial creditors to the foreign debt stock has risen, from 44.7% to 60.1% over that same period. The declining share of official development assistance (ODA) loans reflects a combination of project implementation bottlenecks, limited resources for Government counterpart funding, and an increasingly competitive environment for ODA financing. Looking forward, the increasing reliance on commercial credit increases the Philippines' vulnerability to contagion when emerging-market debt is under pressure. Accessing commercial borrowings at affordable rates in more competitive global financial markets will depend on maintaining macroeconomic and political stability.

The ratio of the Philippines' foreign debt stock to GDP improved by 8.2 percentage points from 63.7% (2004) to 55.5% (2005), although it remains above the 48.1% pre-Asian financial crisis ratio. Overall, however, the Philippines' ability to meet foreign debt service payments relative to foreign exchange flows remains manageable and well below the 20% international benchmark, reflecting the bias for longer-term borrowings and the still substantial share of ODA credits. The foreign debt service burden (measured as the ratio of debt service to export, services, and income receipts) — which declined from 16.9% in 2003 to 13.8% in 2004 — further contracted to a five-year low of 13.3% in 2005. Taking advantage of strong international reserves to save on interest payments, the BSP announced pre-paid in April 2006 — six months ahead of maturity date — its US\$500 million term loan facility. The Government also plans to retire over \$400 million of Brady bonds by June (representing 53% of Brady bonds still outstanding), noting that the bonds had become more expensive vis-à-vis new foreign commercial borrowings due to tighter interest rate spreads. Government officials noted that the retirement would free up about \$300 million worth of collateral, minimizing net foreign exchange outflows from the buyback transaction.

## *Merchandise Trade and Balance of Payments*

The Philippine balance of payments overcame pressures from high and volatile world oil prices, as well as political noise. The country's BOP position reversed from 2004's \$280 million deficit to a 2005 surplus of \$2.4 billion, the best performance since 1999. The current account posted a surplus for a third consecutive year and widened by 44.8% from \$1.6 billion in 2004 (1.9% of GDP) to \$2.4 billion in 2005 (2.4% of GDP) despite a significantly larger trade-in-goods deficit. The capital and financial account, in the red by \$1.6 billion in 2004, reversed to an \$860 million surplus during 2005.

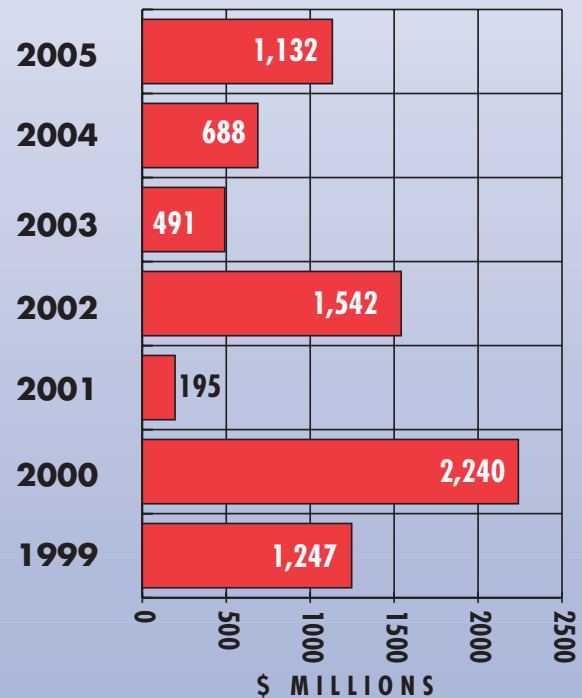
In the current account, the trade-in-goods deficit widened by 32.8% (\$1.9 billion) to \$7.5 billion as import growth (up by 7.4% or \$3.3 billion) outpaced that of exports (up by 3.7% or \$1.5 billion). Export and import growth slowed from their 2004 rates of 9.8% and 8.0%, respectively.

