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PHILIPPINES QUARTERLY UPDATE

GENERATING MORE INCLUSIVE GROWTH

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The World Bank Group in the Philippines

Making Growth Work for the Poor

PHILIPPINES QUARTERLY UPDATE

GENERATING MORE INCLUSIVE GROWTH

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Poverty Reduction and Economic Management Unit
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Preface

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

The *Philippines Quarterly Update* is a product of the World Bank's Philippines Poverty Reduction and Economic Management (PREM) team. It was prepared by Eric Le Borgne (Senior Country Economist and task team leader), Sheryll Namingit, and Marianne Juco, under the general guidance of Ulrich Lächler (Lead Economist). Special Focus contributors include Rashiel Velarde for the section on poverty, Ashley Taylor for the section on the services sector, and Karl Chua for the section on the revision to the national income accounts. The findings, interpretations, and conclusions expressed in this *Update* are those of World Bank staff and do not necessarily reflect the views of the Executive Board of The World Bank or the governments they represent.

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

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Cover photo credits: 1) Eric Le Borgne ("House in Navotas"); 2) Marianne Juco ("High-rise"); 3) Ruth Francisco ("Learning"); 4) David Llorito ("Farmer").

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Executive Summary

Having exited the global recession's rebound phase, the Philippine economy expanded by a steady 4.9 percent in Q1 2011. On the demand side, a sharp upswing in investments and resilient consumer spending drove economic activity, while on the supply side the main engine was industry, thanks to robust activity by the domestically oriented sectors. The external position strengthened further, with a robust balance of payments surplus in Q4 2010 due to strong inflows from the capital and financial accounts. Foreign reserves continued to accumulate at a brisk pace, to exceed the country's total external debt by Q1 2011. Similar to the regional peer performance, the Philippine equity market has performed strongly. Despite these positive developments, the labor market remains weak, reflecting long-standing structural weaknesses, while poverty and hunger have been worsening again following brief modest improvements around mid-2010.

While monetary policy remains accommodative, fiscal consolidation is proceeding ahead of expectations. Even though the Bangko Sentral ng Pilipinas (BSP) tightened policy rates twice in 2011, it retained an accommodative policy stance. Despite rising inflation and real policy rates that turned strongly negative in 2011, inflation remains contained within the BSP target range: we project average inflation for 2011 to reach 4.8 percent. Meanwhile, the fiscal balance has improved notably. In sharp contrast to the large deficit accumulated in the run up to the 2010 election, the National Government (NG) fiscal balance posted a surplus from January to April 2011, and is projected to improve further in 2011—causing the deficit to decline from 3.5 percent of GDP in 2010 to 2.4 percent in 2011. Most of that improvement, however, is due to reductions in total government expenditures, as revenue mobilization continues to pose a major challenge. Although enhanced transparency and accountability standards have helped to reduce wasteful public spending, this pattern raises concerns about the quality of fiscal adjustment from a poverty reduction perspective.

Prospects remain favorable for Philippine growth: we maintain our growth forecast of 5.0 percent for 2011 and 5.4 percent for 2012. (While unchanged, these forecasts reflect the recently revised National Accounts series for the period 1998 to 2010—Special Focus #3.) Investment is projected to continue strengthening in 2011 and onwards. Consumption is expected to be buoyed by strong wage growth and employment among relatively well paid and formal sectors jobs. The current account surplus is projected to narrow as the trade deficit expands and slower deployment of overseas workers reduces the pace of remittance inflows. The impact of ongoing turmoil in the Middle East should remain modest for the Philippines provided the turmoil does not spread to the larger economies in the region. While the disasters in Japan had a negative short-term impact on the Philippines, the medium-term net impact is uncertain but likely to be small.

As growth returns and stabilizes, the challenge is to ensure that growth is more inclusive—i.e., growth that all citizens participate in and benefit from. The Philippines may already have moved to a new 'normal', one with more robust and less variable growth. Such a growth pattern contrasts with the pre-Global Recession perception of the Philippines as a "high beta" country with a weak fiscal position, and with recurrent political crises exposing the country to shocks and volatility. Recent upgrades of the country's sovereign ratings testify to this improvement. However, the current growth pattern is not socially optimal: the latest official poverty estimates reveal that from 2003 to 2009, poverty has increased steadily, whether measured in terms of the number of poor people falling into poverty—an additional 3.4 million people—or by the percentage of the population falling below the poverty line (from 24.9 to 26.5 percent). This worsening poverty incidence sharply contrasts with progress achieved by neighboring countries (Special Focus #1). Similarly, the labor market remains plagued with at least a quarter of the work force either unemployed or underemployed.

