Philippine Economic Outlook

NOVEMBER 2004

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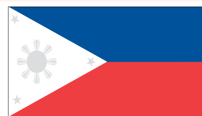
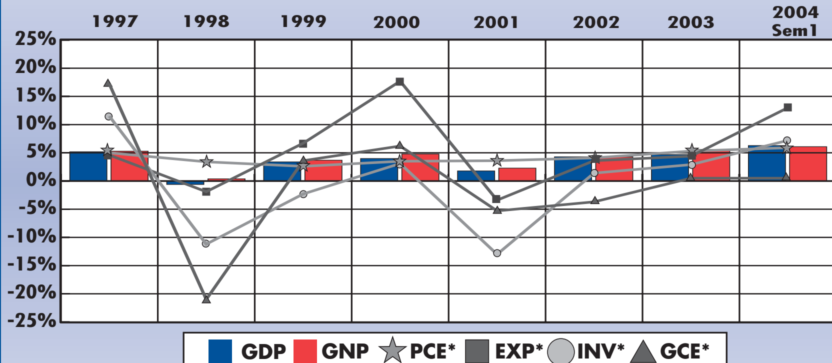
Executive Summary



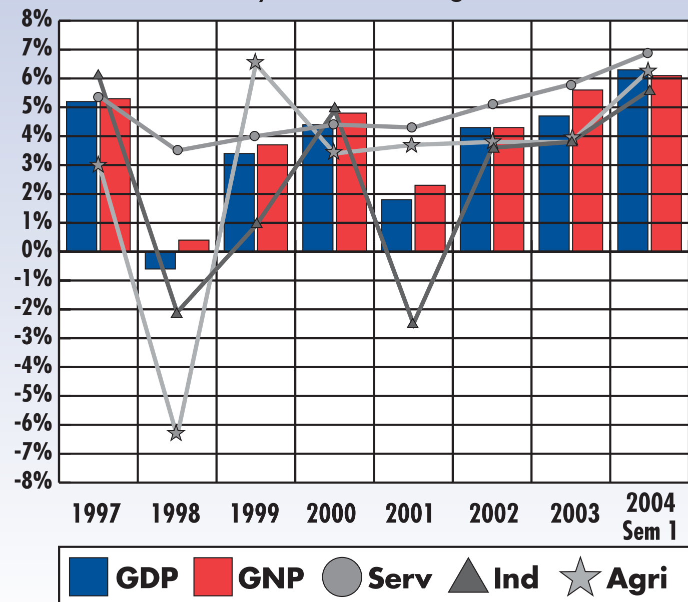
The Philippine economy benefited from the global and regional expansion during the first half of 2004 and exhibited resilience, notwithstanding certain challenges. Economic growth surpassed both public and private sector expectations with first-semester Gross Domestic Product up 6.3% year-on-year, despite election-related jitters, rising global oil prices and domestic interest rates, and pressure on the peso. Growth may have slowed during the second half but full-year 2004's economic expansion is expected to be in the mid- to upper end of the Government's targeted 4.9%-5.8% growth range.

On the fiscal front, the National Government kept within its deficit ceiling during the first nine months of 2004. The Government took several unpopular but necessary steps to move to more market-based pricing for the electricity sector — measures that will help improve the dire financial condition of the Government's National Power Corporation and make the privatization of its power generation and transmission business more attractive to potential investors. The stock market closed October 2004 up 26% from the end of 2003, buoyed by better-than-expected corporate profits, the Philippine Monetary Board's neutral monetary-policy stance, and Government efforts to keep the fiscal deficit in check. In the balance of payments, the first-semester current account surplus widened from 2003 due to stronger exports and tourism receipts. Business-process outsourcing (including call centers) is growing rapidly on the back of the Philippines' large English-speaking work force. The Government also enacted important legislation to help spur the development of the Philippine capital market and enhance banking sector stability.



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

Looking forward, the economy faces a more challenging economic environment in 2005, with high oil prices clouding the outlook for inflation and financing costs, as well as balance of payments prospects. The most pressing challenge over the coming year will be the Government's political will to move forward aggressively with fiscal reforms to avert fiscal problems from potentially spilling over into a financial or economic crisis. Although the Philippines demonstrated considerable resilience during the Asian crisis, its ability to muddle through domestic and/or external shocks has been seriously hampered by a high and unsustainable debt level that, left unattended, threatens to throw the Philippines into a debt-deficit spiral. Meager resources and the large share of debt servicing are squeezing much-needed infrastructure spending and the delivery of basic socio-economic services such as health and education — threatening the country's ability to attract investors and compete in the global economy. Investors have expressed increasing concern over the deteriorating quality of an important competitive edge — English-language skills — as well as weak Math and Science skills.



Notwithstanding a number of bright spots, the Philippines faces other challenges to achieving and sustaining a higher growth path that will make a dent in poverty alleviation. In addition to the vulnerable fiscal situation and a worrisome contingent liability problem, potential foreign investors, expatriate business executives, traders, and tourists continue to express concern about law and order, corruption, and the unpredictable legal and regulatory environment. The country continues to struggle with low competitiveness and high corruption rankings, and with low domestic savings and investment rates. A high population growth rate makes real economic progress and sufficient employment generation all the more difficult. Although improving, banking-sector credit growth remains moderate thus far, hampered by the overhang of non-performing assets. The Central Bank continues to push for important legislative amendments that will strengthen its supervisory and prompt corrective action powers.

President Gloria Macapagal-Arroyo has repeatedly stated that she will use her fresh electoral mandate to push for fiscal consolidation — including legislative passage of new revenue measures — as the top priority in her reform agenda. Credit-rating agencies have warned of rating downgrades absent near-term passage of meaningful revenue measures. Respected economists here have stressed that the Philippines is at a make-or-break fiscal crossroad. Investors and other Philippine observers will be closely monitoring developments on the fiscal front as a crucial gauge of the Government's commitment to broader reforms.

Economic Growth and Inflation

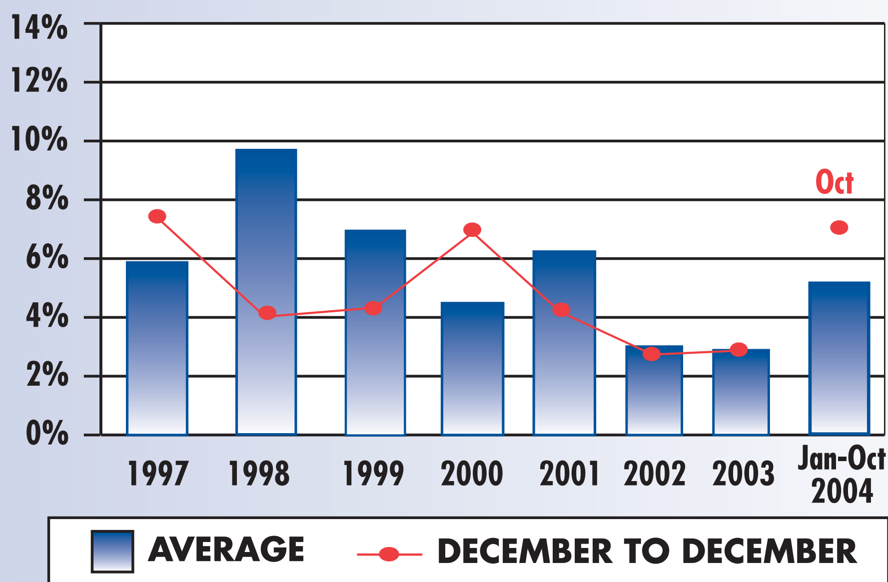
The Philippine economy surpassed both private and public sector expectations, especially in the face of concerns over election-related political and economic stability. First-semester 2004 Gross Domestic Product (GDP) grew by 6.3% from the first half of 2003 — the highest year-on-year expansion for six-month GDP registered in 16 years. While that GDP expansion exceeded those of Indonesia (4.7%) and South Korea (5.4%) and approximated Thailand's, it lagged behind ther Asian countries such as Malaysia (7.8%), Vietnam (7%), Taiwan (7.2%), Singapore (10%), Hong Kong (9.5%), and China (9.7%). At 6.1%, Gross National Product (GNP) was slightly lower than GDP growth because of the slower expansion of overseas workers' remittances and higher property-related outflows.

On the demand side, personal consumption (which contributes over three-fourths to Philippine GDP) accelerated from 5.2% growth during the first half of 2003 to 5.9% growth during the first half of 2004 and spurred over 70% of the overall year-on-year expansion in domestic economic output. First-semester 2004 exports of goods and non-factor services expanded at a faster 13% pace from 2003's lethargic 2.7% performance on stronger global demand and improved tourism receipts. Meanwhile, import growth decelerated to 5.7% from 2003's comparable 14.7% growth rate. The resulting improvement in net exports spurred about 35% of the year-on-year GDP increase.

Gross capital investments (up 9.4%) contributed about a third of the year-on-year GDP expansion. However, that performance fell somewhat short of the previous year's 10% growth rate despite stronger investments in construction because expenditures on durable equipment increased more moderately (6.2% versus 7.7%), as did inventory growth. (Note: The contributions to GDP growth do not add up to 100% because of statistical discrepancies in the GDP expenditure accounts. End Note.) Investment in construction, up by 9.6%, reversed the 3.9% contraction posted during the first half of 2003. Attributed in part

to election-related spending, public-sector construction investments increased by 12.1% and broke from six consecutive semesters of year-on-year declines.