Shipments of electronic products — which contribute 65% to 70% of the country's total export revenues — slowed from 11.5% growth during 2004 to a lethargic 2.2% expansion during 2005. The global slowdown in demand hurt exports from this important sub-sector and combined with the relocation of a major electronic company's high-end product line from the Philippines to China. Exports of semiconductors, which constitute the bulk (75% to 80%) of export revenues from electronics, slowed from nearly 10% growth (2004) to 8.1% growth (2005) but exceeded the estimated 6.8% expansion in worldwide sales of semiconductor devices. Exports of other electronic products contracted by 11.6% year-on-year, pulled down mainly by lower sales of electronic data processing equipment following the relocation of Toshiba's laptop operations to China (which translated to an estimated \$1 billion in lost export sales). On a positive note, revenues from garments — the Philippines' second largest commodity export — mustered a 5.9% year-on-year expansion to \$2.3 billion, notwithstanding the end of the U.S. quota regime and intensifying competition from emerging low-wage exporting economies.

The higher merchandise import bill heavily reflected the surge in world market prices for crude oil and finished petroleum products. The oil import bill rose by 33.2% (\$778 million) to \$6.3 billion and accounted for a quarter of the overall year-on-year expansion in import payments. Its share of total import payments increased from 10.6% (2004) to 13.6% (2005). Purchases of raw materials and intermediate goods increased by 4.8% (\$1.3 billion), spurred mainly by a 4.5% (\$778 million) expansion in materials and accessories required as inputs for the import-dependent electronics industry. Larger payments for rice imports, which more than doubled to almost \$500 million, also contributed as the Government worked to beef up drought-affected domestic inventories. Capital goods imports grew by a modest 1.6%.

By destination, 2005 merchandise exports to non-Japan Asia increased by 11.7% (\$1.9 billion) year-on-year, helping to offset lower sales to Japan and Europe. Non-Japan Asia's share of Philippine export receipts has grown dramatically over the past fifteen years, rising from 17.3% in the early 1990s to 43.7% by 2005. Revenues from shipments to the People's Republic of China (PRC) have expanded robustly over the past five years, from \$663 million (1.7% of Philippine exports) in 2000 to \$4.1 billion (nearly 10% of exports) in 2005. As a result, the PRC in 2005 was the

### NON-RESIDENTS' Net Direct Investments in the Philippines

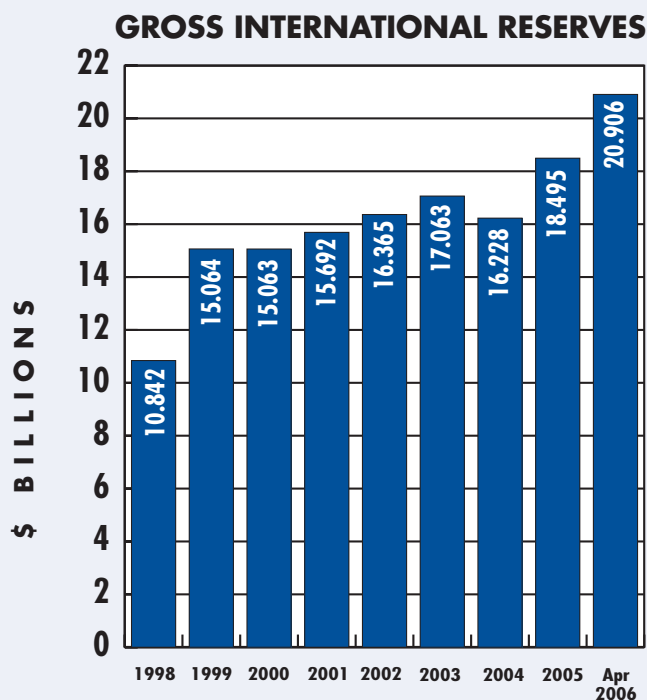


third largest buyer in the world of Philippine goods after the United States and Japan (which together accounted for 35% of export revenues).

On the import side, the value of merchandise purchases from non-Japan Asia slowed to 1.8% (\$338 million) growth during 2005 from 2004's robust 25.3% (\$938 million) expansion. Imports from the Middle East (the country's largest oil supplier) surged by 47.5% (\$1.3 billion), consistent with high global oil prices, while combined imports from the United States and Japan declined by 4.8% (\$772 million). Import payments to the PRC increased by 8.7% (\$231 million). Overall, the share of imports from non-Japan Asia has also been inching up over the past fifteen years, rising to about 43% of the Philippines' total import bill from less than 30% in the early 1990s. The share of imports from the PRC has grown steadily over the past five years, close to tripling from 2.3% to 6.4% between 2000 and 2005, respectively. The PRC was the Philippines' fifth largest supplier during 2005 (versus 12th largest in 2000). Overall, China's share of the Philippines' total trade with the world rose from barely 2% from 8.1% over that same period. China currently ranks as the Philippines' third largest trading partner after the United States and Japan (with shares of 17.8% and 17.2%, respectively).