To bring the Philippines onto a more inclusive growth path, a steady focus on reforms will be needed, as well as additional resources. One year into office, the Aquino government has taken important steps in initiating needed reforms. To deliver on its priority spending agenda, the Philippines Development Plan targets an increase in revenues of 4 percentage points of GDP from 2010 to 2016. Improved tax efficiency, significantly higher equity and progressivity, and simplification of the tax system should drive revenue mobilization effort.

Recent Economic and Policy Developments

Output and Demand

1. **Growth has been slowing down since the first half of 2010 based on the revised and rebased GDP numbers** (Figure 1).[1] Though the revised GDP growth estimates show small deviation from the old base year and methodology, the revision has resulted in a nominal GDP which is 6 percent larger and hence, lower fiscal statistics as a percentage of GDP (e.g., lower tax effort, but improved debt ratio), but also important sectoral growth changes. Investment is now noticeably higher due to improved coverage and transfer of items previously booked under consumption (e.g., military goods)—the investment-to-GDP ratio in 2010 is now 20.5 percent instead of 15.6 percent (See Special Focus on "*The 2011 National Accounts Revisions (1998-2010)*" on page 29 for details).

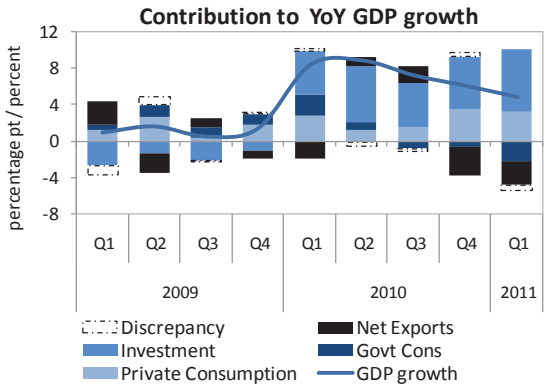
2. **Having exited the rebound phase from the global recession, the economy expanded by a steady 4.9 percent in Q1 2011** (from 8.4 percent in 1Q 2010). The (expected) deceleration in the economy's growth rate mostly stems from a combination of (1) a tightening of fiscal policy; (2) the slowdown in global trade; and (3) a high base effect as Q1 2010 was particularly strong, in part due to election related spending, strongly expansionary fiscal policy, and the rebound from the 2009 global recession. The government's fiscal tightening occurred through a 17.2 percent contraction in nominal National Government spending, in stark contrast with the 21.4 nominal expansion that took place in Q1 2010. As a result, government consumption's contribution to GDP flipped from a positive 2.3 percentage points (pp) contribution in Q1 2010 to a negative 2.0pp contribution in Q1 2011 (Figure 1). The slowdown in global trade and political unrest in the Middle East and North Africa (MENA) constricted exports, as well as, the flow net factor income from abroad (NFIA)—see paragraph 11. On a seasonally adjusted basis, GNI grew by 3.6 percent, a slower pace than GDP, as NFIA has been slowing down for the past two years, mostly mirroring the evolution of the real Peso value of remittances (Figure 12).

3. **A sharp upswing in investments and resilient consumer spending supported economic expansion** (Figure 1). The demand side growth continues to post a remarkable uptick in investment. Investment grew by 37 percent year-on-year and contributed 6.8 percentage points to GDP growth, mostly driven by durable equipment and private construction. Private construction grew by 22 percent, albeit at a slower pace than the preceding three quarters, and compensated for the contraction in public construction which shrank by 37.3 percent due to continued fiscal tightening and a high base effect. Investment in durable equipment grew 17 percent with the building up of inventory in industrial machineries and road vehicles. Notwithstanding rising fuel prices and a contraction in the real peso value of

[1] The National Statistical Coordination Board released its revised national accounts for the period 1998 to 2010. The revisions involve shifting to a new base year (from 1985 to 2000) and adopting SNA 1993 and some areas of SNA 2008. Nominal GDP is now about 6 percent larger than the original estimate.