On the supply side, all three major sectors (i.e., agriculture, industry, and services) exceeded their respective 2003 growth performances. Benefiting from favorable weather, six-month agricultural output expanded by 6.3% year-on-year — a significant improvement from the previous year's modest 2.5%, drought-affected performance — and contributed about 20% to the overall year-on-year GDP increase. Industrial sector output grew by 5.6% (versus 4.2% in 2003) and contributed 29% to GDP growth. Improved construction activity mainly drove the industrial sector's stronger expansion, with the utilities sub-sector also contributing. Up 4.2%, manufacturing (which accounts for about two-thirds of industrial sector output) fell short of its comparable 2003 performance (4.9%). That slowdown partly reflected a 21.5% slump in petroleum products manufacturing, resulting from the decision of a major oil company to cease refinery operations since the fourth quarter of 2003.



The service sector, which contributes over 45% to Philippine GDP, expanded by 6.9% year-on-year (versus 5.6% growth during 2003's first semester) and accounted for 51% of the year-on-year expansion in Philippine gross domestic output. With the exception of government services, major sub-sector groupings (i.e., transportation and communications, trade, finance, real estate, and private services) all surpassed their respective 2003 growth performance and helped to spur the service sector's stronger expansion. Transport and communications (which accelerated from 8.5% to 11.4% growth) contributed the most to the service sector's stronger growth performance, reflecting the continued robust expansion of wireless subscribers, increased tourist arrivals, as well as election-related demand for transport and telecommunications facilities. Consistent with brisker consumer sales, the trade sub-sector (which accelerated from 5.5% to 6.4% growth) also contributed significantly to the service sector's stronger expansion. Private services (up 6.7% versus 5.1% in the first half of 2003) contributed as well, mainly because higher tourist arrivals helped push up the hotel and restaurant business and election-related demand gave broadcast media (an important category under recreational services) added impetus.
The increase in international oil and petroleum prices, rising inflation, upward pressures on domestic and foreign interest rates, and greater fiscal restraint after the elections are expected to moderate the economy's expansion during the second half of 2004. The agricultural sector's high resulted from a relatively low first-semester 2003 base and will likely slow. Nevertheless, we expect full-year 2004 GDP to expand within the mid- to upper end of the Government's targeted 4.9%-5.8% growth range. The Government's 2005 GDP growth target of 5.3%-6.3% hinges heavily on boosting investor confidence and attracting private capital to counteract the threats posed by external challenges. However, worsening competitiveness and corruption rankings and a precarious fiscal situation threaten to pull down credit ratings, dampen investor sentiment, and rein in the economy's expansion. Over the next several months, building confidence will depend mainly on the Philippines' ability to move forward with meaningful but painful measures to avert a fiscal crisis — which credit-rating agencies, investors, and other Philippine observers will be watching as the major barometer of the Government's commitment to broader reforms.

Year-on-year inflation, which began the year at 3.4% in January, had accelerated to 7.1% by October, the highest since May 1999. Inflation began accelerating more markedly during the second

quarter as successive fuel-price hikes, transport fare increases, and long overdue electricity rate adjustments towards more market-based pricing wove their way into general price levels. Year-on-year consumer price inflation averaged 5.1% during the first ten months of 2004 (versus 3.3% during 2003's comparable period). We expect the full-year 2004 average to breach the Government's 4%-5% targeted range.

Labor and Employment

For the first three quarterly 2004 surveys conducted by the National Statistics office (NSO), the Philippine unemployment rate averaged 12.1% percent, up from 2003's 11.8% three-quarter average. In the latest survey conducted by NSO, the Philippine unemployment rate decreased by 0.9 percentage points, from 12.6% in July 2003 to 11.7% in July 2004. This recent decline in the jobless rate was attributed mainly to the recovery in the agriculture, fishery and forestry sector (5.7% employment growth) from unfavorable weather conditions, as well as to the continued expansion in service sector employment (4.1% employment growth).

The labor force participation rate increased slightly to 67.1% from 67.0% for the same period last year. The Philippine employment situation eased as the expansion in employment outpaced the growth in the labor force. Total employed persons rose to 31.62 million this year compared to 30.45 million in the same period in 2003, registering a 3.8% employment growth rate compared to last year's 1.2%. However, a lower ratio (63.6%) of those employed nationally were working full-time (i.e., at least 40 hours a week) than in the July 2003 survey (65.2%), while the ratio of those engaged in part-time work increased from 33.5% to 35% year-on-year. Partly reflecting the nature of farm sector employment, the number of persons in part-time work increased by 8.6% over the yearlong period, exceeding the growth in full-time employment (which increased by only 1.4%).

The underemployment rate (the share of full-time and part-time workers seeking additional hours of work) was down to 17.6% (July 2004) from 20.7% (July 2003). The underemployment rate is highest in the agriculture, fishery and forestry sectors at about 25% as of April 2004.

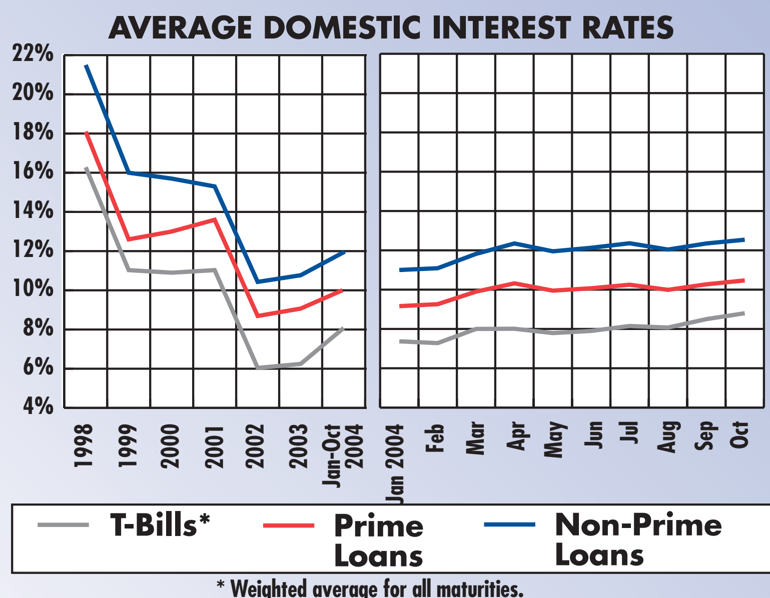
Based on statistics from the National Conciliation and Mediation Board as of September 2004, notices of strikes/lock-outs decreased by 12%, with a total of 426 notices from the 484 cases filed during the same period last year. However, this year's notices covered a greater number of workers (102,054 versus 80,510 last year).

In other developments, Philippine President Gloria Macapagal-Arroyo signed the Anti-Child Labor Law, an act providing for the elimination of the worst forms of child labor and affording strong protection for the working child. The new law strictly prohibits employing children below 15 years of age except in circumstances that are strictly defined and spelled out.

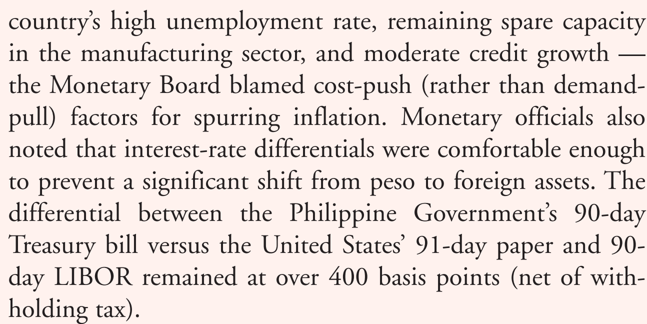
Financial Markets

In February 2004, the Philippine Monetary Board — the highest policy-making body of the Bangko Sentral ng Pilipinas (BSP, the Central Bank) — increased "liquidity reserve" requirements (i.e., mandated reserves that earn market-based rates) by two percentage points (from 8% to 10%), to stem potential inflationary risks from speculative pressure on the peso (see section on Foreign Exchange Rate and International Reserves). Despite intermittent pressures on the local currency, accelerating inflation, and subsequent rate adjustments by the Federal Open Market Committee (totaling 75 basis points as of October), the BSP has refrained from further monetary-tightening measures.

As of October 2004, BSP policy rates — last adjusted in July 2003 — remained at 6.75% (borrowing) and 9% (lending). Citing soft spots on the demand-side — among them the



* Weighted average for all maturities.



country's high unemployment rate, remaining spare capacity in the manufacturing sector, and moderate credit growth — the Monetary Board blamed cost-push (rather than demand-pull) factors for spurring inflation. Monetary officials also noted that interest-rate differentials were comfortable enough to prevent a significant shift from peso to foreign assets. The differential between the Philippine Government's 90-day Treasury bill versus the United States' 91-day paper and 90-day LIBOR remained at over 400 basis points (net of withholding tax).

Bid rates for Government securities have been on the rise, reflecting political risk premiums in the run-up to the June 2004 elections, rising inflation expectations since the second quarter, and concerns over the public sector's precarious fiscal condition. The loan-benchmark 91-day Treasury bills that the Government auctioned off during the first ten months of 2004 averaged 7.239%, up by 125 basis points year-on-year. However, average real interest rates for the 91-day paper softened from 2.699% (2003) to 2.139% (2004). The National Government — which had funded its commercial foreign-borrowing needs for the 2004 budget by April and which received a boost in July from a P41.7 billion ($744.5 million) sale of retail Treasury bonds (i.e., securities in smaller denominations intended mainly for individual investors) — kept nominal borrowing costs from rising more significantly by intermittently rejecting bids it considered too high. With bank lending still struggling to recover, the lower real interest rates for government securities also reflected a dearth of relatively risk-free investment alternatives.