Improvements in the trade-in-services account and other current account transfers during 2004 offset the wider mer-





chandise trade deficit. The current account benefited mainly from the robust expansion of OFW remittances, which expanded by 25% (\$2.1 billion) to a record level of \$10.7 billion. Net travel receipts increased by 14.7% (\$109 million) and also contributed to the current account's positive balance. The Department of Tourism reported that tourist arrivals, which increased by 20.1% in 2004, grew by 14.5% in 2005 to a record 2.6 million visitors.

The capital and financial account reversed from a \$1.6 billion deficit in 2004 to a \$860 million surplus in 2005. Net portfolio investments, which ended 2004 in the red by \$1.7 billion, shifted to a 2005 surplus of \$2.8 billion. Net inflows from non-residents for investments in the stock market (\$1.5 billion) and Philippine debt papers (\$2.5 billion) surged to nearly \$4 billion after recording an \$803 million net outflow during 2004, more than making up for the 33.7% (\$291 million) expansion in net portfolio investments abroad by Philippine residents. Net foreign direct investments (FDI) — which expanded from \$109 (2004) million to \$970 million (2005) — also contributed to the positive capital and financial account balance. However, net FDI flows were low vis-à-vis levels posted by many East/Southeast Asian neighbors, including Thailand (\$3.2 billion), Indonesia (\$2.3 billion), and Vietnam (\$1.9 billion). Net direct investments by non-residents increased by 64.5% (\$444 million) to \$1.1 billion (hitting the \$1 billion

mark for the first time since 2002) and combined with a \$255 million decline in net direct investments abroad by Philippine residents.

Short-term BOP prospects generally remain positive, barring severe external and domestic shocks. Current BSP forecasts are for a BOP surplus of between \$900 million to \$1.5 billion, smaller than in 2005 to reflect, among others, slower growth (10%) of OFW remittances; possibly lower net portfolio capital flows (due in part to less IPOs and lower government borrowings); and a larger merchandise trade deficit. Although detailed BOP accounts (which are released quarterly) are not yet available, the BSP estimated the overall BOP position at a \$2 billion surplus as of February 2006, reflecting government foreign-bond proceeds and continued flows from OFW remittances, and foreign direct and portfolio capital investors. First quarter 2006 remittances stood at \$2.8 billion, up by 14.6% (\$359 million) year-on-year. January-February 2006 net FDI inflows increased by 22% year-on-year to \$344 million. Although lower than 2005's January-April level, net foreign portfolio flows stayed in surplus (\$591 million) during the first four months of 2006, weathering alleged coup attempts and President Arroyo's one-week (February 24 to March 3) State of National Emergency proclamation. Government officials also partly attributed lower net portfolio investments to \$120 million in net outflows during January 2006, as some investors in peso-denominated government securities opted to cash in on profits from the appreciation of the Philippine currency. Boding well for tourism receipts, the Department of Tourism reported that first quarter 2006 tourist arrivals increased by 13%.

Beyond positive short-term prospects, however, longer-term BOP vulnerabilities and challenges remain. The Philippines historically has posted trade surpluses during periods of economic weakness, reversing to deficits as economic expansion accelerates. The Philippines is heavily dependent on electronics for its export revenue and the country's major export products rely heavily on imported inputs. Relatively high dependence on imported oil (which supplies between 35% to 40% of the country's energy requirements) makes the Philippine BOP vulnerable to global price swings. While trade liberalization presents vast opportunities, intensifying global competition and the emergence of low-wage export economies also pose challenges. Portfolio investments, while recently robust, are prone to quick reversals in sentiment. Longer-term BOP stability will also depend heavily on the Philippines' ability to compete for more non-debt sources of foreign exchange as the Government continues working to avert risks posed by the rapid debt build-up of previous years.