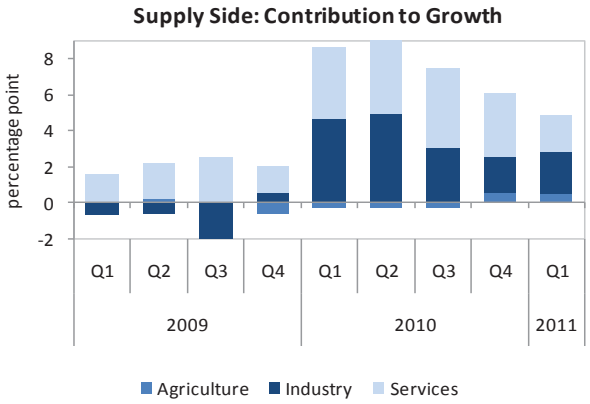
remittances, household spending continued to be a reliable and a stable source of growth, contributing 3.4 percentage points to overall GDP growth, as transport, health and food expenditures drove consumption. Meanwhile, government spending and exports dragged down growth. Non-factor services contracted by 20 percent year-on-year and pulled down net exports (subtracting 2.2 percentage points from GDP growth).

Figure 1. Investment is driving growth while private consumption remains steady



Source: National Statistical Coordination Board (NSCB).

Figure 2. Industry is pulling growth on the supply side



Source: National Statistical Coordination Board (NSCB).

4. **On the supply side, industry was the main driver of growth thanks to domestic oriented sectors** (Figure 2). Manufacturing, mining and construction registered solid growth; with mining expanding 18.6 percent (from 2.4 percent in Q1 2010) thanks to improved natural gas and condensate production. Manufacturing grew 8.6 percent, driven by food and electronics manufactures, and contributed 1.9 percentage points to GDP. Agriculture rebounded and posted its second consecutive quarterly growth of 4.2 percent, thanks to exceptionally favorable weather conditions that supported double digit growths in corn, palay and sugarcane production. Services growth tapered during the quarter, with a significant slowdown in the trade (falling to 0.8 percent from an average of 8.6 percent in 2010) and banking industries (from 10.2 in 2010 to 5.4 percent). Finance, transport and storage, and real estate and the business process outsourcing sectors grew by 5.4, 5.5 and 5.9 percent, respectively.[2] Trade, meanwhile, grew a meager 0.8 percent compared to the robust 11.6 percent growth the previous year (which reflected strong election-related spending).

Employment and Poverty

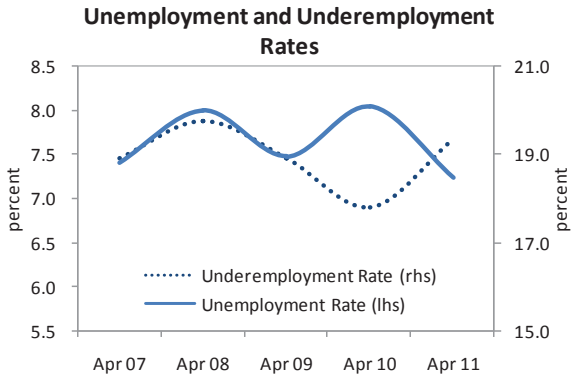
5. **The labor market remained anemic in early 2011, reflecting long standing structural weaknesses**. The unemployment rate improved from a year ago at 7.2 percent in April 2011 (from 8.0 percent in April 2010) while underemployment worsened significantly at 19.4 percent (1.6 percentage points higher than in April 2010)—Figure 3.[3] For the twelve months to April 2011, the number of Filipinos of working age increased by 1.2 million and this translated into a slightly better labor force participation rate (LFPR)—the LFPR increased by

[2] Transport sector growth was thanks to 39.3 percent growth in air transport amid a high fuel price environment. Growth was driven by international traffic as local carriers expanded regional operations for the period.

[3] The significant increase in underemployment rate can be partly attributed to the increase in employment in agriculture which accounted for 43.4 percent of total underemployed.

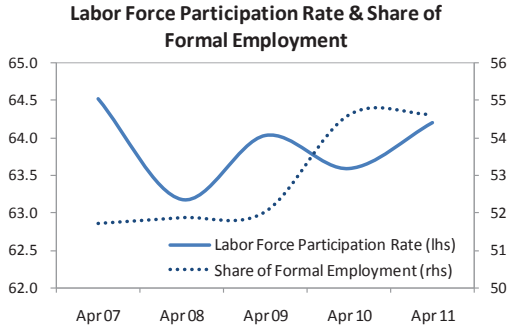
0.6 percentage point to 64.2 percent (Figure 4). The share of formal employment[4] likewise improved slightly to 55 percent (from 54.5 percent last year) while resulting to a net increase of around 450,000 new self-employed and unpaid family workers.[5] After the devastating impacts of the El Niño phenomenon in 2010, agriculture is now adding jobs (Figure 5). Year-on-year, the agriculture sector generated around 640,000 jobs, becoming the main source of employment as of April 2011.