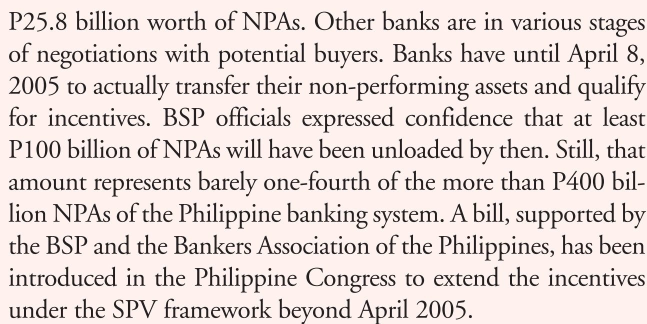
Prime loan rates averaged 9.964% during the first ten months of 2004 versus 8.867% during 2003's comparable period, up 109.7 basis points year-on-year. Average loan rates for non-prime customers rose more sharply (i.e., by 128.1 basis points) from an average rate of 10.683% (2003) to 11.964% (2004) as banks priced in higher debt-servicing risks posed by upward pressures on interest rates.

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 continues to inhibit more aggressive credit growth, constrain capital build-up, and exert pressure on banks' bottom lines. As of August 2004, outstanding loans of the commercial banking system (excluding inter-bank credits) had expanded by 5.5% year-on-year. Although this marked the highest year-on-year expansion in commercial bank credits since April 2002, it remains a far cry from the robust double-digit growth rates before the Asian crisis.

As of end-August 2004, the commercial banking system's NPAs (P449.3 billion) had expanded by 2.3% (P9.9 billion) year-on-year and by 1.6% (P7 billion) from end-2003's P442.3-billion level. Non-performing loans (NPLs), estimated at P247.6 billion, declined by 0.3% (P0.7 billion) from August 2003 but expanded by 0.9% (P2.1 billion) from December 2003 to equal 13.8% of banks' aggregate loan portfolios (versus the August 2003 and end-2003 NPL ratios of 15% and 14.1%, respectively). However, asset foreclosures (P208.1 billion) continued to grow, increasing by 6% (P11.7 billion) from August 2003 and by 2.9% (P5.8 billion) from the end of 2003. Restructured loans (P134.8 billion) also increased by 1% (P1.3 billion) and 0.4% (P0.5 billion) from end-August 2003 and end-December 2003, respectively, although their 7.4% share of outstanding commercial banking system credits declined from end-August 2003's 8.1% and end-2003's 7.7% ratios. The BSP estimated that distressed assets (NPAs and restructured loans) equaled 14.2% of total commercial banking system resources as of August 2004, from less than 5% before the Asian crisis.

Computed according to the Basel Capital Accord formula, Philippine commercial banks' published average capital-adequacy ratio has been estimated at 15.7% as of end-December 2003, better than the BSP's 10% statutory floor and the 8% internationally accepted standard. Provisions for probable losses increased from 31.7% of NPAs as of end-August 2003 to 32.4% as of end-August 2004. However, the International Monetary Fund continues to express concern that current accounting practices, especially for the valuation of foreclosed assets, may be overestimating capital adequacy and NPA-loss reserve ratios. It should also be noted that 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. About 377 banking institutions (including 15 commercial banks) are saddled with NPA ratios exceeding the industry average. Several banks (seven commercial banks, 34 thrift banks, and 151 rural banks) remain short of BSP-prescribed minimum capitalization levels. More than 160 banking institutions (including five commercial banks) have yet to comply with the BSP's 10% capital adequacy ratio.

To help ease the burden of non-performing assets on the financial system, President Macapagal-Arroyo signed the Special Purpose Vehicle (SPV) Act into law in January 2003 and a Congressional Oversight Committee approved the SPV Act's Implementing Rules and Regulations (IRRs) in March 2003. The law provides a regulatory framework for the creation of privately funded asset management companies (AMCs) by extending time-bound fiscal and regulatory incentives. About 36 AMCs had registered with the Securities and Exchange Commission as of September 18, 2004 — the deadline stipulated in the SPV law for transactions to be eligible for incentives. As of mid-October 2004, the Bangko Sentral ng Pilipinas had issued 69 certificates of eligibility (COEs) to 18 banks to unload P15.8 billion worth of non-performing assets, P11.3 billion of which represented exposures of 18 banks to a single debtor (National Steel Corporation) and the remaining P4.5 billion involving sales to individual buyers and "dacion en pago" (payment-in-kind) arrangements. The BSP is processing another P23.1 billion of applications from 19 banks, P17.2 billion of which would involve the first potential wholesale transfers of NPAs by five banks to buyers that include Lehman Brothers and Morgan Stanley. While they have not yet submitted their applications, another two banks have announced that they have reached agreement in principle with potential buyers to unload



P25.8 billion worth of NPAs. Other banks are in various stages of negotiations with potential buyers. Banks have until April 8, 2005 to actually transfer their non-performing assets and qualify for incentives. BSP officials expressed confidence that at least P100 billion of NPAs will have been unloaded by then. Still, that amount represents barely one-fourth of the more than P400 billion NPAs of the Philippine banking system. A bill, supported by the BSP and the Bankers Association of the Philippines, has been introduced in the Philippine Congress to extend the incentives under the SPV framework beyond April 2005.

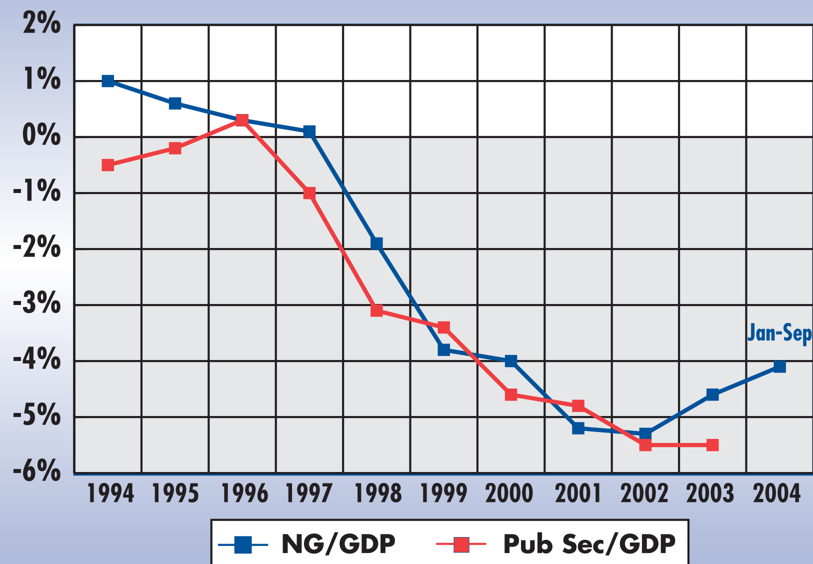
The BSP continues to encourage consolidation in the banking system through time-bound incentives and a temporary moratorium (since September 1999) on the issuance of new bank licenses. From January-September 2004, there were three completed acquisitions/mergers involving one commercial bank, one thrift bank, three rural banks, and two offshore banking units. The BSP has approved 57 acquisitions, mergers and/or consolidations thus far since the Asian crisis (involving 29 commercial banks, 23 thrift banks, 34 rural banks, nine non-bank financial intermediaries, and three offshore banking units) — 52 cases of which had been completed as of end-September 2004. The inability of a number of banking institutions to meet minimum capitalization levels suggests there is room for further consolidation. Another seven acquisition and/or merger proposals are pending BSP approval. In terms of number, smaller-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. Two banks (one thrift bank and one rural bank) were closed during the first nine months of the year — for a total of 145 bank closures since mid-1997 (involving two commercial, 22 thrift, and 121 rural banks).

The Bangko Sentral ng Pilipinas continues to work to fully implement the General Banking Law of 2000, which is geared towards strengthening transparency, bank management, and bank supervision. The BSP has issued several guidelines to widen the application of Basel-prescribed, risk-based capital adequacy standards, enhance risk-based management and supervision systems, and to protect investors through third-party securities custodianship and registry requirements. The BSP has also announced that it will be working to fully adopt Basel 2 standards by 2007 (which, among others, would expand coverage from credit and markets risks to operational risks, as well as enhance the risk-weighting framework). 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. The Central Bank is pushing for 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.

On July 27, President Macapagal-Arroyo signed into law Republic Act (R.A.) 9302, amending the charter of the Philippine Deposit Insurance Corporation (PDIC, the equivalent of the U.S. FDIC) — an initiative that dated back to the Estrada Administration. R.A. 9302 hikes depositors' minimum deposit insurance coverage from P100,000 to P250,000; grants the PDIC greater flexibility to build up its deposit insurance fund; reinstates the agency's authority to examine banks in coordination with the Central Bank; and enhances PDIC's receivership and liquidation powers. The new law also authorizes the PDIC to reorganize and to establish a more competitive compensation structure to enhance organizational efficiency and professionalism. The financial sector hailed the law's enactment as an important step forward in enhancing the stability of the banking system. PDIC officials noted, however, that legislators did not pass a provision protecting PDIC officers and employees from lawsuits.

On the anti-money laundering front, the Philippines avoided sanctions in the October 2004 plenary meeting of the Paris-based Financial Action Task Force (FATF) but remains on the FATF's list of non-cooperative countries and territories (together with the Cook Islands, Indonesia, Myanmar, the Republic of Nauru, and Nigeria). Effective implementation remains the key to the Philippines' removal from the FATF watch list. The FATF continues to express concern over the low volume of suspicious transaction reports, the slow pace of prosecution, and obstacles to the ability of the Anti-Money Laundering Council (AMLC, the Philippines' financial intelligence unit) to expeditiously freeze suspicious accounts. AMLC procurement of an information technology system that can effectively process and analyze suspicious and covered transactions has also faced delays. FATF officials intend to visit the Philippines to conduct an on-site evaluation before the next plenary session in February 2005. The U.S. Government continues to provide training and technical support to assist the Philippines in implementing the Anti-Money Laundering Act, a commitment made during President Macapagal-Arroyo's first working visit to Washington in November 2001.

