PHILIPPINE QUARTERLY UPDATE

INVESTING IN INCLUSIVE GROWTH AMID GLOBAL UNCERTAINTY

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Preface

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

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

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Executive Summary

Despite heightened global economic uncertainty, the Philippine economy grew by 6.4 percent in the first quarter of 2012, a solid recovery from the relatively low 3.9 percent outturn for 2011. Higher growth was driven by a recovery in net exports and government spending, and robust private consumption. Meanwhile, low inflation rates, below 3 percent since February this year, have allowed the central bank to ease policy rates by 50 basis points to 4.0 percent. In addition, ample liquidity exists in the domestic market to finance both public and private sector investment. We project the economy to expand by 4.6 percent for 2012, with growth increasing to 5 percent in 2013.

However, the ongoing European debt crisis and the slowdown in China pose significant downside risks to growth. The main channels of contagion to the Philippines are direct exports and remittance linkages to Europe, and indirect impact through regional production networks centered on China. Relatively sound macroeconomic fundamentals (a current account surplus, high international reserves, robust domestic demand, and a healthy banking system) should help the country to withstand a severe deterioration in the global economic climate. Nevertheless, there remain vulnerabilities, which were evident at the end of last year when exports, particularly of electronic goods to advanced economies, sank, hurting manufacturing jobs. While remittances were resilient during the 2008/09 global crisis, inflows from Europe have started to contract and a decline in overall flows cannot be ruled out in case of a serious global downturn.

The challenge for policymakers is to cushion the economy from potential external shocks, while ensuring that the Philippines invests in inclusive growth. Efforts to increase the pace and efficiency of public spending seem to be paying off, as expenditures on maintenance and operating expenditures, infrastructure and social protection were ramped up, while improving efficiency. Government spending rose by 13 percent year-on-year through May, with revenue mobilization keeping pace due to improved tax administration and implementation of the Run After Tax Evaders program. Revenue collection is expected to further improve in 2013 due to additional, inflation-indexed, excise duties on alcohol and tobacco. However, further improvements in tax administration and tax policy reforms will be needed to allow the government to fund its priority spending targets for investments in human capital and public infrastructure, while ensuring fiscal sustainability and preparing for a prolonged global slowdown.

Political commitment and strong macroeconomic fundamentals provide a window of opportunity for investing in inclusive growth by accelerating the implementation of reforms that improve the business environment for firms of all sizes, and boosting public investment in key infrastructure. Faster human capital accumulation will enhance productivity and drive growth in the medium term by enabling the country to shift gears towards higher value-added activities and more innovation.

Recent Economic and Policy Developments

Output and Demand

1. **Globally, downside risks are significant and large, and near-term visibility remains low.**[1] Turbulence in global financial markets has increased following a brief respite in the first quarter when policy interventions in advanced economies helped to stave off the risks of disorderly default in the Euro zone. Although somewhat less vulnerable than other regions, the East Asia and Pacific region (EAP) remains exposed to headwinds from advanced economies through trade, financing and funding linkages, and to a slowdown in China through regional trade linkages. While the trend growth rates of advanced and emerging economies have decoupled over the past decade, cyclical correlations have grown even stronger. Given this, EAP, including the Philippines, is vulnerable to growth shocks in advanced economies. Over the near to medium term, EAP will likely contend with the new global reality: advanced economies are facing a period of prolonged deleveraging across three sectors simultaneously - the public sector, banking systems and consumers. Accordingly, the region, including the Philippines, needs to find new sources of growth through higher investment and resource mobilization.

2. **The Philippine economy grew by 6.4 percent in the first quarter of 2012** (1Q2012) year-on-year (y-o-y), following an outturn of 3.9 percent in 2011.[2] Growth last year had been pulled down by significant contractions in electronics exports and government spending.[3] This solid performance within the Southeast Asian region (Figure 1) was driven by rising net exports with further support from private consumption and government spending (Figure 2). Net exports rebounded very strongly, contributing 5.2 percentage points (ppt) to GDP growth, the highest in the last five quarters. The recovery in exports can be attributed to the improvement in demand from North American manufacturing firms[4] and the resolution of supply-side disruptions following the twin disasters in Japan and the flooding in Thailand. Negative import growth in recent months (mainly reflecting weak domestic investment) also helped boost net exports. Household consumption remained robust in 1Q2012, contributing 4.6 ppt, on the back of sustained inflows of remittances. Government spending (mainly on social protection and infrastructure) grew by 28 percent y-o-y, contributing 2.9 ppt to GDP growth.

3. **Overall investment was pulled down by a drawdown in inventories, while fixed investments recovered.** Total capital formation fell by 24 percent as a result of a 70 percent decline in the inventory stock. This pulled GDP growth down by 6.2 ppt. However, fixed

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[1] Key risks in the global economy include that in the Euro Zone, intensified adverse feedback loops between sovereign and bank funding pressures that could trigger larger protracted bank deleveraging and sizable contractions in credit and output; and slow progress in developing medium-term fiscal consolidation in advanced economies, including the US and Japan.

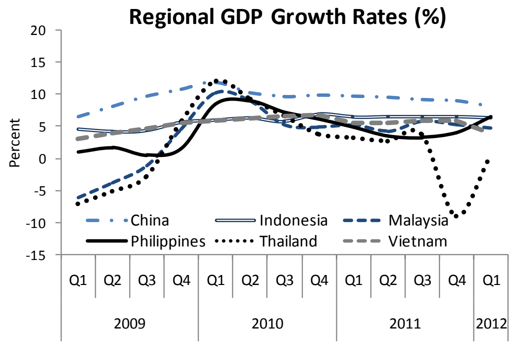
[2] The original target for 2011 was GDP growth of between 7 and 8 percent.

[3] As a result, the poor performance of last year has also helped boost this year's growth numbers.

[4] For instance, the April Book-to-Bill Report by SEMI reports that North American semiconductor industry posted a book-to-bill ratio of 1.10 in April (3-month average), compared with 0.98 in April, 2011 (3-month average), showing a sign of recovery in the industry.

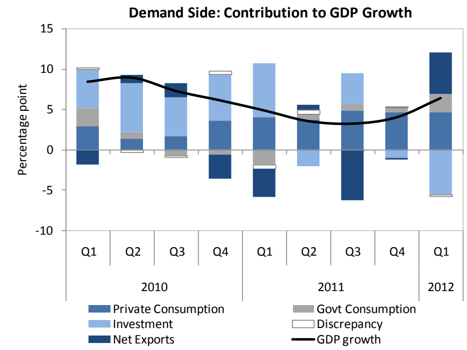
investment[5] continued to recover from its slowdown in 2011, growing by a modest 2.8 percent on the back of a 3.6 percent growth in durable equipment such as industrial machinery (Figure 3). Construction remained sluggish at around the 2011 level, growing negligibly by 0.3 percent. Private construction growth contracted for the third consecutive quarter, offsetting a 62 percent growth in public construction[6] which was driven by the acceleration of government disbursements.

Figure 1. The Philippine economy grew faster than its ASEAN[7] neighbors in 1Q2012.



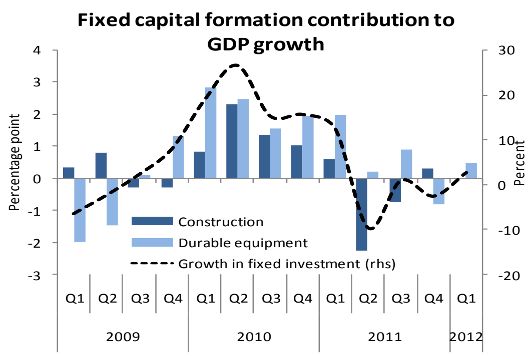
Source: Haver Analytics, Reuters

Figure 2. GDP growth has been buoyed by rising net exports, and government and private consumption.



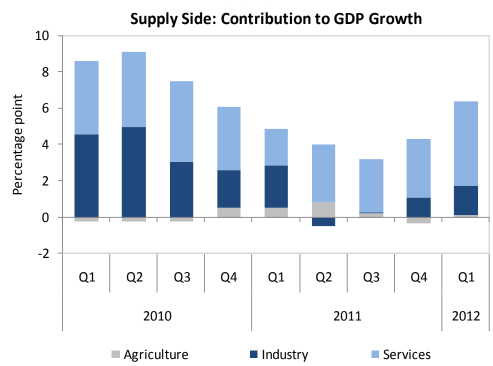
Source: National Statistical Coordination Board (NSCB)

Figure 3. Fixed investments remain low but are recovering



Source: NSCB

Figure 4. The service sector supports growth on the supply side



Source: NSCB

4. **On the supply side, the service sector continues to be the key driver of growth** (Figure 4). The real estate, renting and business activity subsector grew at around 8 percent, driven by strong demand from the fast growing business process outsourcing (BPO) industry. Manufacturing grew by 5.7 percent, and contributed 1.3 ppt to GDP growth. The revival in the manufacturing sector also raised demand for power, resulting in output growth in the utilities

[5] This excludes inventory and intellectual property products.

[6] Private construction accounts for some 7.2 percent of GDP while public construction for 2.4 percent of GDP in nominal terms.

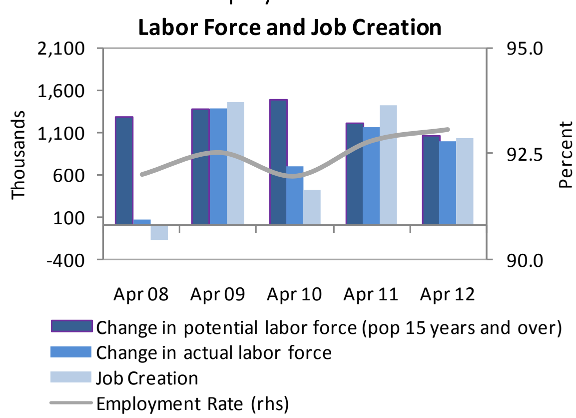
[7] This refers to the Association of Southeast Asian Nations comprising of Brunei, Cambodia, Indonesia, Laos, Malaysia, Philippines, Singapore, Thailand, and Vietnam.

sector by 8 percent (from a meager 0.6 percent in 2011). Typhoons in December continued to take their toll on agriculture which grew by 1 percent (Figure 4), considerably lower than the 4.4 percent expansion registered in 1Q2011. A modest 2 percent growth in crops and livestock was offset by the unabated decline in fish production since 2009. The latter reflects overfishing and the effects of fishing bans in parts of the Celebes Sea and Panatag Shoal.[8,9]

Employment and Poverty

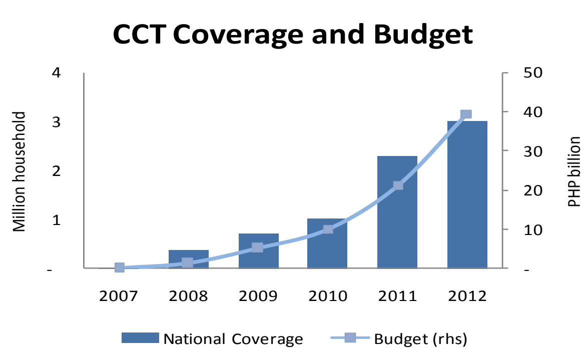
5. **Higher growth yielded modest employment gains, while youth unemployment and the shares of self-employed and unpaid family workers remain high.** Approximately 1 million jobs were created during April 2011 - April 2012, mostly in the service sector which accounted for some 587,000 of these new jobs, in particular, in BPO, hotels and restaurants, construction, and transport sectors.[10] Agriculture remains an important source of employment, creating 337,000 new jobs, even though its contribution to GDP growth is low. Underemployment remains high, with a small improvement of 0.1 ppt to 19.3 percent of the employed. Formal sector employment[11] is yet to show any significant improvement as it expanded only marginally to 55.5 percent in April from 55 percent last year. The shares of self-employed and unpaid family workers remain high, at 11 and 30 percent, respectively – or 422,000 out of the new jobs. The potential labor force (working age Filipinos) increased by the same amount as total new jobs - 1.1 million, while the unemployment rate eased to 6.9 percent in April from 7.2 percent last year (Figure 5). Half of the unemployed belong to the age group of 15-24 years.