## Foreign Exchange Rate and International Reserves

The peso averaged P55.09/\$ during 2005, 1.7% stronger than 2004's comparable average of P56.04/\$. It closed 2005 at P53.09/\$, a 5.7% appreciation from the end of 2004 (P56.28/\$) — ending as Asia's best performing currency. Overall, however, 2005 was a relatively more volatile year for the peso — which traded within a wider 6.4% band of P53.03-P56.44/\$ (versus 2004's 2.5% range of P55.06-P56.45/\$) — despite more robust BOP flows. The peso averaged P54.77/\$ during the first five months of 2005 but weakened to an average rate of P55.82/\$ during the June to September period as the foreign exchange market reacted to political challenges, the resignation of key Cabinet members, rating outlook downgrades, and legal challenges to the amended VAT law. The peso then rebounded during the fourth quarter (averaging P54.59/\$) on easing political tensions and a final Supreme Court ruling upholding the legality of the amended value added tax law.

The Philippine currency strengthened further to an average rate of P51.75/\$ during the first four months of 2006. It traded within a 2.8% band of P50.88-P52.30/\$. The peso sputtered immediately following President Arroyo's February 24 state of national emergency declaration but recovered quickly from initial losses, hitting its strongest intra-day rate (P50.88/\$) since late July 2002 on March 7, 2006. The peso has since lost some ground following a new wave of uncertainties from soaring oil prices and further policy rate increases by the Federal Reserve Board but nevertheless closed mid-May at P52.15/\$, up 6.9% and 1.8% from the end of September and December 2005, respectively. Exporters have

expressed concern over the impact of a markedly stronger peso on profits and external competitiveness, especially for export businesses that rely heavily on domestic inputs. BSP officials have noted that the peso's strength reflects improved economic fundamentals and reiterated its policy of limiting intervention to smoothening out excessive volatility in the foreign exchange market, rather than targeting a specific rate.

Reflecting more robust balance of payments flows, the BSP's gross international reserves (GIR) began hitting new month-end record levels in May 2005 and ended that year at \$18.5 billion, nearly 14% (\$2.3 billion) higher from the end of 2004. The end-2005 GIR level represented 3.9 months worth of imports of goods and services (an improvement from the 3.6 months of import cover at the end of 2004), and was equivalent to 158.8% of public and private sector principal payments falling due in the next twelve months (up from 156.9% as of the end of 2004).

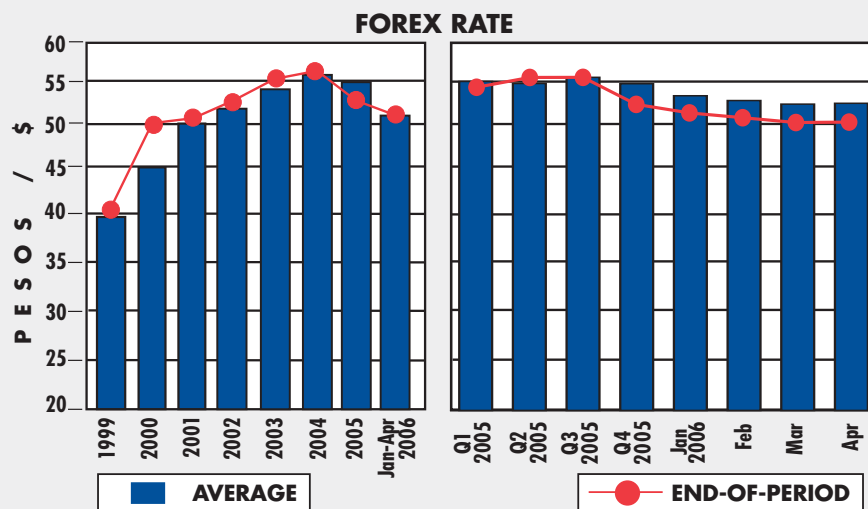
Helped by proceeds from public sector borrowings, OFW remittances, and portfolio capital flows, the BSP's GIR cushion has since increased further to an end-April 2006 cushion of \$20.9 billion, a new record high. That GIR level was equivalent to 4.4 months of import cover and to 177.1% of foreign debt obligations falling due through April 2006.

## Challenges and Prospects

The Philippines prided itself as the least adversely affected Southeast Asian country during the Asian financial crisis but its neighbors have since rebounded strongly. The challenge for the Philippines is to compete effectively for trade, investment, and capital in a rapidly globalizing and increasingly competitive world economy. The current sentiment is

one of cautious optimism following determined fiscal reduction efforts, the political will to pursue unpopular and/or contentious tax measures, and recent economic gains. However, the Philippines continues to grapple with important challenges and sustained reforms will be essential to translating the cautious optimism to more investments, higher economic growth, more jobs, and less poverty.