Buffeted by election-related jitters, the stock market floundered during the first quarter of 2004. The Philippine Stock Price Index (Phisix) closed at 1,388.15 on March 29, the lowest closing level since February 13, 2002, and ended the first quarter at 1,424.33, down 1.3% from the end of 2003. Better-than-expected corporate results and economic-growth figures for the first quarter, generally peaceful national elections on May 10, and President Macapagal-Arroyo's subsequent election victory attracted bargain hunters to the stock market during the second quarter of the year and pushed up the Phisix to an end-June close of 1,579.40 — higher by 10.9% from end-March 2004 and by 9.5% from end-December 2003. Stocks range-traded in July and most of August in the absence of fresh positive news and a pronouncement by President Macapagal-Arroyo that the Philippines was in the midst of a fiscal crisis. However, the Phisix began to ascend on still favorable April-June corporate-perfor-



mance results and economic-growth data; the unveiling of a more concrete fiscal-reform package; and Government efforts to temper domestic interest-rate increases. The Phisix closed September at 1,761.6, up another 11.5% quarter-on-quarter. By October 4, the Phisix had closed at 1,851.6 — the highest since February 21, 2000. Stock prices have since tapered on bargain-hunting, more serious worries over the economic impact of soaring fuel prices and accelerating inflation, and threats of credit-rating downgrades absent near-term Congressional passage of new revenue measures. The Phisix ended October at 1,819.03, up 26.1% from the end of 2003.

President Macapagal-Arroyo signed into law two bills that she had certified as urgent before the previous 12th Congress to help spur the development of the Philippine capital market. She signed R.A. 9243 in February 2004, which rationalizes the Philippines' convoluted documentary stamp tax (DST) system and exempts secondary-market financial transactions to spur the development of a secondary trading market and make long-term bonds attractive to more investors. This measure enhances the success of the first fixed-income bond exchange that the private sector Bankers Association of the Philippines hopes to launch during 2005. In April 2004, the President also signed the Securitization Act into law, which establishes a framework for the issuance of a wide range of asset-backed securities (i.e., securities issued against future revenue streams).

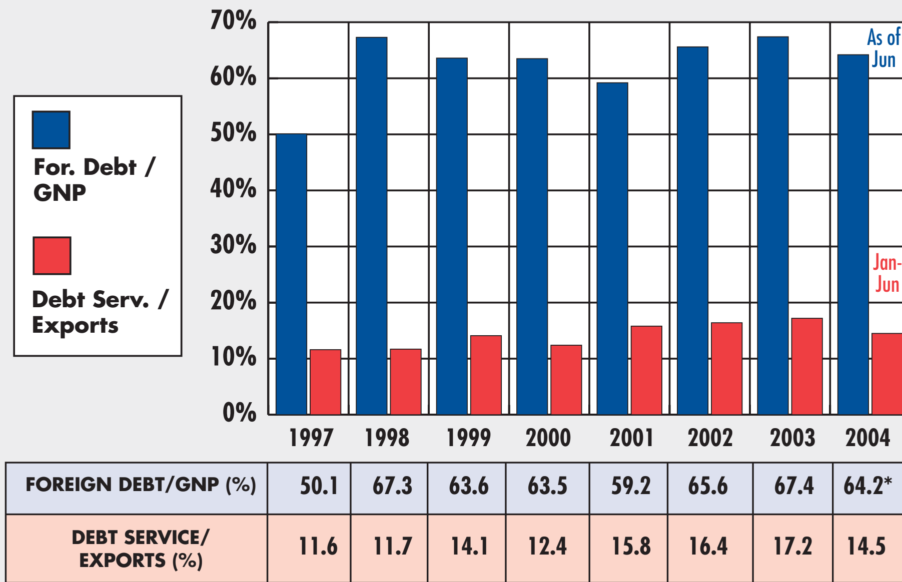
Fiscal Performance

President Gloria Macapagal-Arroyo singled out the public sector's precarious fiscal condition and high debt level as the most pressing challenges facing her Administration. Soon after receiving a fresh electoral mandate, the President laid out her Administration's medium-term fiscal objectives:

- Wipe out the National Government deficit by 2009/2010;
- Reduce the deficit of the consolidated public sector (which, in addition to the National Government, includes government-controlled corporations, local government units, the Central Bank, and state-run social security agencies) from 6.6% of GDP (2004 estimate) to 3% of GDP over that same period; and
- Bring down the ratio of the consolidated public sector debt to GDP from 138% (2003) to 90%.

The National Government succeeded in reducing its fiscal deficit to P199.9 billion (4.6% of GDP) during 2003, from 2002's record P210.7-billion (5.3% of GDP) level. It also managed to prevent further erosion in the tax-to-GDP ratio, which had slipped successively from a peak rate of 17% in 1997 to 12.5% by the end of 2002. The goal for 2004 is to reduce the National Government's fiscal gap to P197.8 billion (4.2% of GDP). The Government is on track thus far to achieving that goal. The fiscal deficit stood at P141.9 billion as of September 2003, slightly below the programmed nine-month ceiling of P143.3 billion. Revenues (P516.4 billion) increased by 13.1% (P22 billion) year-on-year and surpassed the Government's January-September target by 3.1% (P15.4 billion), mainly because of better-than-expected returns on Treasury investments.

Combined nine-month tax collections by the Bureau of Internal Revenue (BIR) and Bureau of Customs (BOC) expanded by 11.9% (P46.3 billion) from 2003 and modestly exceeded the Government's P433.2 billion nine-month goal, with the BOC offsetting lower-than-programmed BIR collections. Although much remains to be done to boost meager resources, the expansion in total tax collections thus far represents an improvement from 8.5% growth during 2003 and a mere 1.5% expansion dur-



	1997	1998	1999	2000	2001	2002	2003	2004
FOREIGN DEBT/GNP (%)	50.1	67.3	63.6	63.5	59.2	65.6	67.4	64.2*
DEBT SERVICE/ EXPORTS (%)	11.6	11.7	14.1	12.4	15.8	16.4	17.2	14.5

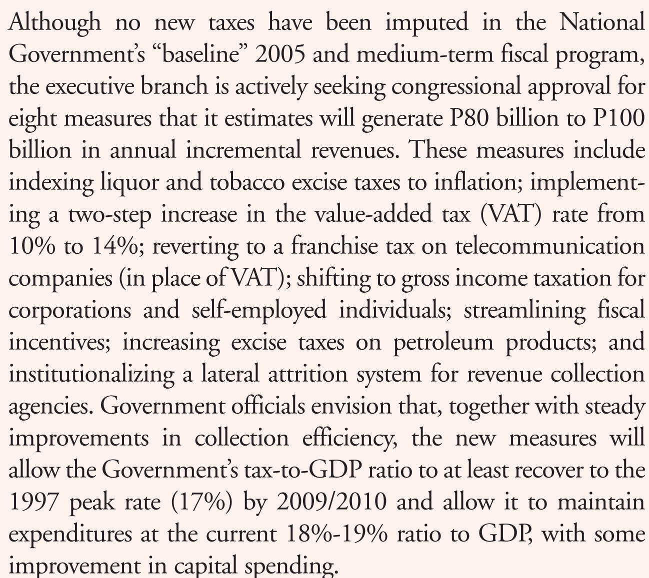
*As of June 2004. For compatibility with annual data, ratio estimated using full-year GNP as denominator (computed as the sum of actual first-semester 2004 GNP and actual second-semester 2003 GNP).

ing 2002. The BIR (which accounts for 80% of National Government tax revenue) collected 10.5% (P32.7 billion) more year-on-year and met its third-quarter 2004 collection target; however, cumulative nine-month internal revenue collections missed the targeted mark by 1.6% (P5.5 billion) because of collection shortfalls during the first half of the year. Nine-month expenditures (P658.3 billion) exceeded the programmed level by 2.2% (P14 billion) as the Government took advantage of better-than-expected revenue inflows to make larger disbursements for infrastructure outlays, including settlement of accounts payable.

In 2005, the National Government intends to further reduce its budget gap to P184.5 billion (3.6% of GDP). On August 25, 2004 President Macapagal-Arroyo submitted a P907.6-billion obligation budget for congressional approval. The proposed budget represents a modest 5.4% nominal increase from 2004 but translates to zero growth after inflation and to negative growth in real per capita terms based on an annual 2.36% population growth rate. A more detailed breakdown indicates that the proposed 2005 expenditure plan is even more austere than it appears. “Non-discretionary” items — i.e., the sum of personnel costs, legally mandated transfers to local government units, and debt service payments — will take up about 82% of the budget. Debt service alone is projected to expand by 11.1%, increasing its share from 31.5% (2004) to 33.2% (2005) — overtaking personnel-related expenditures for the first time in the Government’s fiscal history. The significant chunk of the budget consumed by debt service reflects a history of persistent fiscal deficits, rapid debt accumulation, and the impact of the peso’s depreciation on foreign-denominated loan obligations.