Figure 5. More job creation and lower unemployment rate.[12]



Source: National Statistics Office (NSO)

Figure 6. Around 60 percent of the poor will benefit from the cash transfer program as it expands in scope and budget in 2012.



Source: General Appropriations Act (GAA) and Department of Social Welfare and Development (DSWD)

[8] Fishing bans on the Celebes Sea and Panatag Shoal are brought about by claims of ownership by Indonesia and China, respectively.
[9] Source: Bureau of Fisheries and Aquatic Resources
[10] The BPO sector alone generated some 200,000 new jobs in 2011.
[11] These are wage and salary workers.
[12] Potential labor force is also working age population.

Box1. Spatial Growth Disparity: An Update[1]

Spatial growth disparity remains high, suggesting the continued need for greater market integration through higher labor and capital mobility within the country. Metro Manila accounts for the largest share of GDP, generating around one-third of the national GDP over the last decade, and together with two surrounding regions (Central Luzon and Southern Tagalog) accounted for 55.4 percent of GDP. Not surprisingly, Metro Manila is also the richest region, followed by Cordillera. However, Cordillera's GDP per capita is only half of Metro Manila's. The Autonomous Region in Muslim Mindanao (ARMM) is the poorest region, with GDP per capita equivalent to only 10 percent of Metro Manila's. Relatively high levels of initial GDP per capita in Central Luzon and Southern Tagalog did not translate into higher growth over the past 13 years, due to low GDP and high population growth (Table B1.1). In per capita terms, SOCCSKSARGEN[2] and Northern Mindanao grew fastest at 4.3 and 4.2 percent per annum, respectively, during 1997-2009, associated with brisk expansion of the agriculture sector. While it appears that fast growing industries led to higher GDP growth in Western Visayas, Bicol and Cagayan Valley, this pattern was not seen in Davao. Stark gaps in income between regions may be caused by limited factor mobility and different returns to education, slowing down the process of inclusive growth.

Lagging regions need to be better integrated with leading ones through better connectivity (e.g., transportation) and improved social service delivery (e.g., education).[3] This will help induce more investments in lagging regions, leading to more inclusive and sustainable growth, while building better resilience to external shocks.

Table B1.1 Spatial growth disparity continues (percent)

Region	GDP per capita (1997=100)		Average annual GDP per capita growth (1997-2009)	Composition of GDP						Average population growth (1997-2009)
				Agriculture		Industry		Services		
	1997	2009		1997	2009	1997	2009	1997	2009	
PHILIPPINES	100	127	2.0	21	18	36	32	43	50	2.0
METRO MANILA	235	321	2.7	0	0	41	32	59	68	1.9
CORDILLERA	120	159	2.5	16	14	60	61	24	25	1.7
ILOCOS	55	70	2.1	43	37	17	17	40	46	1.3
CAGAYAN VALLEY	56	71	2.3	54	49	12	17	33	34	1.5
C. LUZON	90	94	0.4	22	24	44	35	34	41	2.2
S. TAGALOG	107	110	0.2	26	22	44	39	30	39	2.9
BICOL	47	64	2.7	37	30	22	28	41	42	1.5
W. VISAYAS	83	125	3.5	30	24	24	29	45	47	1.4
C. VISAYAS	90	123	2.7	14	10	32	29	54	61	1.8
E. VISAYAS	48	60	1.9	31	33	35	30	34	37	1.4
ZAMBOANGA	76	92	1.6	54	49	16	18	30	33	1.9
N. MINDANAO	87	139	4.2	28	32	34	30	39	38	2.1
DAVAO	123	123	0.4	39	24	21	34	40	41	2.0
SOCCSKSARGEN	65	101	4.3	33	42	40	32	26	27	2.5
ARMM	27	31	1.4	58	58	16	11	26	31	1.8
CARAGA	51	64	1.9	35	31	34	34	31	35	1.5

Source: NSCB, NSO and World Bank staff estimates.

1/ This updates Balisacan, Hill, and Piza (2008), "Spatial disparities and development policy in the Philippines." In *Reshaping Economic Geography in East Asia*, ed. Yukon Huang and Alessandro Magnoli Bocchi, World Bank. This section uses the revised and rebased GDP series.
2/ This region is located in Southern Mindanao and comprises four provinces: South Cotabato, Cotabato, Sultan Kudarat, Sarangani, and one city: General Santos City.
3/ For further discussion, see Balisacan et al (2008).

6. **Preliminary, new results from an Impact Evaluation (IE) analysis[13] indicate that the government's conditional cash transfer (CCT) program has been effective in improving the welfare of the poor in the short term.** CCT is the largest social protection program in the Philippines with a budget of PhP39 billion for 2012 (Figure 6). The program grants up to PhP1,400 (US$33) per month to the mother of each beneficiary household, conditional on her children's school attendance and regular visits to health clinics. Currently, 3 million out of the 5.2 million poor households (or 6.5 million children) benefit from the program. In areas where the program has been implemented, preliminary IE analysis finds higher expenditures in education and health, greater school enrollment and attendance, and increased health visits by pregnant women and children.

External Accounts

7. **Strong exports, sustained remittance inflows, and increased foreign direct investments led to a recovery in the balance of payments (BOP) in 1Q2012.** The balance of payments surplus had sharply fallen in 4Q2011 to 0.7 percent of GDP driven by a widening trade deficit and increased capital outflows brought about by heightened risk aversion in response to the prolonged Euro zone crisis. In 1Q2012, however, the BOP surplus improved to 2.2 percent of GDP as the trade deficit narrowed. Remittances and services exports (growing by 12 percent in 1Q2012, y-o-y, mainly from the expanding BPO sector and greater tourist arrivals[14]) continued to support the surplus. With portfolio and foreign direct investments (FDI) rebounding, the capital account also improved although the surplus remains lower than in 1Q2011 (Figure 7), reflecting heightened market risk aversion. FDI inflows doubled in 1Q2012, y-o-y. However, a total of US$850 million worth of FDI remains low compared to neighboring countries.

8. **Net exports rebounded strongly during January-April,** reflecting a recovery in demand for Philippine goods from North American manufacturing firms and negative growth in imports. Following a 32 percent decline in the second half of 2011, electronics exports (accounting for 52 percent of total exports[15]) grew by 0.5 percent y-o-y in the year to April, leading to a fall in domestic inventories. The bounce in electronics (mainly semiconductors) seems to be in response to inventory restocking in the US and a post-tsunami rebound in Japan. The surge in manufacturing net exports also reflected negative growth in imports, especially raw materials.[16,17] Export markets for the Philippines are highly concentrated on the US and

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[13] Chaudhury and Okamura, Conditional Cash Transfer and School Enrollment: Impact of the Conditional Cash Transfer Program in the Philippines, forthcoming August 2012; Impact of the Conditional Cash Transfer Program on Household Welfare in the Philippines: Findings from a Randomized Control Trial and Regression Discontinuity Study; Social Protection, East Asia and Pacific Region, World Bank; forthcoming December 2012.

[14] Tourist arrivals registered 1.15 million in 1Q, and 1.5 million through April.

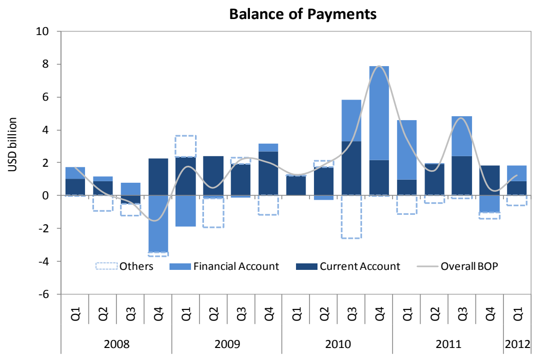
[15] The share of electronics exports used to be as high as 70 percent of total exports in pre-crisis 2007.

[16] Raw material and intermediate goods imports have posted negative growth since December last year.

[17] Analysis indicates that build-up of raw material inventories occurs three months ahead of their electronics exports.

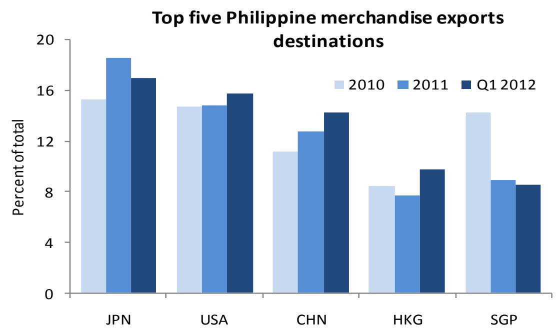
electronics assembly hubs (China,[18] Japan, and Singapore) (Figure 8). Exports to Thailand have recovered and are now at par with pre-flooding levels.[19]

Figure 7. BOP strengthened in 1Q2012, albeit lower than 1Q2011 in light of heightened Euro zone concerns.



Source: *Bangko Sentral ng Pilipinas* (BSP)

Figure 8. Philippine exports show increasing dependence on China.



Source: NSO

9. **Remittances in nominal dollar terms continued to expand, albeit below the average pace of 2011** – at around 5.4 percent in January-April (y-o-y) (Figure 9), reflecting the deteriorating conditions in host economies. In real peso terms, remittance growth remained flat, thanks to the depreciating peso and lower inflation. Remittances from Spain, Norway and Netherlands saw a sharp dip, but, owing to sustained inflows from Germany, Italy and the UK, the contraction of remittance inflows from Europe was limited to 6 percent (y-o-y). In spite of continued political turmoil in the Middle East region and the implementation of Saudi Arabia's moratorium on work permits for Filipinos (the *Nitaquat* program), remittances from this region expanded modestly by 5 percent (y-o-y). Despite the challenging external environment, worldwide deployment of Filipino workers continued to expand by an annual 17 percent or 1.3 million in 2011.

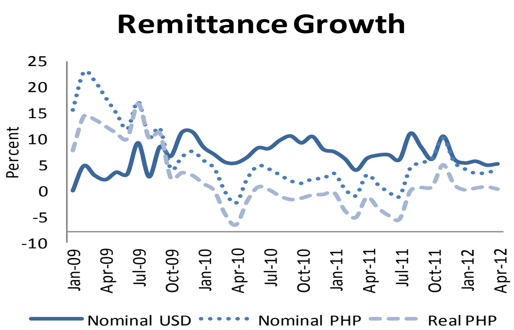
10. **Gross international reserves (GIR) remain at high levels, and exceeded the country's external debt in 1Q2012** (Figure 10). Reserve accumulation was supported by sustained inflows of remittances, exports and income from the *Bangko Sentral ng Pilipinas's* (BSP) investments abroad. GIR slightly declined to US$76 billion in May (from US$77 billion in January) due to the revaluation of the BSP's gold holdings, reflecting lower gold prices in the global market.

[18] Given that around 20 percent of Chinese exports (re-exports) make its way to the EU market and another 20 percent goes to the US, prolonged weakness in exports demand from US and EU hence will have secondary effects to the Philippines through this channel.