Figure 3. The proportion of unemployed or under-employed Filipinos remains high



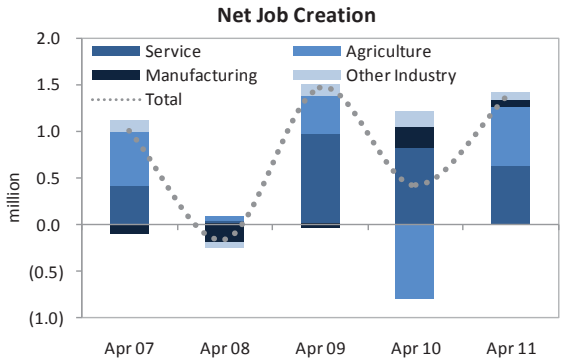
Source: National Statistics Office (NSO).

Figure 4. Strengthening labor force participation and formal employment



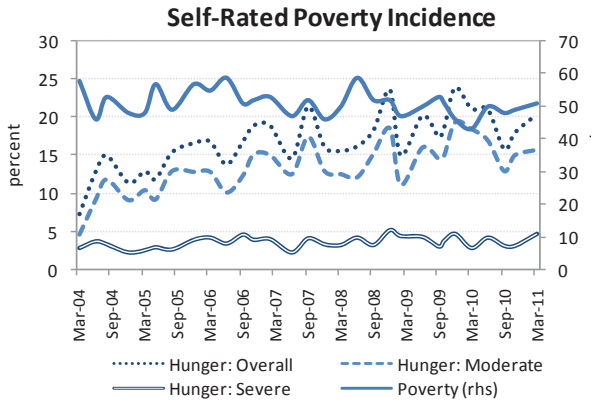
Source: National Statistics Office (NSO).

Figure 5. Agriculture is generating net jobs again



Source: National Statistics Office (NSO).

Figure 6. Poverty and hunger are trending up again



Source: Social Weather Station (SWS).

6. **Following some tepid improvement through mid-2010, poverty and especially hunger have been worsening anew** (Figure 6). Self-rated poverty and hunger incidence rose noticeably in March. Self-rated poverty incidence also worsened as 51 percent (10.8 million) of households considered themselves poor against 43 percent in March 2010. Meanwhile, the latest hunger incidence of 20.5 percent (around 3.4 million families) is 2.4 points higher than in

[4] Proxied as the share of workers receiving wages and salaries.

[5] The reduction of around 1 million self-employed was offset by an increase of 1.5 million unpaid family workers.

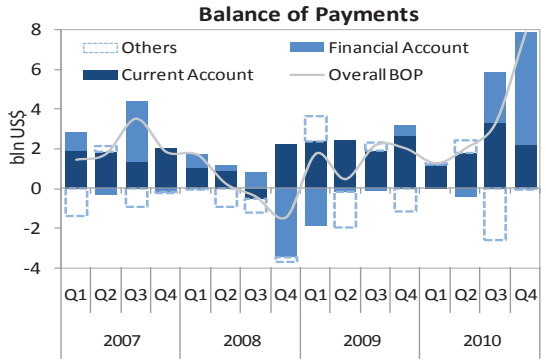
the previous quarter and is nearing the record high of 21 percent reached from December 2009 to June 2010. The self-rated poverty threshold[6] has also remained flat for several years, indicating that poor families have been lowering their living standards in recent years.[7] Over a longer time horizon, it should be noted that based on the same qualitative surveys used to collect the information on self-reported hunger, self-reported poverty and self-reported food-poverty a paradox arises, namely: a declining trend from 1990 to 2011 in both poverty and food-poverty but an increase in hunger (the latter series starts in 1998).