As in the past, “discretionary” items essential for economic development are being squeezed in the austere 2005 budget proposal. It allots P56.5 billion (about $1 billion) for infrastructure which, while up 10% year-on-year, does not make up for the 15.3% slump in infrastructure spending during 2004 and still only equals barely 1.5% of Philippine GDP. Foreign and domestic investors, as well as senior Government officials, frequently cite inadequate and poorly maintained infrastructure as a major impediment to doing business in the Philippines. Other figures further illustrate the challenge of juggling extremely limited resources among competing needs. The large share of the budget gobbled up by debt service outlays will allow zero to modest nominal growth rates for spending on other important sectors (such as agriculture, education, health, social security and employment, defense, transport and communications) that will not keep pace with inflation and population growth. Considering the limited leeway available, lower-than-programmed revenues and/or unexpected upward movements in interest rates could constrain the delivery of basic services and infrastructure support even further; or, many analysts here warn, imperil the Government’s deficit-reduction plan.

Reflecting legal victories in the Philippine and Swiss courts after more than a decade of legal wrangling, the Government finally gained control during the first quarter of 2004 over an estimated $650 million (P36.4 billion) of Marcos-family wealth. The Government has already factored P14.8 billion of the recovered amount into the 2004 budget (helping push up non-tax revenues) and another P9.7 billion into the 2005 budget proposal. However, like the much hailed privatization program of the mid-1980s to early 1990s, non-recurring revenue windfalls will not ensure long-term fiscal viability. The Government will need to make sustained, aggressive efforts to improve tax administration, correct structural deficiencies in the tax system, broaden the tax base, and combat corruption. These will be crucial for a viable deficit-reduction program conducive to sustainable long-term growth, global competitiveness, and poverty alleviation.



Although no new taxes have been imputed in the National Government's "baseline" 2005 and medium-term fiscal program, the executive branch is actively seeking congressional approval for eight measures that it estimates will generate P80 billion to P100 billion in annual incremental revenues. These measures include indexing liquor and tobacco excise taxes to inflation; implementing a two-step increase in the value-added tax (VAT) rate from 10% to 14%; reverting to a franchise tax on telecommunication companies (in place of VAT); shifting to gross income taxation for corporations and self-employed individuals; streamlining fiscal incentives; increasing excise taxes on petroleum products; and institutionalizing a lateral attrition system for revenue collection agencies. Government officials envision that, together with steady improvements in collection efficiency, the new measures will allow the Government's tax-to-GDP ratio to at least recover to the 1997 peak rate (17%) by 2009/2010 and allow it to maintain expenditures at the current 18%-19% ratio to GDP, with some improvement in capital spending.

On the expenditure front, President Macapagal-Arroyo has issued executive orders for government agencies to adopt fiscal austerity measures and to conduct a strategic review of their operations. She is also seeking legislative support for, among others, a proposed Fiscal Responsibility Act to prevent the enactment of new expenditures without accompanying revenue measures; an Omnibus Re-Engineering Act to authorize a major reorganization/rationalization of the bureaucracy; and legislation limiting or scrapping automatic loan guarantees for Government corporations.

The President and her economic team have stressed on several occasions that boosting revenues will be especially critical as the National Government braces itself to begin absorbing, by the end of the year, over a third of the $10.5 billion debts to date of the financially saddled National Power Corporation (NPC). Otherwise, they warned that the additional debt-service burden from the debt assumption would exert further pressure on the National Government's already bare-bones medium-term budget plan and put at risk the National Government's goal to wipe out the fiscal deficit by the end of President Macapagal-Arroyo's term.

Fiscal planners expect larger deficits of government firms — especially the National Power Corporation — to widen the deficit of the consolidated public sector from P234.9 billion (5.5% of GDP) in 2003 to P307.8 billion (6.6% of GDP) in 2004. This large consolidated deficit demonstrates the urgency of moving forward aggressively with the restructuring of the electric sector and the privatization of NPC under the provisions of the Electric Power Industry Reform Act. NPC accounts for about 65% of the combined deficit of non-financial government firms and of the P760.1 billion ($13.5 billion) of total public sector debts guaranteed by the National Government. The Government regularly has had to advance debt-service payments for NPC and, over the past several years, to borrow more aggressively in behalf of the cash-strapped firm to obtain cheaper rates. (See special feature on "The Philippine Power Sector: Where Is It Headed?") The Government faces another important challenge in addressing threats to the longer-term viability of state-run pension funds arising from imbalances between contributions received and benefits paid.

Contingent liabilities (i.e., government-guaranteed loans and performance undertakings under Build-Operate-Transfer and similar arrangements) are a growing concern. Problems have already begun to emerge in this area, in some cases because the Government has bowed to public pressure against service-fee adjustments, aggravating the National Government's already substantial fiscal burden. The risks posed by contingent obligations underscores the urgency of inventorying Build-Operate-Transfer Projects, quantifying potential risks arising from Government commitments, and developing an early-warning mechanism to detect problem areas. The Government is also considering possible contingent-debt management measures, including a budget ceiling for new contingent obligations and a buffer fund to meet contingent liabilities.

In late January 2004, Moody's Investors Service downgraded its sovereign-credit ratings for Philippine long-term foreign and local currency debt by a notch, mainly on election-related worries. That action followed earlier downgrades by Standard & Poor's in April 2003 and Fitch in June 2003. In July 2004, Standard & Poor's downgraded its sovereign credit rating for long-term local currency debt by another notch, noting potential risks posed by upward interest rate pressures on the Government's already limited fiscal flexibility. Standard & Poor's maintained its long-term foreign currency rating, noting the Philippines' satisfactory external liquidity position and the continued support provided by overseas workers' remittances. Credit-rating agencies have recently warned that the Philippines faces further sovereign-rating downgrades if the Government fails to pass meaningful revenue-raising measures over the next few months. Combined with further possible increases in benchmark foreign interest rates (reflecting expectations of further U.S. monetary tightening), credit-rating downgrades will widen the already high spreads for Government debt papers and further push up financing costs.

President Macapagal-Arroyo and her top economic advisers recognize, and have repeatedly articulated, the utmost urgency of addressing the fiscal sector's precarious fiscal and debt situation. To marshal support for her Administration's revenue-raising measures, the President has gone as far as saying that the Philippines is already in the midst of a fiscal crisis. Top economists here have also strongly warned of the Philippines' extremely limited fiscal leeway to muddle through another round of severe external or domestic shocks without more dire consequences for the general economy.

New and/or higher taxes continue to face resistance from vested interests and public disenchantment over waste, corruption, and languishing cases against "big fish" tax evaders. As this edition of the *Philippine Economic Outlook* went to print, the House of Representatives had passed a diluted excise tax bill for tobacco and liquor products. If carried by the Senate, the approved bill would increase excise taxes by 20% during the first year and by another 3% for each of the two succeeding years — with no provisions for

The Philippines faces many challenges in ensuring a secure, environment-friendly and reasonably priced electricity supply. At present, coal-fired (27%) and natural gas (25%) power plants are the foremost sources of total installed capacity, while geothermal (19%), hydro (15%) and oil-based (14%) plants produce the remainder. The Government is placing an increased emphasis on the development and utilization of cleaner energy sources, including wind and solar power to ensure self-sufficiency and security. The country hopes to double its renewable energy-based capacity in the next ten years. The first on-grid wind farm with an expected output of 20 megawatts will be switched on by December 2004. Other wind-powered systems are being developed in Negros and Northern Luzon. Off-grid solar power systems provide electricity to many households and villages in Mindanao and throughout the Visayas. A larger on-grid system is under consideration for Palawan.

Through the landmark Electric Power Industry Reform Act (EPIRA) of 2001, the Government has taken important steps to restructure the power sector. Many key reforms still need to be implemented, however, especially in the privatization of the National Power Corporation's (NPC) transmission and generation assets.

The privatization of generation assets is moving along slowly. Although the Government hopes to sell 70% of NPC's power capacity by end-2005, it is following a stepladder approach to privatization, off-loading small generation facilities first before moving on to the larger power plants. At present, only four small plants with a combined 7.3 megawatts have been sold. The Government will tender the first large power plant, the 600-megawatt coal-fired Masinloc plant north of Manila, before end-2004.

The Government is still determining the best mechanism for selling off NPC's transmission assets. After two rounds of competitive bidding failed to attract the requisite number of offers, the Government opened direct discussions with interested parties for a negotiated award. When these offers proved difficult to compare, the Government decided to hold a third round of bidding before end-2004, and expected to award the concession by early 2005. The Government will seek Congressional passage of the Transco franchise bill after the concession is awarded.

The huge debts of the NPC continue to soar, adversely affecting the country's already shaky fiscal condition. NPC's debt is estimated at $10.5 billion; its total liabilities are estimated at $25 billion. The NPC continues to rely on National Government borrowings to meet its ballooning obligations. President Arroyo ordered the National Government to assume one-third of NPC's debt ($3.55 billion) beginning in late 2004 to encourage investor interest, with the remaining two-thirds of NPC's debt financed by privatization proceeds.

The Government has achieved some success in establishing an efficient and independent regulatory system to encourage private sector investment and ensure fair and open competition. Recent rulings by the Energy Regulatory Commission (ERC) unbundled rates for 132 out of the 140 distribution utilities, removed two-thirds of intra-grid cross subsidies at the wholesale level, eliminated interclass subsidies on 80 utilities, and adopted time-of-use rates for electricity consumption. Investors welcomed the ERC's decision to lift the 40-centavo cap on purchase power and increase NPC's generation rates to reflect market costs. Concerns remain that judicial intervention could undermine these decisions. To reassure industrial customers and investors, the ERC issued new guidelines on the mechanisms for recovering costs attributed to systems loss and power generation. The ERC also issued a "Magna Carta" to ensure that the rights of residential consumers are protected.

The Philippine Government targets initial implementation of open access and retail competition by June 2006 in the Luzon Grid. This target is contingent on getting the Wholesale Electricity Spot Market in operation, unbundling transmission and distribution wheeling charges, removing cross subsidies, and privatizing at least 70% of the NPC's generating capacity.