[19] The average monthly exports value to Thailand is at around US$180-200 million, but it dropped to US$100-120 million in the fourth quarter of 2011 as factories remained closed. However, its impact on Philippine exports was small as exports to Thailand account for only 4-5 percent of total exports, on average. For a more thorough discussion on the effects of the Thai and Japanese natural disasters on East Asia's manufacturing supply chain, see World Bank (2012), *EAP Regional Economic Update*, May.

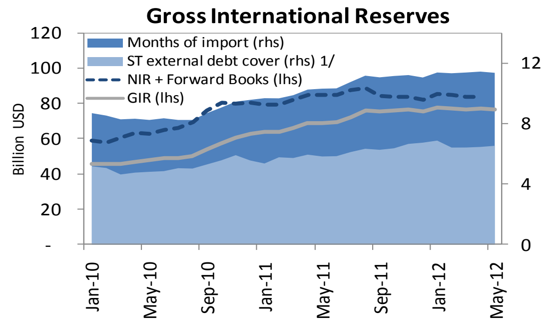
Nonetheless, GIR is 21 percent higher than the country's external debt which stood at US$63 billion in March 2012.[20] As of March 2012, it could cover 11.2 months worth of imports, or 630 percent of the country's short-term external debt based on residual maturity.

Figure 9. The Euro zone crisis takes its toll on remittances.



Source: BSP

Figure 10. Reserves remain at a healthy level.



Source: BSP

1/ Based on residual maturity

Financial Markets

11. **Domestic liquidity expanded by 5.6 percent in March (y-o-y), indicating ample liquidity in the domestic financial system to finance higher levels of investment, including the country's much needed infrastructure projects.** Short-term rates of Treasury bills fell below the policy rate in May, signaling a recovery in the economy.[21] Yet, uncertainty remains high given that the banking and sovereign debt crisis in the Euro zone has yet to be fully resolved and this has been reflected in the relatively flatter yield curve than end-2011 (Figure 11) and a recent uptick in Philippine sovereign spreads (Figure 12). Deposits in the central bank's special deposit accounts continue to expand, which is twice as large as the total required reserves of depository institutions[22] and grows faster than net domestic credit.

12. **The equity market reached new highs in 1Q2012, but has since fallen back as global volatility increased**. After stagnating in 4Q2011, the Philippine stock exchange index breached the 5,300 level in 1Q2012. It closed at 5,000 in mid-June after dipping to the 4,900 level (Figure B2.1). Net foreign buying was at its highest since the 2007 pre-crisis peak, amounting to PhP33 billion for the first half of the year, double the amount from the same period last year.[23] While

[20] According to the government's definition.

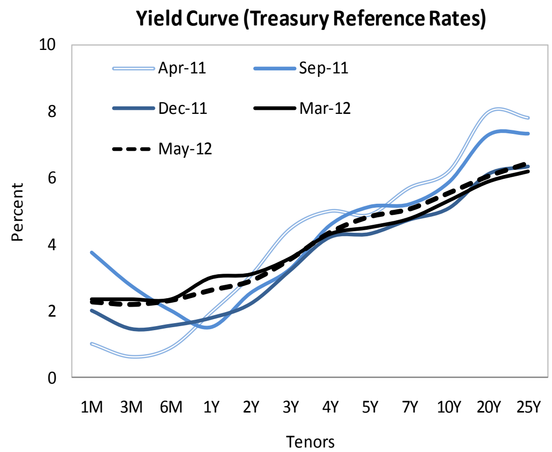
[21] The narrower the differences between short-term rates and the policy rate, the tighter the lending conditions. Thus, a steeper yield curve sends a signal of an economic expansion and a flatter one signals uncertainty in the economy.

[22] Filardo, Andrew and James Yetman, 2012, "The expansion of central bank balance sheets in emerging Asia: What are the risks," BIS, June.

[23] Net foreign buying for the first half of 2007, 2010, and 2011 are PhP68, 16.6 and 16.8 billion respectively. In 2008 and 2009, net foreign selling equivalent to PhP14.4 and 11.2 billion, respectively.

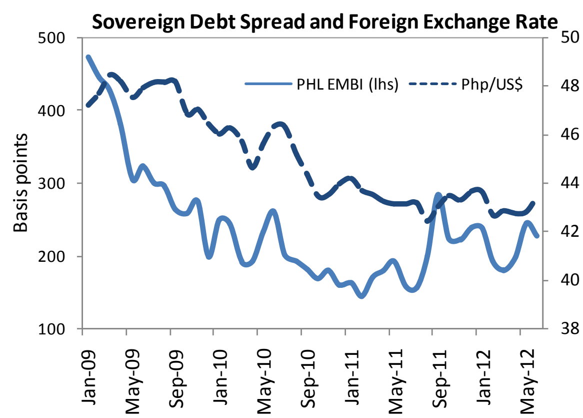
concerns over the Euro zone continue to put downward pressure on share prices in East Asian markets, the Philippines' low interest rate environment as well as positive earnings reports of publicly listed firms helped boost appetite for local stocks. The announcement of high first quarter growth in May also pushed up demand.

Figure 11. The flattening of the yield curve suggests that investors are becoming more cautious about the macroeconomic environment.



Source: Philippine Dealing and Exchange Commission

Figure 12. Sovereign spreads have increased slightly as global financial uncertainty has increased. The exchange rate however remains stable.

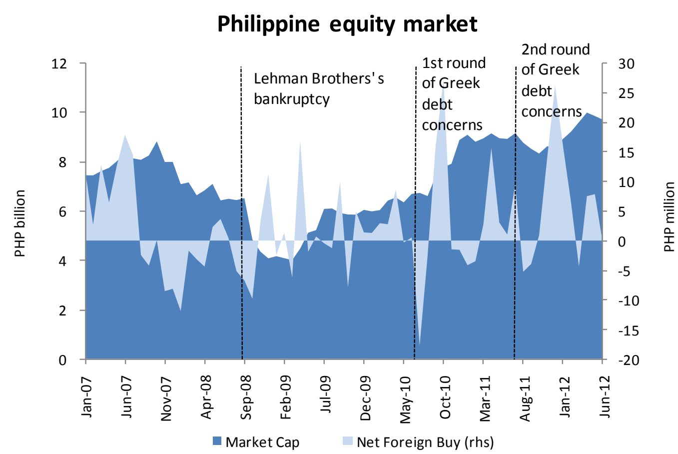


Source: BSP

Box 2. The Bullish Philippine Equity Market

In addition to higher earning differentials and the low interest-rate environment, strong interest in the mining sector has also helped to boost the stock market. Mining stocks led the Philippine stock exchange index to new heights in 2011. The mining sector withstood the 2008-09 collapse of global equities markets, growing by an average of around 90 percent, creating wealth amounting to PhP378 billion and leading the increase in market capitalization since 2008. This bullish sentiment is based on expectations of higher gold prices, which would encourage exploration and development.

Figure B2.1. Greater resiliency



Source: CEIC

Fiscal Policy

13. **The efforts of the government to improve the pace and efficiency of public spending are showing positive results.** Government spending through May was up by 13 percent compared to last year. The early release of some PhP1.2 trillion (or 70 percent of the 2012 budget) was facilitated by operational measures implemented earlier by the Department of Budget Management to address implementation bottlenecks and capacity constraints such as more efficient payment schedules with a regular monitoring of disbursement performance. Higher spending for the year was also registered in maintenance and other operating expenditures (MOOE), which expanded by 37 percent (y-o-y) to PhP97 billion from January through May. Infrastructure and capital outlays increased by almost 50 percent, reaching PhP107 billion as of May, with more efficient bidding, implementation and payment schemes in the Department of Public Works and Highways. Allotments to local government units declined by 5 percent this year, in line with the mandated Internal Revenue Allotment (IRA) for 2012.[24]

14. **Revenue collection grew at par with spending on account of improved tax administration**, resulting in an overall fiscal deficit of PhP22.8 billion[25] or 0.2 percent of GDP. The country registered a primary surplus of PhP108 billion from January through May this year. The tax effort improved in 1Q2012 to 12.5 percent of GDP, up from 11.8 percent in 1Q2011. Tax revenues grew by 12.3 percent and reached PhP566 billion for the period, pulled up by higher excise and sales tax collections which grew by almost 30 percent from last year. The excise tax reform bill was recently passed in the Lower House. Continued vigilance in tax collection and cracking down on tax evaders would further improve tax collections this year.

Box 3. Early Results of the DPWH Transformation Program

The Department of Public Works and Highways (DPWH) has initiated a *Transformation Program* to tighten project and budget management. The objectives of the program are to: (i) transform the organization and its employees, (ii) simplify or innovate systems to reduce corruption and improve efficiency, and (iii) optimize resources. The new policies that emerged from the program imposed greater rigor in project selection, including more detailed reviews of designs and cost. Albeit in the short run, this resulted in lower government spending in mid-2010 through 3Q2011 due to slower execution of projects and lower-than-projected actual project costs.[1]

Policies to streamline and tighten assessment procedures of projects are now resulting in higher spending as well as lower project execution costs. Stricter procedures on project identification, preparation, implementation, operation, maintenance, and evaluation, including the implementation of transparent and competitive biddings, resulted in lowering costs and

[24] IRA for the year is based on 3 years lagged national revenue collection. Tax collections fell in 2009 with the implementation of a reduction in corporate income tax to 30 from 35 percent.
[25] According to the government's definition.

generating savings equivalent to PhP6 billion in 2011 and an estimated PhP2.2 billion in early 2012.[2] As of March 2012, accelerated spending has now become headline news for the DPWH. Ninety three percent or 1,817 projects (out of the 1,949) that were bid out under the fiscal year 2012 program have now been issued notices to proceed. Moreover, about four-fifths of the programmed public infrastructure projects for the year have been implemented in 1Q2012.[3]

Sources:
DPWH (2010), Annual Report. *Right Project, Right Cost, Right Quality*.
Landingin, R. (2012). More Open Bids, Savings Up Amid Project Delays. *Philippine Center for Investigative Journalism.* Retrieved June 26, 2012, from http://pcij.org/stories/more-open-bids-savings-up-amid-project-delays.

1/ DPWH Secretary Singson disclosed in a Senate budget hearing that only PhP500 million out of the PhP90.9 billion infrastructure funds were spent in the first semester of 2011. The secretary said the department at that time sought to be more prudent in spending, ensuring that contracts with the right amount were awarded to deserving bidders.
2/ This has prompted the issuance of yet another guideline (DO 47, August 22, 2011) on the utilization of savings derived from projects implemented under FY 2011 General Appropriations Act.
3/Business World, (2012), DPWH - 81% of Projects Implemented, March 27.

Inflation and Monetary Policy

15. **Headline inflation has remained muted at an average of 3 percent since January, which is at the low-end of the central bank's target range.** This partly owes to low food prices driven by ample food supply (Figure 13). Increases in rice and sugar prices were offset by lower prices in other key food items such as vegetables. Inflationary pressures on non-food items such as housing, utilities and transport also eased owing to lower fuel prices.[26] Hence, average core inflation registered 3.5 percent from January through May (y-o-y). Despite electricity supply shortages in Mindanao, electricity rates have remained low, albeit high by international standards, rising by a modest 6 percent in May (y-o-y) from a 9 percent high in March when electricity shortages escalated.[27] The minimum wage hike of PhP42 in the National Capital Region (NCR), effective in May, is in line with inflation expectations and therefore is unlikely to have any persistent effects on actual inflation. The large pool of un/underemployment contributes to wage restraint so that wages do not respond much to fluctuations in economic activity (Cacnio, 2012).[28,29]

[26] Weights for rental and household equipment in the CPI basket are 13.75 and 3.22 percent, respectively. The share of housing rental falls under utilities together with electricity, gas and water. Though rental price increases have accelerated, overall utilities inflation has gone down due to lower prices of water, electricity and gas.
[27] To temporarily mitigate the power deficit, the Department of Energy issued a department circular compelling electric cooperatives to source the needed capacity from more expensive diesel-fueled power barges, which may result in higher power costs for consumers. The power shortage is not expected to be resolved soon as another hydro facility closed for maintenance in April and power plants under construction are expected to become operational no earlier than 2014.
[28] Cacnio, Faith Christian Q. 2012. "Inflation Dynamics and Unemployment Rate in the Philippines," BSP Economic News Letter No. 12-02.