The Arroyo Administration deserves credit for cutting the public sector deficit and forging ahead with unpopular measures to avert a fiscal crisis, helping to lift confidence despite lingering political uncertain-



ties. Financial markets have rewarded fiscal consolidation efforts with a stronger peso, lower domestic borrowing costs, and narrower risk premiums. Effective implementation, collection, and expenditure management — which will be closely watched by credit rating firms, investors, the political opposition, and the general public — will be key to a sustainable fiscal consolidation plan that promotes macroeconomic stability and addresses the needs of a rapidly growing population. There will be substantial public pressure on the Administration to show concrete results for painful fiscal measures.

While the economy has demonstrated considerable resilience in the face of domestic and external shocks, higher investment levels remain critical to achieving and sustaining a higher growth path and generating employment. The country's investment-to-GDP ratio, estimated at about 20% in the early 1990s, was barely 16% in 2005 — the lowest in Southeast Asia and paling in comparison to regional neighbors such as Thailand (31.6%), Indonesia (21.3%), and Vietnam (35.4%). Real GDP growth has averaged just a little over 4% over the past fifteen years and the Philippines historically has had trouble sustaining growth above 5% — lower than the estimated 7%-8% pace required to make more significant inroads in poverty alleviation for a population that is growing at 2.4% per year and over 40% of whom subsist on less than \$2 per day. The heavy dependence of economic growth on consumption limits the country's ability to shift to a more robust growth path.

A low domestic savings rate requires aggressive efforts to address long-standing investor and business issues that

have resulted in low anti-corruption and competitive rankings in the Transparency International Index and other indices. Investors continue to express concerns about corruption, the unpredictable legal and regulatory environment, outdated bankruptcy and corporate recovery laws, peace and order, and a fractious political climate. Privatizing the electricity sector can be an important barometer of the Government's determination to improve the investment climate, in addition to being critical to providing more competitive power rates and ensuring stable electricity supply.

Fighting corruption remains an important challenge. The Government has been working to reinvigorate its anti-corruption drive, and the Office of the Ombudsman has reported improved conviction rates. Despite recent progress, however, the Philippines will need to do more to improve international perception of its anti-corruption campaign — an effort that will require strong political will and significantly greater financial and human resources. The Philippines hopes to receive assistance under the United States Millennium Challenge Account's (MCA) Threshold Country Program (TCP) to strengthen areas of weakness in transparency and governance. In April 2006, the Government submitted a detailed Threshold Country Plan for the consideration of the Millennium Challenge Corporation. The TCP is intended to assist countries that have demonstrated a commitment to reform but that require additional policy progress in certain areas to qualify for core MCA funding.

#### PROJECTIONS FOR 2006: SELECTED INDICATORS

	<u>2004</u> Actual	<u>2005</u> Actual	<u>2006</u> Forecast a/
<b>GDP Growth</b> (Year-on-Year, %)	6.0	5.1	5.0-5.5
<b>GNP Growth</b> (Year-on-Year, %)	6.2	5.8	5.4-5.9
<b>Average Year-on-Year Inflation</b> (1994=100, in %)	6.0	7.6	7.3-7.8
<b>Average 91-day T-bill Rate</b> (%)	7.34	6.36	5.5-6.0
<b>Average Forex Rate</b> (Pesos/US\$)	56.04	55.09	51.90-52.75
<b>Exports</b> (\$Billions)	38.8	40.2	42.8-43.2
Growth (Year-on-Year, %)	9.8	3.7	6.5-7.5
<b>Imports</b> (\$Billions)	44.5	47.8	51.6-52.1
Growth (Year-on-Year, %)	8.0	7.4	8.0-9.0
<b>Trade Balance</b> (\$Billions)	(5.7)	(7.5)	(8.4-9.3)

a/ Embassy projections as of May 2006.

Sources: National Economic and Development Authority, Bureau of Treasury, Bangko Sentral ng Pilipinas.