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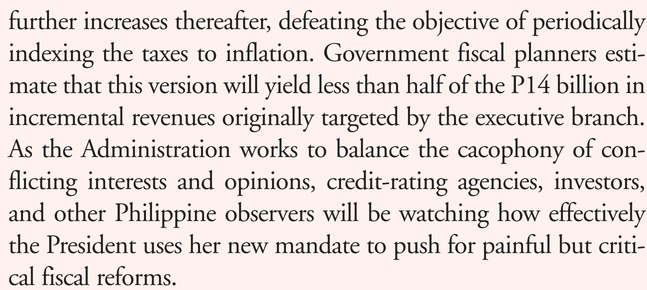


further increases thereafter, defeating the objective of periodically indexing the taxes to inflation. Government fiscal planners estimate that this version will yield less than half of the P14 billion in incremental revenues originally targeted by the executive branch. As the Administration works to balance the cacophony of conflicting interests and opinions, credit-rating agencies, investors, and other Philippine observers will be watching how effectively the President uses her new mandate to push for painful but critical fiscal reforms.

Foreign Debt and Debt Service

The National Government's target is to raise $1.9 billion from external sources during 2004, after having borrowed $4.4 billion during 2003. That amount represents 20% of the total domestic and foreign borrowing plan for the year, down from the more than 40% share during 2002 and 2003. The heavier reliance on domestic debt reflects growing concerns over foreign exchange and interest rate risks posed by the nearly 50% share of foreign loans in the National Government's debt portfolio. Foreign commercial borrowings make up $1.4 billion (74%) of the 2004 foreign financing program and official development assistance (ODA) loans for the $500 million (36%) balance. Of the targeted commercial borrowings, $850 million would go to completing the $1.9 billion commercial loans required to finance the 2004 budget (over $1 billion of which the Government prefunded during 2003) and the remaining $550 million to prefunding the 2005 budget.

By April 2004, the National Government had raised the remaining $850 million needed from international bond markets to fully finance 2004 budgetary requirements. This reflected efforts to complete external commercial funding for the 2004 budget ahead of the June national elections to temper political risk premiums. By the end of September, the National Government had raised another $250 million from international bond markets to pre-fund the 2005 budget, bringing its total nine-month foreign commercial borrowings to $1.1 billion (79% of the full-year program). The Government tapped $420 million of ODA from multilateral and bilateral donors during the first nine months of 2004, 76% of the Government's full-year ODA financing goal. In addition to its own budget financing needs, the Government also raised $1.4 billion from voluntary capital markets during the first nine months of the year in behalf of the National Power Corporation to obtain more affordable rates for the cash-strapped firm.

During 2005, the National Government plans to raise $2.2 billion from external sources, representing 22% of the Government's total borrowing program for that year. It hopes to tap 46% ($690 million) of that amount from multilateral and bilateral lenders and to raise 54% ($1.5 billion) from international commercial markets.

According to the most recent quarterly estimates, 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 $56.3 billion as of June 2004. That level represented a 0.7% ($0.4 billion) increase year-on-year but a 1.7% ($1.1 billion) decline from the end of 2003. The decline from end-2004 mainly reflected statistical improvements in capturing residents' holdings of Philippine debt papers booked under commercial banks' Trust Departments. Starting this year, the BSP has excluded these holdings from its estimation of the external debt stock, consistent with the international norm that includes only debts owed to non-residents. To a lesser extent, revaluation adjustments arising from the weakening of third-country currencies (particularly the yen) relative to the US$ also contributed to the decline in the Philippines' foreign debt from end-2003. These factors more than offset the $1.7 billion in six-month net inflows (i.e., borrowings less repayments) from external financing transactions.

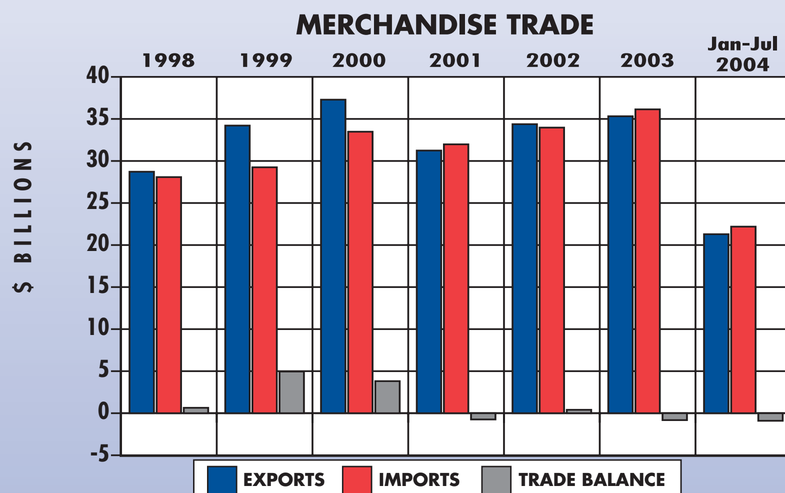
The public sector owed two-thirds of the Philippines' outstanding external liabilities as of June 2004. Medium- to long-term (MLT) accounts made up more than 88% of the Philippines' total foreign debt portfolio. The MLT loans had an average weighted maturity of 17 years, with public sector loans averaging more than 19 years and private sector loans more than 11 years. By type of creditor, 44.3% of external obligations as of June 2004 were owed to official lenders (defined as multilateral financial institutions, and foreign governments and their export credit agencies) at generally more concessional terms. Bondholders accounted for 26.7%, banks and financial institutions for 21.2%, and other creditors (mainly suppliers) for 7.8% of the country's external debt stock.

The share of debt owed to official lenders has been declining over the years, from 55.3% as of end-1996 (just before the onset of the Asian crisis) to 44.3% as of end-June 2004. Conversely, the cumulative share of commercial creditors to the foreign debt stock has risen, from 44.7% to 55.7% over that same period. The declining share of official development assistance (ODA) reflects 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 stability and stable sovereign credit ratings. The National Government's most recent $1 billion foreign bond issue in September, maturing in 2015 and 2025, carried spreads of 497 and 492 basis points, respectively, over U.S. Treasury benchmark yields.

The Philippines was one of 70 candidate countries competing for Fiscal-Year 2005 funding from the United States' Millennium Challenge Account (MCA). It did not make it to the list of 16 countries selected by the Millennium Challenge Corporation (MCC) as eligible for FY 2005 funding under the MCA. However, the MCC included the Philippines as one of 12 eligible countries under the "Threshold Program" (i.e., countries that

do not qualify for MCA assistance but have demonstrated a commitment to meeting eligibility requirements in the future). As a threshold country, the Philippines will be invited to submit proposals for funding to improve its performance on the MCC selection criteria, which the MCC will evaluate in coordination with USAID.

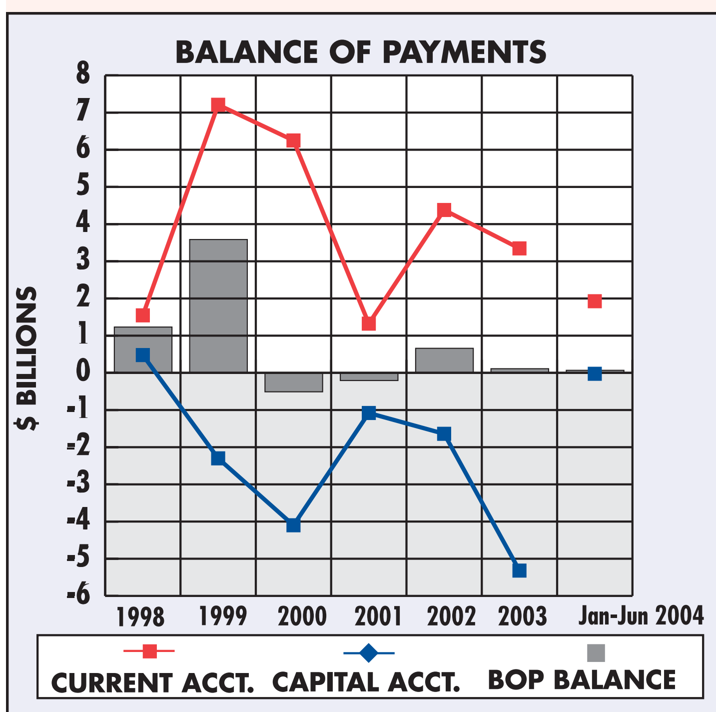
The ratio of foreign debt to GDP has risen to more than 70% from just over 50% in the mid-1990s as debt accumulation, particularly by the public sector, outpaced the expansion in nominal economic output. However, the Philippines' foreign debt service burden — measured as the ratio of debt service payments to export, services, and income receipts — remains manageable, reflecting the bias for medium- to long-term loans and the substantial share of official borrowings. Still, it is worth noting that the debt service ratio has risen to between 16% and 17% in recent years, from under 12% in the mid-1990s. These developments suggest vulnerabilities to unexpected reversals in export markets, highlighting the importance of addressing the weak state of government revenues and attracting more sustainable, non-debt sources of balance of payments financing.



	1998	1999	2000	2001	2002	2003	Jan-Jul 2004
EXPORTS	24.609	28.726	34.211	37.295	34.376	35.319	21.290
IMPORTS	34.439	28.082	29.252	33.481	33.970	36.140	22.190
TRADE SURP/ DEFICIT	-9.830	0.644	4.959	3.814	0.406	-0.821	-0.900

Merchandise Trade and Balance of Payments

Detailed balance of payments statistics through June 2004 showed a modest surplus of $68 million — a reversal from January-June 2003's $609 million deficit. The six-month current account surplus more than doubled from $782 million to $1.9 billion, while the capital and financial account deficit shrank to $256 million (less than one-tenth of 2003's comparable first semester level).