16. **The BSP's monetary policy stance remains accommodative.** The BSP has cut policy rates twice since the start of the year by a total of 50 basis points to 4 percent and, in response, household lending has accelerated, growing by an average of 20 percent through March (Figure 14), albeit starting from a low base. The reserve requirement ratio was cut by 3 ppt since the beginning of the year to 18 percent but its impact is somewhat offset by changes in the reserve requirement framework, including those to remove the remuneration of banks' unified reserve deposits and exclude cash in vaults from the computation of compliance of the reserve requirements. The financial system remains broadly stable with capital adequacy ratios of banks above the BSP's minimum ratio of 10 percent, well above the Basel Accord's 8 percent.

Figure 13. Inflation has remained subdued, averaging at the low end of the central bank's target

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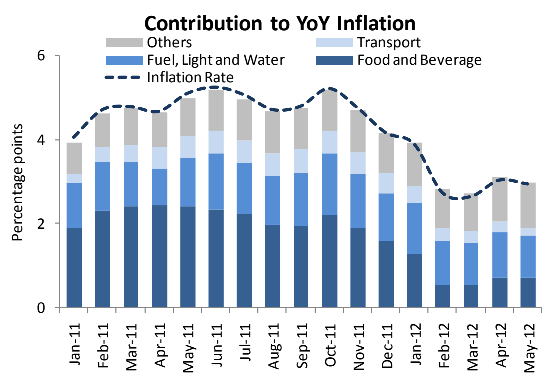
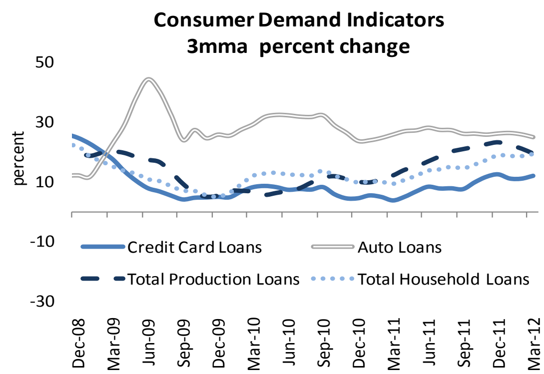


Source: NSO and BSP

Figure 14. Consumer loans posted a modest increase in the face of a low interest rate regime.



Source: BSP

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[29] However, the increase in the minimum wage brings the minimum wage much closer to the average wage, thereby distorting the wage distribution. For example, minimum wage workers who have worked for 10 years are just paid slightly higher than new hires. For further discussions, see World Bank (2012), *Philippine Development Report*, forthcoming.

Prospects

Output and Demand

17. **We have revised our growth forecast upward to 4.6 percent from 4.2 percent for 2012 (Table 1), reflecting higher growth in Q1. However, this projection does not yet factor in a possible intensification of the crisis in Europe and a further slowdown in China.** The global economy is projected to expand at a slower pace this year at 2.5 percent compared to 2.7 percent in 2011.[30] A positive current account balance, ample reserves (the country is a net external creditor), and a flexible exchange rate provide buffers for the Philippines in case the external economic environment deteriorates. A relatively low share of exports in total GDP compared to its neighbors, and remittances which remained stable in the 2008-09 global financial crisis, suggest that the country is moderately vulnerable to heightened global risks. That said, export markets are highly concentrated: nearly 40 percent of all exports were shipped to the G3 in 2011, with another fifth to China. And manufacturing exports (mainly electronics) have proven highly susceptible to a fall in global demand, which would cause severe job losses in the sector.

Table 1. World growth projections under the base-case scenario[1]

	2007	**2008**	**2009**	**2010**	**2011**	**2012F**
World output	5.2	3.2	-0.7	4.1	2.7	2.5
Advanced economies	2.7	0.9	-3.7	3.0	1.6	1.4
USA	2.0	1.1	-3.5	3.0	1.7	2.1
Euro Area	2.7	0.9	-4.3	1.8	1.6	-0.3
Japan	2.4	-0.6	-6.3	4.5	-0.7	2.4
Emerging and developing economies	8.3	6.1	2.8	7.4	6.1	5.3
China	13.0	9.0	9.2	10.4	9.2	8.2
ASEAN 5	6.3	4.9	1.7	7.1	4.3	5.0
Philippines	6.6	4.2	1.1	7.6	3.9	4.6

Source: World Bank (2012), *Global Economic Prospects*, June. For the Philippines, it is based on World Bank staff projections. ASEAN 5 refers to Philippines, Indonesia, Malaysia, Thailand, and Vietnam.
1/ The base-case scenario assumes a mild recession in Europe. For the Philippines, the base-case scenario adds the country's above-expectation growth in 1Q2012.

18. **Domestic demand will continue to support growth in the near term.** Domestic business sentiment continued to remain buoyant in 2Q2012 supported by strong private and public sector spending. Going forward, domestic consumption is expected to remain robust for the rest of 2012 driven by higher government spending[31] on the back of continuing improvements in the pace and efficiency of disbursements and robust private consumption.[32] The latter is

[30] Using 2005 PPP weights, the global economy is estimated to expand by 3.3 percent in 2012 compared to 3.7 percent in 2011.
[31] See World Bank (2012), *Philippines Quarterly Update*, March, p.17 for discussion the correlation between government spending and GDP growth.
[32] For instance, the Chamber of Automotive Manufacturers in the Philippines Inc. forecasts an 8 to 9 percent growth in car sales this year, from contracting by 4 percent in 2011.

expected to increase at a pace similar to that of last year, supported by continued remittance inflows (albeit at a slower pace). Net exports are likely to be subdued reflecting the unfavorable external environment, suggesting large downside risks to growth in the manufacturing sector. Prospects on the service sector remains favorable, benefiting from solid growth forecast of the BPO industry, which expanded even during the global financial crisis. The agriculture sector will remain susceptible to climate change and adverse weather conditions unless there are corresponding investments to improve risk mitigation and policies to promote productivity.

19. **With significant global headwinds likely to persist in the near future, the Philippines will need to raise investments to sustain growth.** Currently, recovering consumer confidence and positive business sentiment coincide with strong macroeconomic fundamentals, improved efficiency in public spending, and the tackling of corruption at the highest levels. However, further deterioration in the global economic outlook can escalate downside risks to growth. To seize the current window of opportunity and prepare for a global slowdown, the government should continue to accelerate the implementation of its reform agenda. This includes improving the investment climate for firms of all sizes in order to increase private investment in the economy, and ramping up public investments in infrastructure and human capital.

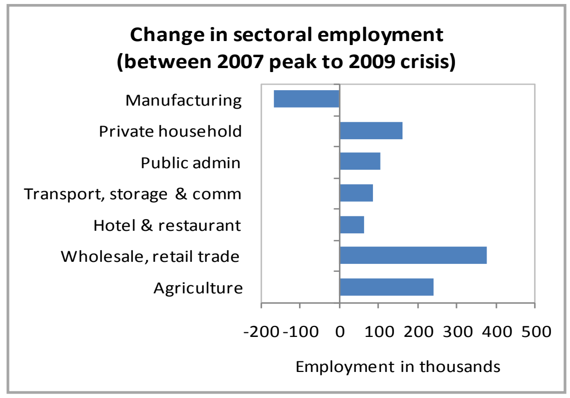
Employment and Poverty

20. **As in 2008-09, the level and quality of employment will be adversely affected if another global economic crisis materializes.** However, the public sector can help cushion the impact through accelerated spending on infrastructure and social protection. Manufacturing jobs will likely be hard-hit by lower external demand for Philippine products, with laid-off formal, skilled and full-time workers being absorbed by the low-productive agriculture sector, the unpaid family worker segment, and the informal sector (Figure 15). This would be a repetition of the impact seen during the global financial crisis, with attendant negative impact on real wages. However, due to the projected increase in government spending and continued growth in BPO services, net job creation in the service industry is expected to remain relatively resilient to significant global headwinds. The BPO sector expects to create 100,000 new full-time, skilled positions in 2012, in spite of the weak global environment. A slowdown in private construction is expected to release a large number of temporary workers. This could be compensated by accelerating public infrastructure projects, including those in the public-private partnership (PPP) pipeline.

21. **In the event of a major global crisis, the government's social protection programs will be important in shielding the poor from the fallout.** The expanded CCT program and other

priority poverty reduction programs will ease the recipients' hardship in the short term and, by conditioning assistance on health and education, can build the foundation for significant poverty reduction in the long term. Slower growth in remittances would bear a limited direct impact on poverty. Our analysis suggests that, even in the worst-case scenario – i.e., a 20 percent reduction in remittances, the overall poverty headcount is estimated to increase by a modest 1 percent.[33] The most affected will be those in urban areas (where households source 9 percent of their total income from remittances) and those living just above the poverty line (the 4th decile). However, these estimates take into account only the direct effect of remittances, and therefore, exclude the economy-wide impact through the multiplier effect of remittances.

Figure 15. In times of crises, job losses in the manufacturing sector are absorbed by agriculture and low skilled services.



Source: NSO

External Accounts

22. **Remittances will help keep the current account in small surplus.** In our worst-case scenario, global remittances to developing countries are projected to contract by 6 percent.[34] In our baseline scenario, we expect remittances to the Philippines to be somewhat more resilient thanks to a continued expansion of deployment of overseas Filipino workers (OFWs) and OFWs' diverse occupations and destinations, slowing to 5 percent in 2012 and 4 percent in 2013, lower than historical growth rates. Merchandise exports are projected to grow slowly by 4.9 and 7.5 percent respectively in 2012 and 2013, reflecting weak prospects for semiconductor exports (accounting for 50 percent of merchandise exports), but with some offsetting demand from the recovery in Japan and Thailand. Services exports will continue to record a surplus, supported by further expansion of the BPO sector.

23. **Reform efforts to improve the investment climate need to be accelerated to attract more foreign investment.** Even though foreign portfolio inflows will likely retreat in case of an intensifying Euro zone crisis, over the medium to longer term, the positive earnings differential between developing and advanced economies as well as the Philippines' relatively stable macroeconomic environment could help attract foreign investments. Similarly, regional economic developments could also result in higher FDI inflows to the Philippines in the medium term. For instance, China's eroding manufacturing competitiveness due to rising wages may drive offshore companies to look for cheaper alternatives, presenting a new opportunity for the

[33] The estimates do not in any way factor in multiplier effects of the contraction in foreign remittance flows.
[34] The worst-case scenario assumes that the freezing up of credit is to spread to two larger Euro economies (equal to around 30 percent of Euro area GDP), generating similar declines in GDP and imports of those economies. For more details, see World Bank (2012), *Global Economic Prospects*, June.

Philippines.[35] More importantly, however, seizing these new opportunities depends on acceleration of concrete reforms to improve the investment climate.