## PHILIPPINES: KEY ECONOMIC INDICATORS

(In Million USD, unless otherwise noted)

	2004	2005	2006	p/
<b>Domestic Economy</b>				
Population (millions)	83.9	85.9	87.9	
Population growth (%)	2.36	2.36	2.36	
GDP (current) <i>a/</i>	86,123	97,647	--	
GNP (current) <i>a/</i>	92,212	105,204	--	
Per Capita GDP, current dollars <i>a/</i>	1,026	1,137	--	
Real Per Capita GDP (% change, yr.-on-yr.)	3.6	2.7	--	
Real GDP (% change, yr.-on-yr.)	6.0	5.1	--	
Real GNP (% change, yr.-on-yr.)	6.2	5.8	--	
Consumer Price Index (ave. % change, yr.-on-yr. 2000=100)	6.0	7.6	7.2	Jan-Apr
<b>Production, Employment, Fiscal Accounts</b>				
Unemployment rate (%) <i>b/</i>	11.8	11.4	10.7	Jan
Industrial prod. (1985=100), % change yr.-on-yr.	5.2	5.3	--	
Nat'l gov't budget surplus/(deficit) <i>a/</i>	(3,338)	(2,660)	(1,303)	Jan-Mar
as % of GDP	(3.9)	(2.7)	--	
Consolidated public sector surplus/(deficit) <i>a/</i>	(4,139)	(1,925)	--	
as % of GDP	(4.9)	(2.0)	--	
<b>Interest Rates (%)</b>				
Weighted average T-bill rate (all maturities)	8.1	7.5	6.2	Jan-Apr
Average prime loan rate	10.1	9.1	8.2	Jan-Apr
<b>Balance of Payments</b>				
Exports (FOB)	38,794	40,231	3,266	Jan
Growth (% , yr.-on-yr.)	9.8	3.7	(0.7)	Jan
Imports (FOB)	44,478	47,777	3,681	Jan
Growth (% , yr.-on-yr.)	8.0	7.4	5.1	Jan
Trade balance	(5,684)	(7,546)	(415)	Jan
Current account surplus/(deficit)	1,626	2,354	--	
as % of GDP	1.9	2.4	--	
BOP surplus/(deficit)	(280)	2,407	2,045	Jan-Feb
<b>Foreign Debt, as of end of period <i>c/</i></b>				
Debt service paid	7,217	7,519	--	
Debt service (% of exports of goods and services)	13.8	13.3	--	
<b>BSP International Reserves, as of end of period</b>				
	16,228	18,495	20,906	Apr
<b>Exchange Rate (pesos/\$)</b>				
Average exchange rate	56.04	55.09	51.75	Jan-Apr
Closing exchange rate	56.28	53.03	51.78	Apr
<b>Foreign Direct Investment (BSP registrations) <i>d/</i></b>				
Total (cumulative, since 1973)	17,268	17,820	--	
U.S. (cumulative, since 1973)	3,566	3,604	--	
U.S. share (%)	20.7	20.2	--	
<b>U.S.-Philippine Trade (Phil. Data)</b>				
Philippine exports to U.S., FOB <i>e/</i>	7,088	7,402	630	Jan
Growth (% , yr.-on-yr.)	(2.4)	4.4	0.4	Jan
Philippine imports from U.S., FOB <i>e/</i>	8,270	7,970	602	Jan
Growth (% , yr.-on-yr.)	(8.0)	(3.6)	(10.6)	Jan
Philippine trade balance with U.S. <i>e/</i>	(1,182)	(568)	28	Jan
U.S. share of Philippine imports (%)	18.8	17.7	16.4	Jan

*a/* originally peso values, converted to USD; *b/* annual figures computed as average of quarterly surveys (Jan/Apr/Jul/Oct); *c/* excludes "net due to" accounts of foreign commercial banks, private sector loans not approved and/or registered by/with the BSP, and debt owed to residents; *d/* principally exercised to enable foreign exchange purchases from the banking system for capital repatriation and profit remittances (data used as rough estimate of FDI stock in the absence of alternative statistics); *e/* differs significantly from USG data which estimated the Philippines' trade surpluses with the U.S. at \$2.0 billion in 2004, \$2.4 billion in 2005, and \$148 million in January 2006; *p/* preliminary

**Sources:** National Economic and Development Authority; Department of Finance; Bureau of the Treasury; Bangko Sentral ng Pilipinas