In the current account, both trade-in-goods and trade-in-services deficits narrowed from 2003. First-semester 2004 merchandise exports expanded by 8.4% clip year-on-year after expanding by barely 3.3% during the first half of 2003. On the other hand, the first-semester merchandise import bill expanded by a slower pace (5.4%) after rising by 11.2% during 2003's comparable period. The year-on-year import slowdown partly reflected unusually high import demand during the first quarter of 2003, during which the import bill expanded by over 24% as declining inventories and uncertainties over the Iraq conflict prompted importers to stockpile raw materials and petroleum products. The cumulative six-month import bill for oil and petroleum products increased by 12.4% from the first half of 2003 and contributed 18.1% of the overall year-on-year expansion in imports. As a result, first quarter 2004 payments for oil and petroleum products contracted by 2.6% from the heavy first-quarter 2003 inventory build-up. However, sharp increases in world market prices and higher import volumes drove up second-quarter 2004 payments for oil and fuel purchases by 29% year-on-year, which accounted for over a third of the total import expansion from 2003's second quarter.

Shipments of machinery and transport equipment (up 27.7% or $911 million) and electronic products (up 7.8% or $678 million) mainly drove the first-semester expansion of merchandise exports and contributed more than 70% to export revenues. By destination, Philippine exports to Asia, including Japan, increased by 13.6% ($1.3 billion) and to Europe by 16.2% ($500 million) — more than offsetting the 11% ($420

million) decline to North American countries (mainly the U.S.). Exports to Japan expanded by 34% ($900 million) and to other major Asian markets (i.e., Hong Kong, Singapore, Taiwan, Malaysia, Mainland China, South Korea, and Thailand) by nearly 6% ($420 million). Non-Japan Asian economies contributed more than 40% to export revenues (up from less than 20% in the early 1990s). Export receipts from the U.S. declined by 12% ($440 million) from the first half of 2003, according to Philippine Government statistics. Although expanding at a faster pace than the 2.7% growth rate posted during the 2003 full year, the Philippines' first-semester export performance has trailed the robust two-digit growth rates posted by neighboring Southeast Asian economies such as Thailand (22.4%), Malaysia (19.8%), Singapore (23.9%), and Vietnam (20%); as well as other Asian countries such as China (35.7%) and South Korea (38.1%).

The six-month trade-in-services deficit narrowed from $812 million to $330 million mainly because net travel receipts increased by more than 37% ($368 million) and offset larger net outflows for transportation and insurance. Crediting the Government's intensified promotion efforts, the Department of Tourism reported that January-August tourist arrivals increased by 28% year-on-year, rebounding strongly from the 1.3% decline logged during the 2003 full-year. The income account posted a somewhat smaller $2.7 billion surplus vis-à-vis the first half of 2003 mainly because overseas Filipino workers' (OFW) remittances expanded more slowly, combining with higher outflows for dividend payments and branch profit remittances to non-residents. OFW remittances decelerated from 8% growth (2003) to 3.5% growth (2004), which Government officials attributed to year-on-year declines in April and May because of tighter anti-money laundering regulations implemented by Saudi Arabia (a major market for Philippine workers).

In the capital and financial account, both foreign direct and portfolio investments slipped year-on-year, reflecting uncertainties in the run-up to the June 2004 national elections and concerns over fiscal prospects. However, the capital and financial account deficit significantly narrowed from the first half of 2003 because the "other investments" account — which reversed from a $3.1 billion deficit to a $331 million surplus — compensated for the deterioration in direct and portfolio investments. This turnaround reflected larger short-term foreign loans and inter-bank borrowings by local banks; higher short-term trade credits for the private sector; and larger currency and deposit placements by non-residents in local financial institutions. Net foreign direct investments (FDI) slipped from an $86 million surplus to a $55 million deficit. Although FDI inflows increased to $338 million (from $193 million during the first half of 2003), these were more than offset by capital withdrawals, repayments of inter-company loans, and offshore investments by Philippine residents. Net foreign portfolio investments also reversed from a $223 million surplus to a $524 million deficit as larger net redemptions of foreign bonds offset a modest improvement in net inflows.

More recent, preliminary indicators suggest that the BOP surplus widened to roughly $150 million as of September 2004, helped in part by stronger exports, National Government borrowings, higher net inflows of foreign portfolio capital, and stronger workers' remittances during the third quarter. More recent statistics through August 2004 showed workers' remittances up by 9.4% from the first eight months of 2003, higher than the Government's 6% full-year forecast. OFW remittances are expected to surpass the $8 billion mark by the end of 2004. However, higher oil prices, maturing loan obligations, and the specter of credit-rating downgrades threaten to erode that slim margin and push the Philippine BOP to negative territory by the end of the year (from full-year 2003's BOP surplus of $111 million). Attracting higher levels of foreign direct and portfolio investments will be crucial during 2005 to compensate for BOP pressures resulting from continued high oil prices and the Government's continuing foreign-debt reduction efforts. Analysts estimate that the Philippines' current account will slide into a deficit in 2005 if the price of Dubai crude averages $45/barrel.

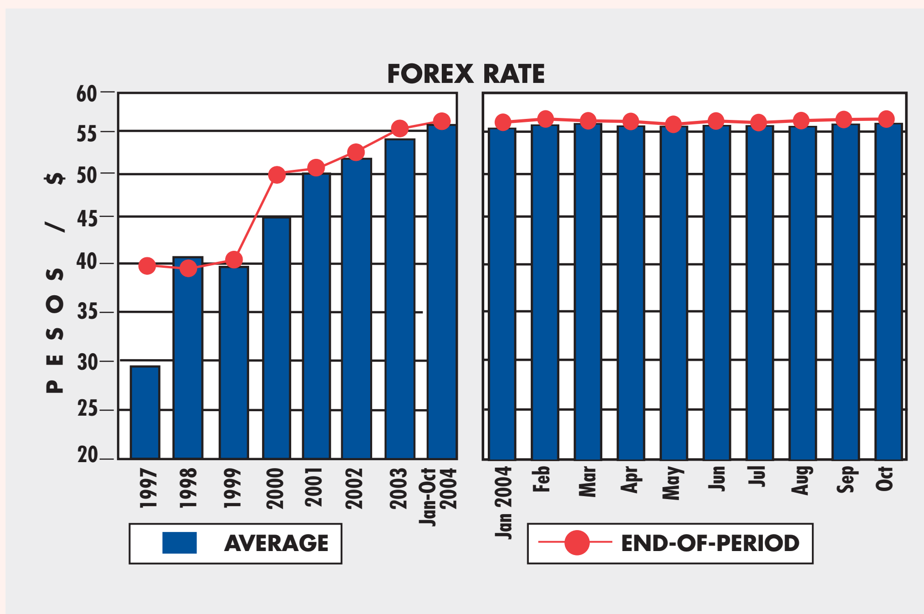
Beyond short-term prospects, longer-term BOP vulnerabilities remain. The Philippines historically has posted trade and current account surpluses during periods of economic weakness, reversing to deficits as economic expansion accelerates. Although improving, the country's major export products rely heavily on imported inputs. While trade liberalization presents vast opportunities, intensifying global competition and the emergence of low-wage export economies also pose challenges. Longer-term BOP stability likewise will depend heavily on the

Philippines' ability to compete for non-debt sources of foreign exchange as the Government works to avert heightened risks posed by the rapid debt build-up of previous years.

Foreign Exchange Rate and International Reserves

The peso averaged P56.00/$ during the first ten months of 2004, 3.8% weaker than 2003's comparable ten-month average of P53.96/$. However, the peso has been less volatile during the year and has traded thus far within a narrower 2.5% band of P55.06-P56.45/$ (versus 2003's 7.7% range of P51.88-P55.85/$).

The peso averaged P55.97/$ during the first quarter of 2004, reflecting weak balance of payments flows, Moody's credit-ratings downgrade, fiscal uncertainties, and political jitters in the run-up to the May elections. The peso hit a historic intra-day low of P56.45/$ on March 22. During the second quarter, the peso averaged a stronger P55.91/$ as BOP flows improved, fiscal uncertainties ebbed with Government efforts to meet deficit targets, and the foreign exchange market reacted positively to prospects of a Macapagal-Arroyo election victory. The peso strengthened further to a July-August average of P55.89/$ but began to flounder after President Macapagal-Arroyo, in an August 23 speech stressing the urgency of new revenue measures and fiscal reform, stated that the Philippines was already in the midst of a fiscal crisis. Renewed fiscal uncertainty, seasonally larger end-of-quarter payments for imports prior to the Christmas season, and increasingly expensive oil shipments pulled down the peso — which revisited its historic P56.45 intra-day low on September 27 and slipped to its weakest closing rate (P56.45) on October 13. The peso has since strengthened somewhat as import-related foreign exchange demand eased and Filipino overseas workers' remittances began to rise for the Christmas holidays. The local currency closed October at P56.325/$, down 1.5% (P0.83) from the end of 2003.



The BSP's gross international reserves (GIR) closed each of the months through October 2004 below the end of 2003's $16.9 billion cushion, which partly reflected the Government's conscious effort to significantly reduce foreign borrowings during the year. Although lower than at the end of 2003, the BSP's $15.9-billion international reserves as of end-October did not translate to a dramatic decline vis-à-vis the Philippines' ability to pay for its import requirements and to service short-term debt servicing obligations.