Fiscal Policy

24. **Higher tax revenues are needed to sustainably ramp up job-creating infrastructure spending and social protection measures, if a severe global crisis materializes.** The projected 4.6 percent growth for 2012 assumes sustained government spending from the continuing appropriations of last year's Disbursement Acceleration Plan, which would mitigate the impact of a projected 2012 global slowdown. While two public-private partnership (PPP) projects have been bid-out this year (Daang Hari and the schools project) with the bidding of Daang Hari completed, the PPP program is yet to have a significant impact on investments. Further acceleration will be an important factor to boost growth in the second half of the year.

25. **Under the base case, the fiscal deficit for this year is expected to widen to 3.0 percent of GDP from 2.1 percent last year (GFS basis)**. Controlling the deficit for 2013 would hinge on additional tax collections (equivalent to some 0.3 percent of GDP) from inflation-indexed excise duties on alcohol and tobacco,[36] in addition to incremental gains from improved tax administration (at least by 0.2 percent of GDP). Subsidies to government owned or controlled corporations are expected to increase during the remaining year, particularly additional allocations to PhilHealth[37] for its health insurance program.

26. **The deficit will likely rise further in case of a severe global downturn.** Weaker domestic economic activity due to declining exports and remittances, falling corporate profitability and job losses in manufacturing will all take a toll as automatic tax and spending stabilizers come into play. As a result, the deficit could conceivably rise by 0.3 ppt in the worst-case scenario, from a projected 3.0 percent of GDP in the base case, on account of higher interest payments. This could create funding pressures for the government in the short term, with fiscal space further constrained by the relatively high debt service-to-revenue ratios (discussed below).

27. Risks inherent in public debt structure can be mitigated by modifying the debt structure, taking into account the cost of doing so, and by lining up contingent financing.[38] Debt re-profiling needs to be assessed within a broader framework of its balance sheet and the nature of its revenues and cash flows**.** Our debt sustainability analysis shows that, even under a

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[35] China's cost advantage has been eroding relative to domestic manufacturers in advanced economies and to competing low-cost destinations. Source: Hackett Group

[36] The estimated 0.3 percent of GDP comes from the current version of the Abaya Bill passed in Congress, as opposed to 0.5 percent of GDP from expected revenues of the original version.

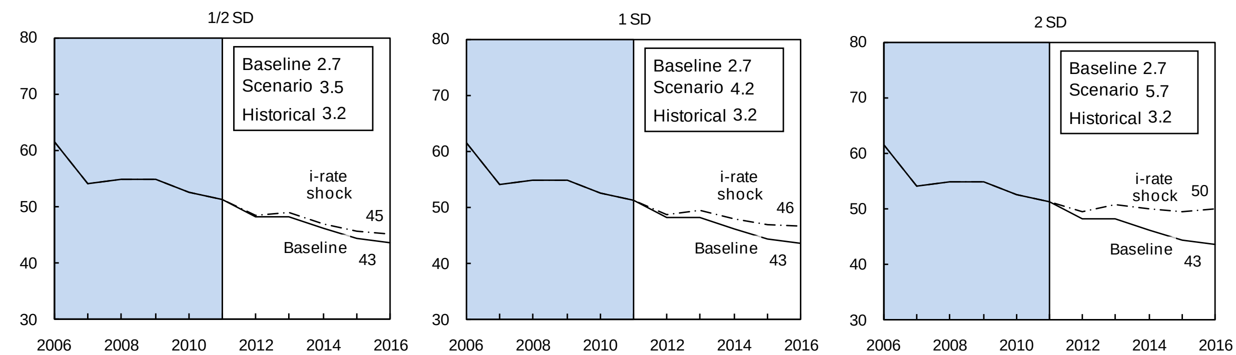
[37] It stands for Philippine Health Insurance Corporation.

[38] As part of the government's debt liability management, the government recently signed a debt-for-development swap agreement with Italy. The government's other debt liability management initiatives include a domestic debt swap to lengthen maturities and the issuance of peso-denominated global bonds.

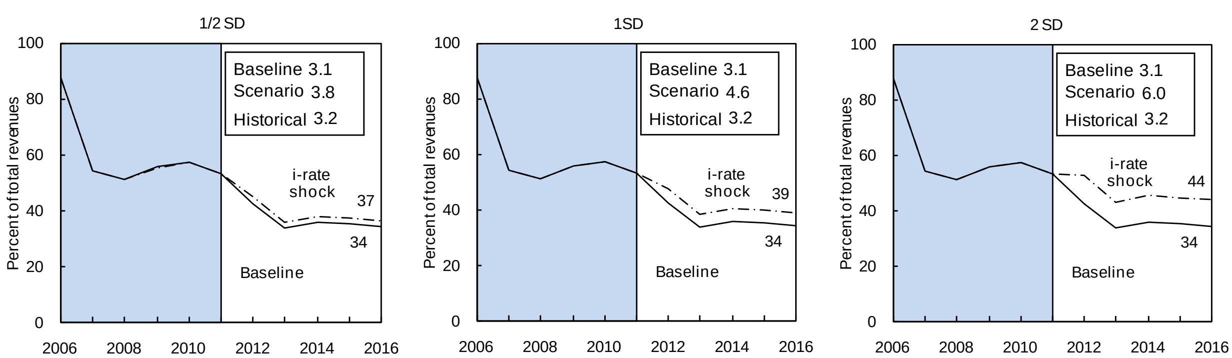
worst-case scenario,[39] public debt dynamics are favorable – reaching around 50 percent of GDP but below its historical highs (Figure 16.a). On the other hand, the debt service-to-revenue ratio (DSR) of 53 percent in 2011 is rather high by international standards,[40] albeit declining, and could increase fiscal vulnerability to a rising interest rate. Severe shocks on real interest rates (i.e., an increase by 2 standard deviations) could keep the DSR at the current elevated level for the remainder of the year before it starts to decline (Figure 16.b). The composition of debt service payments has shifted in the past ten years and is now primarily comprised of principal payments (61 percent of total debt service)[41] largely on domestic debt, given the increasing share of domestic debt in total debt.

Figure 16. National government debt and debt service sustainability outlook in response to exogenous interest rate shocks

(a) Debt-to-GDP ratio



(b) Debt service-to-revenue ratio



Source: World Bank staff estimates

Notes: 1/ Shaded areas represent actual data. 2/ Permanent shocks are applied to real interest rates.

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[39] It assumes a shock on interest rates by 2 standard deviations.

[40] International standards of the DSR refer to debt service of general government debt, while the Philippine DSR includes debt services of national government debt only.

[41] In 2000, principal payments comprised only 38 percent of total debt service.

Inflation and Monetary Policy

28. Policy rates are expected to remain unchanged in the near term and our inflation projection remains unchanged at 3.5 percent, at the low end of the BSP's inflation target, with risks to inflation mixed. Inflation for the year is projected to be low due to lower food prices given ample domestic supply, as the La Nina weather phenomenon weakens.[42] On the other hand, downside risks stem from higher electricity rates as local power remains in short supply.

29. Financial sector risks are low. The domestic banking sector has proven its resilience during the global financial crisis. Hence, under our baseline scenario, the Euro zone crisis would be unlikely to affect the economy through the direct banking/liquidity channels as Philippine banks' exposure to European banks is low. The sector is still at the nascent stage with about US$150 billion worth of total assets (70 percent of GDP). Non-performing loans are relatively low and banks have been shoring up capital in reaction to the continued global volatility and in anticipation of the adoption of Basel III.[43] Domestic credit growth has been at manageable levels and foreign exposures are limited to 10 percent of total liabilities.

30. However, a negative shock to the real sector may expose weakness in the financial system. For instance, a large supply of real estate in the pipeline may put downward pressure on real estate prices, which would increase risks in the financial system directly and indirectly, especially through real estate developers who are using their balance sheets to provide in-house financing to their real estate buyers. The central bank is aware of the risks in the financial system and has put in place conservative supervisory and macro-prudential policies to mitigate these risks.

Possible Downside Scenarios for the Philippines

31. **The Philippine economy is estimated to expand slower by 3.1 to 2.5 percent in 2012 in case the Euro zone crisis worsens (i.e., under our low and worst-case scenarios, Table 2).** Our low case scenario assumes a relatively orderly crisis in Europe characterized by a credit squeeze in one or two European economies; and the worst-case scenario refers to a disorderly crisis characterized by a full-blown freezing up of credit spreading across two larger European economies, causing possible second-round impacts through China. The Philippines is vulnerable to the Euro zone crisis through trade and remittance linkages. In the worst case, global trade is projected to fall by 10 percent and remittances to developing countries to contract by 6 percent. For the Philippines, goods exports in 2012 are projected to contract by 12 to 16

[42] La Niña is the weather phenomenon characterized by heavy rain.

[43] Basel III is a comprehensive set of reform measures, developed by the Bank for International Settlements (BIS) Basel Committee on Banking Supervision, to strengthen the regulation, supervision and risk management of the banking sector.

percent (Table 2).[44] With remittance inflows from Europe accounting for 16 percent of total remittances, we project 3.6 percent growth for 2012 and further deceleration in 2013-14 under the worst-case scenario. Together, the combined shock to exports and to remittances should undermine household incomes, spending and sentiment, limiting the support to growth from private domestic consumption.

32. **Capital outflows from the Philippines are expected to bear a limited economic impact, but heightened risk aversion could take a toll on private investment.** Current levels of FDI are low, and despite some volatility, portfolio inflows are likely to return to the Philippines because of growth rate, interest rate, and risk differentials. Nonetheless, the impact on investor sentiment, particularly in equity markets, should not be discounted. This could discourage businesses from investing, which is already subdued, particularly if the ability of firms to raise funding from equity markets is also affected.

Table 2. Implications of Low- and Worst-Case Scenarios[1, 2]

	Historical				Base case			Low case			Worst case		
Key variables	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2012**	**2013**	**2014**	**2012**	**2013**	**2014**
GDP growth	4.2	1.1	7.6	3.9	4.6	5.0	5.0	3.1	4.2	4.7	2.5	1.6	3.4
Current account balance (% of GDP)	2.2	5.6	4.2	3.1	1.8	2.2	2.9	1.4	2.2	3.1	0.9	0.3	0.2
Exports goods growth	-2.5	-22.1	34.8	-6.9	4.9	7.5	8.0	-12.0	-6.6	1.9	-15.9	-25.5	3.1
Import goods growth	5.6	-24.0	31.5	11.1	7.5	8.4	7.0	-9.5	-3.8	0.5	-12.3	-13.6	5.7
Remittance growth	13.7	5.6	8.2	7.2	5.0	4.0	3.0	4.1	2.6	1.8	3.6	1.7	0.3

Source: NSCB and BSP for historical, World Bank staff estimate for projections
1/ All scenarios are consistent with those presented in World Bank (2012)'s Global Economic Prospects (June).
2/ Note that the low- and worst-case scenarios should be interpreted together with a range of outcomes and not necessarily point estimates.

33. **The challenge for policymakers is to cushion the economy from potential external shocks while ensuring that the Philippines continues to improve its competitiveness.** Political commitment and strong macroeconomic fundamentals provide a window of opportunity to accelerate the implementation of reforms to improve the business environment for firms of all sizes, and to boost public investment in key infrastructure and human capital accumulation. Faster human and physical capital accumulation will enhance productivity and drive growth in the medium term by enabling the country to shift gears towards higher value-added activities and more innovation.

34. **Improved productivity and higher revenues would help prepare the country in case of a prolonged global slowdown.** The ability of the government to fund its priority spending targets for investments in human capital and public infrastructure, while ensuring fiscal sustainability, will require improved tax administration and policy reforms, through broadening the tax base and improving efficiency and transparency in tax collections.

[44] For estimating this, we used an elasticity and input demand approach. The elasticity model uses an estimate of partner import and GDP growth to PHL export and GDP growth. The input models are i) a regression of the North American book to bill ratio to PHL electronics exports, and ii) a regression of PHL import of electronic parts to PHL electronic exports. All models are significant and give a high correlation.