Balance of Payments and External Debt

7. **The balance of payments (BoP) registered a strong surplus in Q4 2010** (Figure 7). The surplus of US$7.9 billion surplus was four times higher than in Q4 2009. The turnaround in capital and financial inflows arose thanks to improved risk appetite for emerging market investments. For 2010, the BoP posted a record surplus of US$14.4 billion (1.7 times the surplus posted in pre-crisis 2007) while the current account surplus decreased to 4.2 percent of GDP as a result of a widening trade deficit. The current account was buoyed by transfers which posted a surplus of US$4.4 billion, up 6.8 percent from a year ago as remittances from non-resident overseas Filipinos remained strong.

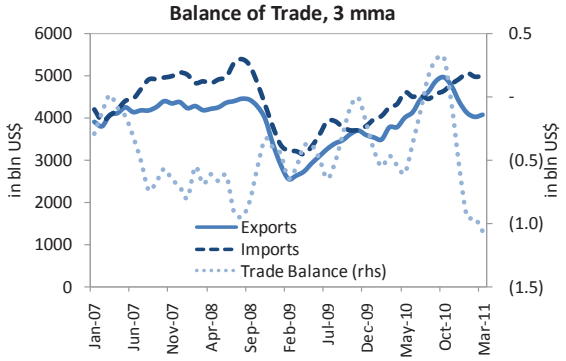
8. **Following a remarkable rebound, export growth started contracting in January 2011** (Figure 8). After growing 34 percent in 2010, exports growth slowed to a 17-month low of 4.0 percent in March 2011. Export of electronics started to decrease in February and registered a 2 percent decline for Q1 2011. Import growth remained strong in Q1. As a result, the trade deficit surged in Q1 2011 reaching US$3.4 billion. Meanwhile, the suspension of plant operations of major semiconductor companies in Japan due to the earthquake, tsunami and nuclear event at Fukushima is expected to negatively impact Philippines electronics exports. Japan has been the top destination of Philippine exports through March accounting for 16.3 percent or US$2 billion of the country's total exports for the year. The Semiconductor and Electronics Industries in the Philippines (SEIPI) cut its export outlook for Q2 to flat.

Figure 7. A strong BoP: a steady current account surplus is now helped by capital and financial inflows



Source: Bangko Sentral ng Pilipinas (BSP).

Figure 8. The trade balance is returning to its past large deficits as exports stumble



Source: Bangko Sentral ng Pilipinas (BSP).

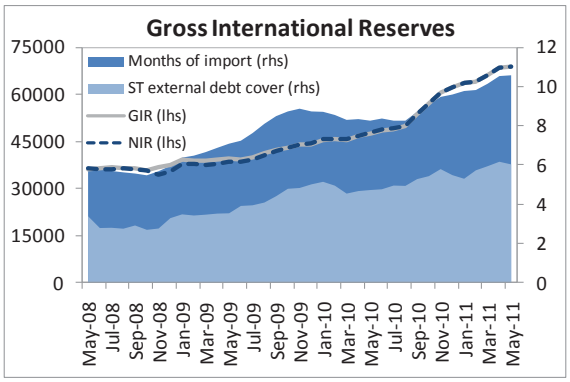
[6] This refers to the monthly budget that poor households need in order not to consider themselves poor in general.

[7] For example, the median poverty threshold of PhP15,000 in Metro Manila is 50 percent above the PhP10,000 threshold of 2000, even though inflation has risen by 66 percent over that period.

9. **Strong inflows from the capital and financial accounts were the key contributor to the record BoP surplus in 2010**. Part of the recent capital inflows into emerging economies may originate from the US Fed's Second Quantitative Easing program (QE2)—as liquidity created from the asset purchase program found its way into emerging economies with high growth prospects and comparatively good fundamentals. Net foreign portfolio inflows for 2010 reached a record US$4.6 billion (5.1 percent of GDP), exceeding the pre-crisis high of 2007 as investments in PSE-listed shares doubled (Figure 10). January-to-April transactions resulted in a net inflow of US$1.6 billion, 176.8 percent higher than the same period last year, thanks to strong demand for Peso-denominated government securities. In contrast, foreign direct investment (FDI) continues to be meager. The two-month cumulative FDI level of US$304 million this year trails the 2010 level by 38.7 percent.