The end-October GIR level was equivalent to 4.3 months' worth of import cover (from 4.6 months of cover as of end-2003). It also equaled 142.7% of public and private sector debt falling due in the next 12 months (up from 136.8% as of October 2003 and 140% as of December 2003). However, reserves are expected to come under further pressure, with the BSP currently forecasting an end-2004 level closer to the $15-billion mark (less than four months of import requirements). Considered as "secondary reserves", the BSP estimated that banks' foreign currency deposit units (FCDUs) had $14.7 billion in deposits as of July 2004, up 13.1% year-on-year and 9.7% from the end of 2003. The bulk (95%) of FCDU deposits are from Philippine residents.

Challenges and Prospects

Shortly before her inauguration, President Macapagal-Arroyo outlined a ten-point agenda for economic growth that restated, among others, her commitment to balance the budget; create more jobs; improve public-school educational facilities; expand the delivery of basic services (specifically water and electricity); and decentralize progress around the nation through improved transportation, telecommunications, and infrastructure networks. These goals were repeated in her July 2004 State of the Nation Address (SONA) and further articulated in the Government's recently unveiled 2004-2010 Medium-Term Philippine Development Plan (MTDP).

In addition to balancing the National Government budget over the next six years, the MTDP "fighting targets" include increasing the GDP growth rate to 7%-8% by 2009/2010; hiking the investment-to-GDP ratio to 28% by 2010; and reducing poverty incidence to below 20% by 2009. GDP growth has averaged only 3.5% over the last fifteen years and the economy has had difficulty in sustaining economic growth of over 5%. The invest-

ment-to-GDP ratio (estimated at about 24% in the early 1990s) was barely 19% in 2003 — behind Asian neighbors such as Thailand (25.2%), Vietnam (35.1%), Malaysia (22%), as well as trade competitors such as China (44.4%) and South Korea (29.4%). The Government's latest poverty survey estimates that 28% of families and 34% of the Philippine population live below the poverty line.

The Government's goals are ambitious, especially in the light of severely constrained public sector resources, uncertainties over passage of new revenue measures, and a rapidly growing population. Achieving them will therefore hinge heavily on attracting higher levels of local and foreign private investments. Given the country's low domestic savings rate, the Philippines must work aggressively to attract foreign capital in a fiercely competitive global environment by addressing the worrisome slippage in its competitiveness ranking relative to its neighbors. In a September 2004 visit to the Philippines, members of the U.S.-ASEAN Business Council urged the Government to address precarious public sector finances, take a tougher stance against graft and corruption, and move forward with energy sector reforms to boost business confidence and lure investors.

The Government seems to have reinvigorated its anti-corruption drive. The Office of the Ombudsman reported improved conviction rates. In December 2003, the President issued an executive order creating the Revenue Integrity Protection System (RIPS), an anti-corruption watchdog in the Department of Finance that has worked closely with the Ombudsman to help curb corruption in revenue collection agencies. In her July 2004 SONA, the President articulated her desire to strengthen the Office of the Ombudsman to as efficient an agency as Hong Kong's Independent Commission Against Corruption, although the President's goal will require strong political will and significantly greater financial and human resources. Despite recent progress, the Philippines will have to do more to improve international perception of its anti-corruption drive. The Philippines' score in Transparency International's annual Corruption Perceptions Index survey has averaged 2.5-2.6 (out of a best score of 10) since 2002, down from 3.6 in 1999.

Over the years, the Philippines has demonstrated considerable resilience and prided itself as the least adversely affected Southeast Asian country during the Asian financial crisis. With its neighbors now rebounding strongly, the challenge for the Philippines is to compete effectively for trade and capital in a rapidly globalizing world economy. Historically low revenue collections and chronic budget deficits are the cause of many economic problems, including the inadequate infrastructure, the worrisome debt level, the overburdened educational system that has begun to erode English language skills, and the economy's "boom-and-bust" growth pattern. Although the Philippines has muddled through in the past, the current state of public finances has seriously impaired the Philippines' ability to withstand external and domestic shocks. Top economists here have strongly warned that the Government has, at most, two years to gets its fiscal house back on a more solid and sustainable track. Over the coming months, investors, credit-rating agencies, and other Philippine observers will gauge the Government's resolve to pursue broader economic reforms primarily on progress in the fiscal front.

PROJECTIONS FOR 2004-2005:
SELECTED INDICATORS

	2002 Actual	2003 Actual	2004 Forecasts *a/*	2005 Forecasts *a/*
GDP Growth (Year-on-Year, %)	4.4	4.7	5.3-5.8	4.5-5.2
GNP Growth (Year-on-Year, %)	4.5	5.6	5.4-5.9	4.7-5.5
Average Year-on-Year Inflation (1994=100, in %)	3.0	3.0	5.3-5.5	6.3-7.0
Average 91-day T-bill Rate (%)	5.43	6.03	7.3-7.6	8.5-9.0
Average Forex Rate (Pesos/US$)	51.60	54.20	56.05	57.00-57.25
Exports ($Billions)	34.4	35.3	38.4-38.8	41.7-42.7
Growth (Year-on-Year, %)	10.0	2.7	9.0-10.0	8.5-9.0
Imports ($Billions)	34.0	36.1	38.6-39.0	42.2-43.3
Growth (Year-on-Year, %)	6.2	6.4	7.0-8.0	9.0-11.0
Trade Balance ($Billions)	0.4	(0.8)	(0.2)	(0.5-0.6)

a/ Embassy projections as of November 2004

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

PHILIPPINES: KEY ECONOMIC INDICATORS

(In Million USD, unless otherwise noted)

	2002	2003	2004	
Domestic Economy				
Population (millions)	80.1	82.0	83.9	
Population growth (%)	2.36	2.36	2.36	
GDP (current) ***a/***	76,737	79,335	40,300	Jan-Jun
GNP (current) ***a/***	81,847	85,209	43,284	Jan-Jun
Per Capita GDP, current dollars ***a/***	958	968	480	Jan-Jun
Real Per Capital GDP (% change, yr.-on-yr.)	0.8	2.3	3.9	Jan-Jun
Real GDP (% change, yr.-on-yr.)	4.3	4.7	6.3	Jan-Jun
Real GNP (% change, yr.-on-yr.)	4.3	5.6	6.1	Jan-Jun
Consumer Price Index (ave. % change, yr.-on-yr. 1994=100)	3.0	3.0	5.1	Jan-Oct
Production, Employment, Fiscal Accounts				
Unemployment rate (%) ***b/***	11.4	11.4	12.1	Jan/Apr/Jul
Industrial prod. (1985=100), % change yr.-on-yr.	3.6	3.8	5.6	Jan-Jun
Nat'l gov't budget surplus/(deficit) ***a/***	(4,084)	(3,688)	(2,536)	Jan-Sep
as % of GDP	(5.3)	(4.6)	(4.1)	Jan-Sep
Consolidated public sector surplus/(deficit) ***a/***	(4,239)	(4,333)	—	
as % of GDP	(5.5)	(5.5)	—	
Interest Rates (%)				
Weighted average T-bill rate (all maturities)	6.0	6.7	8.0	Jan-Oct
Average prime loan rate	8.7	8.9	10.0	Jan-Oct
Balance of Payments				
Exports (FOB)	34,376	35,319	21,290	Jan-Jul
Growth (%, yr.-on-yr.)	10.0	2.7	7.7	Jan-Jul
Imports (FOB)	33,970	36,140	22,190	Jan-Jul
Growth (%, yr.-on-yr.)	6.2	6.4	5.2	Jan-Jul
Trade balance	406	(821)	(900)	Jan-Jul
Current account surplus (deficit)	4,383	3,347	1,926	Jan-Jun
as % of GNP	5.4	3.9	4.4	Jan-Jun
BOP surplus/(deficit)	663	111	68	Jan-Jun
Foreign Debt, as of end of period *c/*	53,645	57,395	56,331	Jun ***d/***
Debt service paid	7,445	7,967	3,529	Jan-Jun
Debt service (% of exports of goods and services)	16.4	17.2	14.5	Jan-Jun
BSP International Reserves, as of end of period	16,171	16,866	15,876	Oct
Exchange Rate (pesos/$)				
Average exchange rate	51.60	54.20	56.00	Jan-Oct
Closing exchange rate	53.30	55.50	56.33	Oct
Foreign Direct Investment (BSP registrations) *e/*				
Total (cumulative, since 1973)	15,099	16,587	17,142	as of Aug
U.S. (cumulative, since 1973)	3,300	3,525	3,550	as of Aug
U.S. share (%)	21.9	21.3	20.7	as of Aug
U.S.-Philippine Trade (Phil. Data)				
Philippine exports to U.S., FOB ***f/***	8,683	7,263	3,976	Jan-Jul
Growth (%, yr.-on-yr.)	(3.3)	(16.4)	(8.4)	Jan-Jul
Philippine imports from U.S., FOB ***f/***	7,286	7,400	3,963	Jan-Jul
Growth (%, yr.-on-yr.)	13.6	1.6	(11.6)	Jan-Jul
Philippine trade balance with U.S. ***f/***	1,397	(137)	13	Jan-Jul
U.S. share of Philippine imports (%)	20.6	19.7	17.0	Jan-Jul

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 and private sector loans not approved and/or registered by/with the BSP; ***d/*** 2004 data reflects refinements in segregating debt held by residents (which are excluded from foreign-debt estimates); ***e/*** principally exercised to enable foreign exchange purchases from the banking system for capital repatriation and profit remittances; ***f/*** differs significantly from USG data which estimated the Philippines' trade surplus with the U.S. at $3.7 billion in 2002, $2.1 billion in 2003, and $0.9 billion during January-July 2004.

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