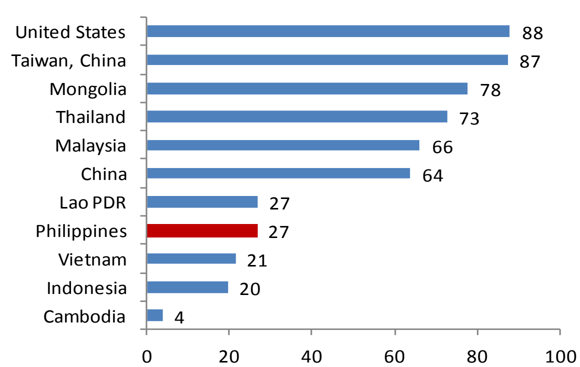
Special Focus

This Special Focus section concentrates on two building blocks for inclusive growth: better access to financial services for the poor and human capital accumulation through reforms in education.

I. Access to Basic Financial Services in the Philippines[45,46]

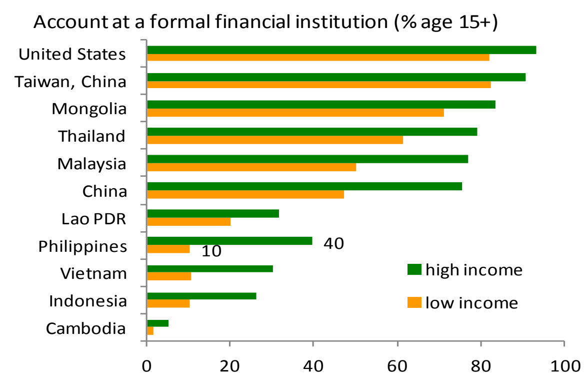
1. **Financial inclusion, or broad access to basic formal financial services, supports inclusive growth as it assists individuals to mitigate risks and smooth consumption.** Savings, credit, and insurance services enable individuals to smooth consumption, which for the vulnerable can mean not falling back into poverty. Financial services offered by formal financial institutions[47] are also safer and cheaper than informal alternatives which are often the only available option for the poor, and enable micro-entrepreneurs to integrate into a formal economy. Recent research shows that low-income entrepreneurs given access to a formal bank account invest more in their businesses, consume more, and are less prone to sell business assets to deal with health emergencies.[48]

Figure S1.1 Less than a third of Filipinos have an account in a formal financial institution.



Source: Findex database, World Bank (2012)

Figure S1.2. In the Philippines, only 10 percent of low income adults have an account with a financial institution.



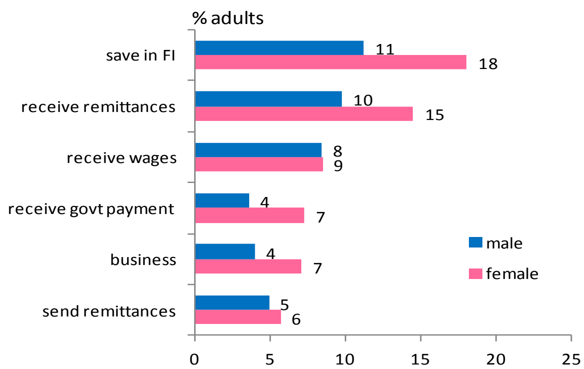
Source: Findex database, World Bank (2012)

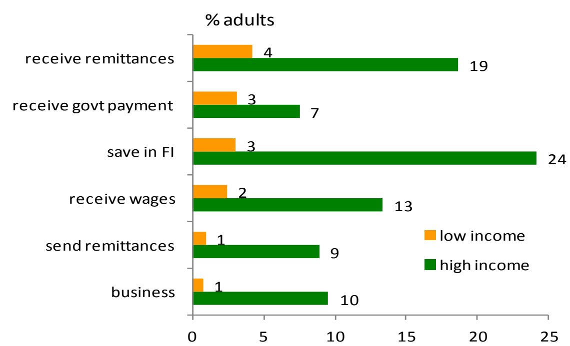
[45] This section reports analytical findings from the World Bank's Findex database (2012), which for the first time allow for a comparison of the use of the basic financial services by individuals across countries and regions.
[46] In this analysis, access to financial services refers to actual use of financial services rather than the possibility of using financial services. For definitions, see Beck, Demirguc-Kunt and Peria (2005), "Reaching out: Access to and use of banking services across countries," World Bank Policy Research Working Paper 3754.
[47] Formal financial institutions include commercial, rural, and cooperative banks, savings and credit cooperatives, microfinance NGOs, registered lending investors, and savings and loan associations.
[48] Caskey, John, Clemente Ruiz Duran, and Tova Maria Solo. 2006. "The Urban Unbanked in Mexico and the United States." Policy Research Working Paper 3835. World Bank. Dupas, Pascaline, and Jonathan Robinson. 2009. "Savings Constraints and Microenterprise Development: Evidence from a Field Experiment in Kenya." NBER Working Paper 14693. Karlan, D., Ashraf, N., & Yin, W. (2007) *Female Empowerment: Impact of a Commitment Savings Product in the Philippines.* Center for Global Development, Working Paper No. 106.

2. In the Philippines, actual use of formal financial services is low, particularly among low income groups. First, less than a third of Filipinos (27 percent) have an account with a formal financial institution such as commercial, rural or cooperative banks, and savings and loans cooperatives (Figure S1.1). The overall size of the banking system is small, with total assets of some US$150 billion (or 74 percent of GDP). Second, the share of account holders is as low as 10 percent among lower income population,[49] and the Philippines exhibits the widest gap between high and low income groups in terms of account access in the East Asia and Pacific region, mirroring broader economic inequality (Figure S1.2).

3. Savings and money transfers including receipt of government payments contribute to the broader use of formal financial services, with more women than men owning an account. In the Philippines, accounts with formal financial institutions are mostly used to save money and to receive remittances, especially among adults in the low income group (Figure S1.3). The Philippines stands out in that more women have accounts than men – 34 percent compared to 19 percent; and they use their accounts to save, receive remittances, receive government payments and manage business expenses.

Figure S1.3. The accounts are mostly used to save money and to receive remittances.





Note: sorted by female use
Source: Findex database, World Bank (2012)

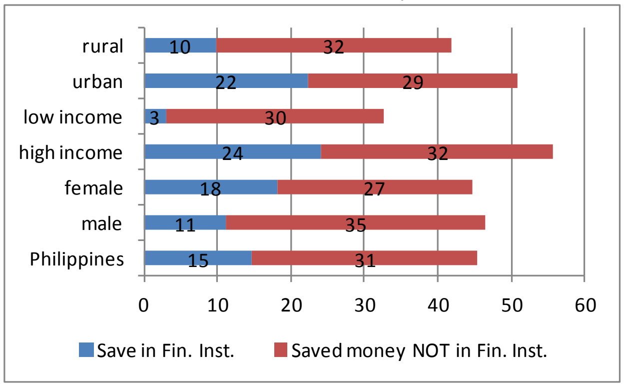
Note: sorted by low income use
Source: Findex database, World Bank (2012)

4. Most Filipinos rely on a wide range of informal services to save and borrow. Only about 15 percent of Filipino adults use formal financial institutions to save and the pattern is more prominent in the low income group and in rural areas (Figure S1.4). Similarly, only a fraction of Filipinos (14 percent) borrow from the formal financial institutions, the second lowest in East Asia and Pacific, after Indonesia. Instead, they rely heavily on a wide range of informal sources for borrowing money, including friends, stores, private lenders and employers (Figure S1.5). The reliance on informal sources of credit is likely a reflection of many factors

[49] "Low income" refers to the bottom 40 percent of the income distribution and "high income" to the top 60 percent of the income distribution.

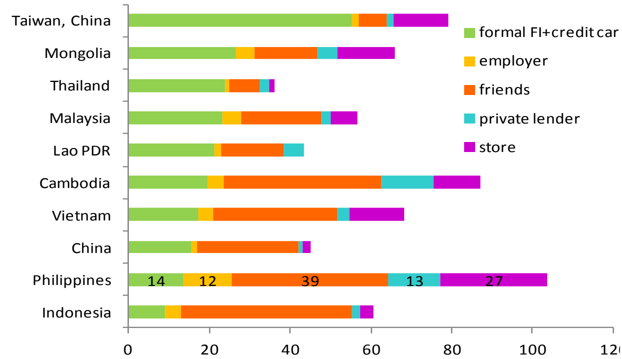
including the lack of suitable credit products, limited credit supply especially for lower income borrowers, or a preference to avoid borrowing from banks owing to the lack of collaterals or banks' cumbersome procedural requirements.

Figure S1.4. Majority save outside of the formal financial system.



Note: region median values
Source: Findex database, World Bank (2012)

Figure S1.5. Most Filipinos borrow from informal sources.



Note: categories are not exclusive
Source: Findex database, World Bank (2012)

5. **Health and education expenditures are the most cited reasons for borrowing**, partly owing to low health insurance coverage and limited buffers for eventualities.[50] Micro-insurance is expanding in the Philippines following the introduction of enabling regulations in recent years. [51] Though products are mostly limited to life insurance thus far, a number of providers are experimenting with health insurance products which target the low income market.

6. **High mobile phone connectivity contributes to expanding access to financial services.** The Philippines is a leader in the East Asia and Pacific region in terms of introducing money transfer and payments through mobile phone network (e.g., BDO's GCash). The number of people using mobile phones to receive remittances and to make payments supersedes the number of people using accounts in financial institutions, notably in rural areas and in the low income group. Thus, the introduction of new technologies, such as money transfers through mobile phone network and linking of these services to other financial services, holds a great promise in improving access to financial services.

7. **While access remains low, the government has implemented a number of important reforms aiming to improve access to basic financial services.** Through the implementation of the Microfinance Strategy and introduction of enabling environment for mobile banking, the Philippines is recognized as one of the pioneers in exploring innovative approaches to improve financial inclusion. Efforts to promote favorable business conditions for privately provided microfinance earned the Philippines international recognition from the Economic Intelligence

[50] The questionnaire did not ask questions on vehicle or consumer goods financing.

[51] As of June 15, 2012, micro-insurance products are offered by 6 life insurance entities, 12 non-life insurance entities and 19 mutual benefit associations (MBAs). Micro-insurance products approved are 33 life insurance, 16 non-life and 19 MBA products.

Unit, the business information arm of The Economist Group. In the Global MicroScope 2010, the Philippines was recognized to have the best regulatory environment for microfinance among 54 countries. This is a good starting point to attain the vision of the Philippine Development Plan: "a regionally-responsive, development-oriented and inclusive financial system which provides for the evolving needs of its diverse public."

II. Building Human Capital – Education[52]

1. **The Philippines has embarked on providing quality education to all.** Quality education is a pathway out of poverty, as it enables children to accumulate knowledge and develop lifelong skills that allow them to take advantage of opportunities for gainful employment in a dynamic globalized economic environment. Education increases opportunities for higher income/earnings. For instance, in the Philippines, in their 40s, college graduates earn nearly three times more than high school graduates (Figure S2.1). Thus the implementation of the new K-12 program, which adds a full two years to secondary school, would augment higher income opportunities.[53] Our preliminary results indicate that an additional year of high school increases productivity and an additional 2 years of schooling has an estimated return of about 28 percent on average.

2. **The Philippines's education system faces major challenges in the following areas:**

(i) Access to education. Slow progress in net enrollment rates is largely a result of a rapidly growing school-going age population. Net enrolment significantly increased from 84.33 percent in school year (SY) 2005-6 to nearly 90 percent in SY 2010-11, thanks to the extensive efforts of the government to enhance access to basic education through formal and non-formal delivery modes and through demand-side interventions (such as the government's CCT Program.) However, the net enrollment rate is still below the 1990s level (Figure S2.1), as this has barely kept pace with the fast growth in the school-going age population. The cohort survival rates improved little over the period with only about five out of ten elementary graduates making it to the tertiary level (Figure S2.1). Elementary completion rates slightly improved from 70.2 percent in SY 2003-4 to 72.1 percent in SY 2010-11.[54] In general, school enrollment rate

[52] This section is heavily drawn from World Bank (2011), "Medium Term Spending Plan for Basic Education, 2012-17, Draft; World Bank (2012), "Private Internal Rate of Return to Additional Two Years of Education," Preliminary draft; and "World Bank (2010), Discussion Notes.

[53] Prior to the K-12 program, the Philippines's basic education has covered 6 years of primary school and 4 years of high school. The K-12 program covers kindergarten and 12 years of basic education (6 year of primary education, 4 years of junior high school and 2 years of senior high school.

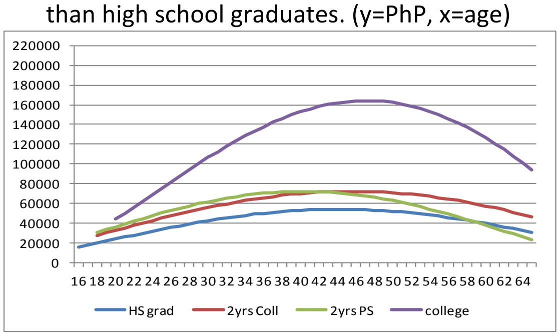
[54] This is based on DepEd's completion rate formula which looks at efficiency (i.e., those who completed primary school in accordance with the required number of years). The elementary completion rate is higher than 90 percent as of the previous school year, according to the WB/UNESCO Institute of Statistics formula for Primary Completion Rate (i.e., calculated by taking the total number of students in the last grade of primary school, minus the number of repeaters in that grade, divided by the total number of children of official completing age.

positively correlates with income.[55] For instance, in the ARMM, one of the poorest regions, only 82.9 percent of children 16 years or younger attended school compared to the national average of 91 percent.

(ii) Quality of education. While results have started to improve at the national level, overall school achievement levels continue to be a major concern, especially at the secondary level. Table S2.1 shows that average test scores of Grade 6 students improved from 54.7 percent in SY2003-4 to 68 percent in SY2009-10. However, those for high school students have remained flat and only 4 percent of examinees in 2008 obtained average scores higher than 75 percent. The average achievement level improved slightly for Mathematics and Science (Table S2.1). In the 2003 Trends in International Math and Science Study, the average test score of Filipino eighth graders was only 378 in Mathematics against the international average of 466, and 377 in Science against the average of 473 of participating countries. The quality of higher education institutions also shows shortcomings, as indicated by the low passing rate of graduates in professional examinations.[56]

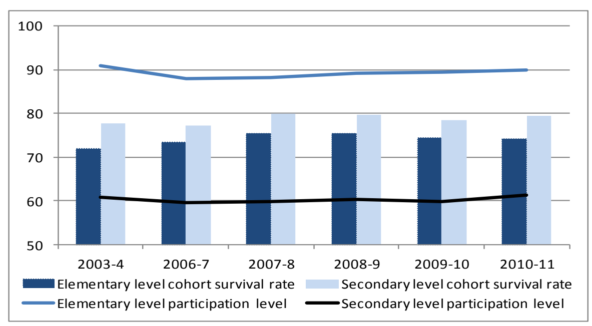
(iii) Insufficient school infrastructure. Higher spending on basic education in recent years eased input deficits in public schools. However, basic education budget per student has been persistently low, fluctuating within the PhP5,000 – PhP6,000 band in real terms (measured in 2000 prices) since 2000, while school-age population has been growing rapidly. As the education budget has yet to catch up with population growth, schools still cannot find sufficient space to teach their children. According to DepED, in SY2011-2, overall, public schools lack education materials, 48,802 classrooms, 132,564 teachers, and 106,604 toilets.

Figure S2.1. College graduates earn far more than high school graduates. (y=PhP, x=age)



Source: World Bank (2012), preliminary

Figure S2.2. Declining school enrollment rates



Source: Department of Education (DepED)

[55] The school enrollment rate increases by household expenditure levels, from 85 percent in the poorest quintile to 98.1 percent in the richest.

[56] Orbeta, Aniceto (2008). Background Paper on Higher Education. Manila. Unpublished.

Table S2.1. Student achievement indicators, 2003-9

	2003-4	2006-7	2007-8	2008-9	2009-10
Grade 6 Achievement (2005) 1/	54.7	59.9	64.8	66.3	68.0
Mathematics	53.7	60.3	63.9	68.7	63.3
English	54.1	60.8	61.6	62.1	67.8
Science	46.8	51.6	57.9	59.6	63.1
Hekasi (Social Studies)	59.5	61.1	67.4	69.0	70.9
Secondary school Year 2 Achievement (2005) 1/	44.3	46.7	49.3	47.4	45.5
Mathematics	47.8	39.1	42.9	39.5	39.6
English	47.7	51.8	53.5	52.4	46.8
Science	38.0	42.0	46.7	43.4	43.7
Hekasi (Social Studies)	..	51.5	55.6	50.5	39.3

Source: DepED.

Note: 1/ Assumes the National Education Testing and Research Center will test equate to allow valid comparisons across years; only means reported for 2004-2005.

3. **Given these existing challenges, additional resources for the basic education sector are needed.** The new K-12 program is expected to further increase the resource requirements, especially from 2016 onwards when the students currently in secondary school year 1 reach year 5 for the first time in the secondary education system. The necessary budgetary increases to achieve these spending targets must come from both the central and local governments. This requires, among others, motivating the local government units to invest more of their own resources in local education improvements and supporting the empowerment of schools and communities.[57] The government can also promote private involvement in basic education to help share necessary resource requirements with the private sector, though this requires an effective audit and fraud monitoring mechanism in place. The Education Service Contracting Program has been shown to be a cost-effective scheme compared to the alternative option of building new schools and classrooms and hiring new teachers to accommodate the growing number of enrollees in public schools.[58] As higher spending does not automatically translate into better education outcomes, it is important to address institutional and policy issues to improve access to education across regions and the quality of education. [59]

[57] For detailed recommendations in this regard, see World Bank (2010), Discussion Notes:Education.

[58] Patrinos,Harry Anthony, Lynnette Perez, Juliana Guaqueta, Emilio Porta, Honesto Nuqui, and Michael Alba (forthcoming). "Philippines Education Service Contracting Study." Draft.

[59] Hanushek (2007) find that teacher upgrading, across-the-board salary increases, and higher teacher-student ratios have little impact on learning achievement in the medium term.

Data Appendix

Table 3. Philippines: Selected Economic Indicators, 2009-13

	2009	2010	2011	2012	2013
	Actual		Prel. Act.	Projection	
Growth and inflation	(in percent of GDP, unless otherwise indicated)				
Gross domestic product (% change)	1.1	7.6	3.9	4.6	5.0
Inflation (period average)	3.2	3.8	4.8	3.5	4.0
Savings and investment					
Gross national savings	22.1	24.8	24.9	24.3	25.6
Gross domestic investment	16.6	20.5	21.8	22.5	23.6
Public sector					
National government balance (GFS basis) 1/	-3.9	-3.6	-2.1	-3.0	-2.8
National government balance (Govt Definition)	-3.7	-3.5	-2.0	-2.9	-2.7
Total revenue (Govt Definition)	14.0	13.4	14.0	14.0	14.6
Tax revenue	12.2	12.1	12.5	12.8	13.4
Total spending (Govt Definition)	17.7	16.9	16.0	16.9	17.3
National government debt	54.8	52.4	51.1	49.0	48.0
Balance of payments					
Merchandise exports (% change)	-22.1	34.8	-6.8	4.9	7.5
Merchandise imports (% change)	-24.0	31.5	2.6	7.5	8.4
Remittances (% change of US$ remittance)	5.6	8.2	7.2	5.0	4.0
Current account balance	5.6	4.2	3.1	1.8	2.0
Foreign direct investment (billions of dollars)	1.6	1.2	1.3	1.5	2.5
Portfolio Investment (billions of dollars)	-0.6	4.0	5.5	4.0	4.0
International reserves					
Gross official reserves 2/ (billions of dollars)	44.2	62.4	75.0	78.1	82.0
Gross official reserves (months of imports)	8.7	9.6	11.1	11.1	11.0
External debt 3/	37.3	36.3	34.8	33.3	32.1

Source: Government of the Philippines for historical, World Bank for projections

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

2/ Includes gold

3/ Based on World Bank definition. The difference with central bank definition is that it includes the following: i) Gross--Due to Head Office/Branches Abroad of branches and offshore banking units of foreign banks operating in the Philippines, which are treated as quasi-equity in view of nil and/or token accounts of permanently assigned capital required of these banks, ii) Long-term loans of non-banks obtained without BSP approval which cannot be serviced using the foreign exchange resources of the Philippine banking, and iii) Long-term obligations under capital lease agreements.

Table 4. Philippines: National Government Cash Accounts (GFS Basis), 2008-12

	2008	2009	2010	2011		2012		
				Jan-Apr	Year	Jan-Apr	Budget	WB proj.
				(in percent of GDP, unless otherwise stated)				
Revenue and grant	15.2	14.0	13.4	4.7	14.0	4.9	14.2	14.0
Tax revenue	13.6	12.2	12.1	4.0	12.3	4.2	13.1	12.8
Net income and profits	6.2	5.2	5.4	2.0	5.9	2.0	5.9	6.1
Excise tax	0.8	0.7	0.7	0.2	0.7	0.2	0.6	0.9
Sales taxes and licenses	2.3	2.7	2.4	0.8	2.4	0.9	2.7	2.5
Others	0.8	0.6	0.7	0.2	0.7	0.2	0.6	0.8
Collection from Customs	3.4	3.1	2.9	0.9	2.7	0.9	3.3	2.5
Nontax revenue 1/	1.6	1.7	1.3	0.7	1.6	0.7	1.1	1.2
Grant	0.0	0.00	0.0	0.0	0.0	0.0	0.0	0.0
Total expenditure 2/	16.7	17.9	17.0	4.8	16.1	4.9	16.9	17.0
Current expenditures	13.6	14.3	13.8	4.1	13.3	4.2	13.4	13.5
Personnel services	4.9	5.2	5.2	1.5	5.1	1.5	5.4	5.4
MOOE	1.8	2.1	2.0	0.5	2.1	0.7	2.4	2.5
Allotment to LGUs	2.2	2.5	2.4	0.8	2.4	0.7	2.0	2.0
Subsidies	0.2	0.2	0.2	0.1	0.5	0.1	0.2	0.3
Tax expenditures	0.8	0.6	0.5	0.1	0.3	0.1	0.3	0.3
Interest payment	3.7	3.7	3.4	1.1	3.0	1.1	3.1	3.0
Capital outlays	2.9	3.4	3.1	0.6	2.6	0.7	3.3	3.3
Net lending	0.2	0.2	0.1	0.1	0.2	0.0	0.2	0.2
Balance (GFS definition)	-1.5	-3.9	-3.6	0.0	-2.1	-0.1	-2.7	-3.0
Balance (GOP definition)	-0.9	-3.7	-3.5	0.0	-2.0	0.0	-2.6	-2.9
Primary Balance (GFS)	2.2	-0.3	-0.2	1.0	0.8	1.1	0.4	0.0
Memorandum items								
Privatization receipts (PHP billion	31.3	1.4	0.9	0.7	0.9	0.0	2.0	2.0
CB-BOL interest payments (% of GI	0.2	0.2	0.1	0.0	0.1	0.0	0.1	0.1
Nominal GDP (PHP trillion) 3/	7.7	8.0	9.0	9.7	9.7	10.6	11.0	10.6

Source: Department of Finance, Bureau of Treasury, and Department of Budget and Management

1/ This excludes privatization receipts. These are treated as financing items in accordance with the Government Financial Statistics Manual (GFSM).

2/ Data are sourced from the Department of Budget and Management. Allocation to local government (LGUs) units excludes capital transfers to LGUs. They are included in national government capital outlays.

3/ Nominal GDP is based on World Bank staff estimate.

Selected Special Focus from Previous *Quarterly Updates*

March 2012 PQU: From Stability to Prosperity for All

Financing the Economic Costs of Disasters in the Philippines: Challenges and Opportunities. The Philippines is one of the most disaster-prone countries in the world. It is regularly hit by earthquakes and typhoons. These natural disasters, in particular typhoons, have grave social and economic consequences for the country. About 1,000 lives are lost every year and the estimated cost to the economy is almost one percent of GDP per year. The fiscal capacity of the general government to mitigate risks and address these costs is limited. The amount of funds available is well below 10 percent of the total direct property damages incurred annually. Recent disasters suggest that the country needs up to five percent of GDP to mitigate risks and rebuild damaged properties. Recognizing this shortcoming, the government recently revamped its disaster and risk management strategy from ex-post reconstruction to ex-ante preparedness. Moreover, the Philippine government is preparing an analytic framework and strategy to explore the feasibility of disaster risk financing and transfer options to address the layers of risks faced by the country. In this process, the government could employ a risk layering methodology, commonly adopted in corporate risk management, to improve overall risk management.

Cycles of Conflict and Displacement in Mindanao. This special focus summarizes the results of a major survey conducted in and around the Autonomous Region in Muslim Mindanao (ARMM) to understand the people's experience of conflict and displacement in the past decade. The findings are analyzed in a joint World Bank-World Food Programme (WB-WFP) report entitled "Violent Conflicts and Displacement in Central Mindanao: Challenges for Recovery and Development." The results highlight the frequency and prevalence of displacement, and the damage done to livelihood, access to services, and social cohesion. The study makes some recommendations on how to improve support to vulnerable households and shape strategies for sustainable peace.

The Philippine Real Estate Market: A Cause for Concern? The real estate market plays a unique role in economic development and financial stability. Boom-bust cycles are intrinsic in real estate markets and impact the economy directly and indirectly through other sectors such as construction and finance. Real estate is often the largest store of wealth in any economy. In the Philippines, households tend to have greater preference for holding wealth in the form of real estate rather than equities. Given these, a closer look at real estate market developments is a critical element of ensuring macroeconomic stability. The Philippine real estate market today is largely driven by BPOs and remittances and less on investors seeking higher returns. Borrower leverage is low and banks have more prudential measures in place. Overall, systemic risks are fairly low, although the residential segment may face downside risks arising from oversupply, hence, the need for careful monitoring.

Stepping Up Disbursements by Improving Absorptive Capacities in Agencies. Weak public spending, especially in the first half of 2011, slowed down Philippine economic growth last year. In October 2011, the Aquino government launched the PhP 72 billion Disbursement Acceleration Plan (DAP). The DAP strategy entailed identifying slow-moving projects, including unspent allocations, and then realigning them to i) agencies that can quickly disburse funds, ii) programs and projects that have poverty reduction impact, and iii) programs and projects that have big multiplier effects. While the strategy helped to boost public spending in the last quarter of 2011, the mere realignment of funds does not guarantee sustained improvement in public spending to address growth and poverty targets. A long-term strategy should address internal bottlenecks in national government agencies, which include low absorptive capacity of agencies and weak monitoring and evaluation system, among others.

December 2011 PQU: Sustaining Growth in Uncertain Times

Raising Excise Taxes on Tobacco and Alcohol Products. The real revenue yield from excises on tobacco and alcohol has declined significantly since 1997. As a result, from 1997 to 2009, excise collection as a share of GDP fell by about 0.6 percentage points from an already low yield of 1.2 percent of GDP. Quite alarming, Philippine tobacco excise tax rates and burden are among the lowest in South East Asia. Raising excise tax revenues requires i) shifting from multiple to uniform excise tax rates, ii) raising excise tax rates closer to international benchmarks and indexing to nominal GDP growth thereafter, and iii) improving tax administration to minimize leakages from smuggling and evasion. A first best reform would yield as much as 1.3 percent of GDP in additional revenues over the next five years. This incremental revenue would enable the government to increase its human and physical investment to improve the country's growth and development prospects.

Philippine Exports: Where Do They Stand? Despite being an open economy, the Philippines' openness to trade is lower than its neighbors and its exports have been growing slower than GDP. Export diversification has improved in terms of market destination (e.g., more exports to China and other emerging markets and less to the US) but not in terms of product line. The global market share of its main export, semiconductors, has continued to decline. This is in part due to the adverse external environment, changing technology that the Philippines has yet to fully adopt (e.g., new generation gadgets such as tablet computers and smart phones), and stagnant physical capital per worker. In terms of exports survival, the Philippines scores the lowest among comparable ASEAN countries. Thus, improving the country's business environment, particularly in non-PEZA areas, will be essential to boost physical investments, encourage innovations, and promote investments in human capital so that the country can better internalize and harness advanced technologies and business know-how embedded in foreign direct investments. In terms of services exports, a more efficient regulatory system would improve the industry's productivity, thus improving its competitiveness.

September 2011 PQU: Solid Macroeconomic Fundamentals Cushion External Turmoil

External Spillovers to Philippine Growth. During 1997-2011, shocks from East Asian-3 economies, China in particular have become more important for ASEAN-5 including the Philippines than those from the United States and the Euro zone. Spillovers of East Asian economies' shocks are channeled to the Philippines through trade, while the United States and the Euro zone shocks are transmitted largely through financial variables. The findings suggest that vigorous growth in the East Asian economies can cushion declines in demand from the West.

The 2012 Proposed National Government Budget. The 2012 national budget is a results-focused budget and calls for higher spending in general, particularly on social services. The budget will rest on increased revenue collection efficiency by broadening the tax base and improving tax administration and collection efforts. The Administration aims to lower government debt payment for 2012, which would release additional resources available for priority spending. The budget continues to employ the zero-based budget approach to rationalize expenditures and includes reforms to make further progress in improving spending efficiency, transparency, and accountability. Some of the major reforms include (i) fleshing out lump sum funds and (ii) tightening the use of savings, particularly from unfilled authorized positions. The reform in the use of savings implies that the government agencies and institutions, in particular those in the education sector, need to speed up on hiring. For poverty reduction and inclusive growth, higher spending on priority areas (education and health in particular) is required – an increase to 5-7 percent of GDP. To support this additional spending needed, the government needs to continue to strive for heightened revenue mobilization.

June 2011 PQU: Generating More Inclusive Growth

Poverty and Inequality in the Philippines. The recently released 2009 poverty estimates and household survey (FIES) provide a much needed update on poverty, inequality and income dynamics in the Philippines. The FIES reveals that in contrast with previous trends, household per capita incomes grew from 2006 to 2009 and that, remarkably, rural and poorer households strongly outperformed. However, despite this increase and a resilient economy poverty incidence continued to increase through 2009 though, some improvements occurred in both the gap and severity of poverty. Therefore, poverty, and especially poverty dynamics, in the Philippines remains worse than its neighbors. Spatially, poverty remains highly concentrated in rural areas and in terms of sectors, households that rely on agricultural income are significantly more likely to be poor than other households. From 2006 to 2009, poverty in urban areas increased more rapidly, became more severe, and contributed more to the continuous increase in poverty. Across regions, 10 of the 17 administrative regions experienced an increase in poverty incidence.

The Service Sector in the Philippines. The service sector has the potential to play an important role in promoting inclusive growth in the Philippines. The sector is already large and has been an important driver of employment and GDP growth. However, this has not necessarily led to a rise in the average quality of jobs or productivity gains. Unshackling the constraints on services as a source of inclusive growth will require broad-based policy action: providing higher quality education for all to meet the demand for skills as services move up the value chain; improving infrastructure and enabling policies to facilitate agglomeration economies; removing investment climate distortions to allow services firms to invest and innovate.

The 2011 National Accounts Revisions (1998-2010). The Philippines recently revised its national accounts series for the period 1998 to 2010. The revisions involve shifting to a new base year (from 1985 to 2000) and adopting most of the recommendation of the System of National Accounts (SNA) 1993 and some recommendations of SNA 2008. The new series shows roughly the same GDP growth though sectoral growth varies. The revisions led to a significantly higher investment-to-GDP ratio and to a higher level nominal GDP—of about 6 percent for 2010. Finally, the previously large statistical discrepancies between the production and the expenditure accounts have largely been eliminated through a methodological improvement that made use of the supply-and-use table.

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3	Violent conflicts and displacement in Central Mindanao : challenges to recovery and development (Vol. 2 of 2) : Key findings	4/20/2012	Working Paper
4	Distortions in the international migrant labor market :evidence from Filipino migration and wage responses to destination country economic shocks	4/1/2012	Policy Research Working Paper
5	Who benefits from social assistance in the Philippines? Evidence from the latest national household surveys	3/1/2012	Brief
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12	The Economic Returns of Sanitation Interventions in the Philippines	8/1/2011	UNDP-Water & Sanitation Program
13	Philippines - Discussion notes : challenges and options for 2010 and beyond	6/9/2011	Other Financial Accountability Study
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21	The Search for Durable Solutions : armed conflict and forced displacement in Mindanao, Philippines	3/1/2011	Working Paper
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26	Philippines - Private provision, public purpose : a review of the government's education service contracting program	1/1/2011	Working Paper
27	Philippines - Typhoons Ondoy and Pepeng : post-disaster needs assessment (Vol. 1 of 3) : Executive summary	1/1/2011	Other Environmental Study
28	Philippines - Typhoons Ondoy and Pepeng : post-disaster needs assessment (Vol. 2 of 3) : Main report	1/1/2011	Other Environmental Study
29	Philippines - Typhoons Ondoy and Pepeng : post-disaster needs assessment (Vol. 3 of 3) : Sector reports	1/1/2011	Other Environmental Study
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2. Asian Institute of Management KDC
   Joseph R. McMicking Campus, 123 Paseo de Roxas, Makati City 1226

3. Ateneo de Naga University KDC
   James O'Brien Library, Ateneo Avenue, Naga City 4400

4. Central Philippine University KDC
   Ground Floor Henry Luce III Library, Lopez Jaena Street, Jaro, Iloilo City 5000

5. House of Representatives KDC
   Congressional Planning and Budget Department, 2F R.V. Mitra Building, Batasang Pambansa Complex, Constitution Hills, 1126 Quezon City

6. Notre Dame University KDC
   Notre Dame University Library, Notre Dame Avenue, Cotabato City 9600

7. Palawan State University KDC
   Graduate School - Law Building, Manalo Campus, Valencia St., Puerto Princesa City 5300

8. Saint Paul University Philippines KDC
   3rd floor, Learning Resource Center, Mabini St., Tuguegarao City 3500

9. Silliman University KDC
   Silliman University Library, Dumaguete City 6200

10. University of San Carlos KDC
    University Library, P. Del Rosario Street, Cebu City 6000

11. University of Southeastern Philippines KDC
    Obrero, Davao City 8000