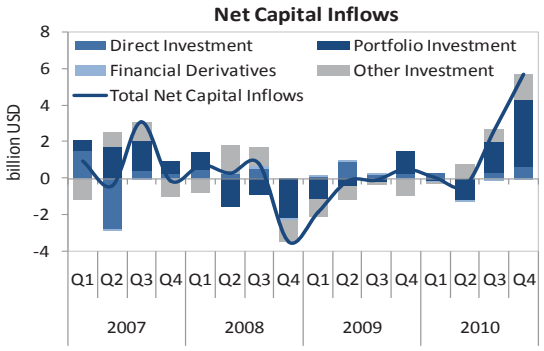
10. **The Philippines continues to accumulate foreign reserves, as these grew to exceed the country's external debt in Q1 2011**. Gross international reserves (GIR) reached US$68.8 billion in May, about 15 percent higher than the country's external debt which stood at US$60 billion. Reserves accumulation was driven by continued growth in overseas Filipino remittances, strong external inflows and foreign exchange operations. As of May 2011, the country's GIR could cover 602 percent of the country's external debt based on residual maturity and 10.6 months worth of imports (Figure 9). The country's outstanding external debt as a percent of GDP decreased to 31.8 percent at end-2010 from 34 percent at end-2009.

Figure 9. Foreign exchange reserves provide ample cover for both short-term debt or imports 1/



Source: Bangko Sentral ng Pilipinas(BSP).
1/ Short-term debt by residual maturity

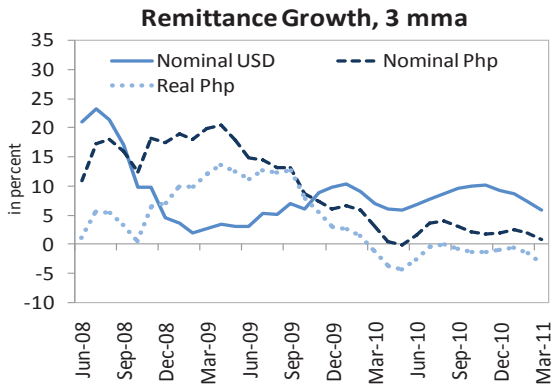
Figure 10. Mobile investment inflows surged while more permanent ones stalled



Source: Bangko Sentral ng Pilipinas(BSP).

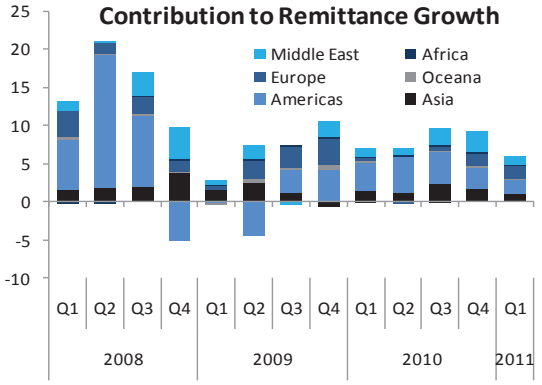
11. **Remittances keep flowing into the country but at a slower pace**. Nominal dollar remittances grew by 5.9 percent year-on-year in Q1 2011 to US$4.6 billion (Figure 11). Political turmoil in MENA did not translate in a contraction in remittances from the region, but might have contributed to the slowdown in the growth of money remitted to the Philippines (from an average of 11 percent growth in 2010 to 6.6 percent in March 2011)—Figure 12. Remittance flows from Japan also showed resiliency amid the earthquake, tsunami, and nuclear threat, as most Filipino workers in the country reside outside the affected areas. In real Peso terms, remittance growth has been negative, averaging a decline of 2.1 percent since March 2010. In part due to a deployment ban to some Middle East countries, worldwide deployment for Q1 2010 totaled 380,188, which is 4 percent lower than in Q1 2010.

Figure 11. The growth rate of remittance inflows is waning



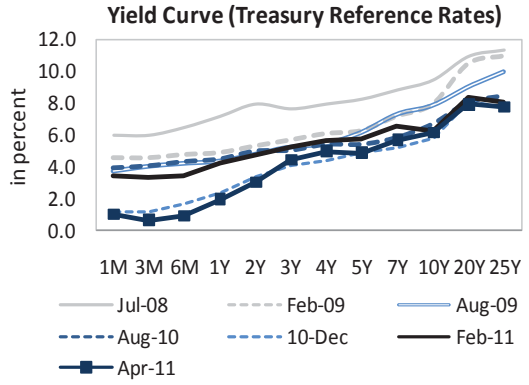
Source: Bangko Sentral ng Pilipinas (BSP).

Figure 12. Remittances from the Middle East continued to grow in Q1 despite the turmoil



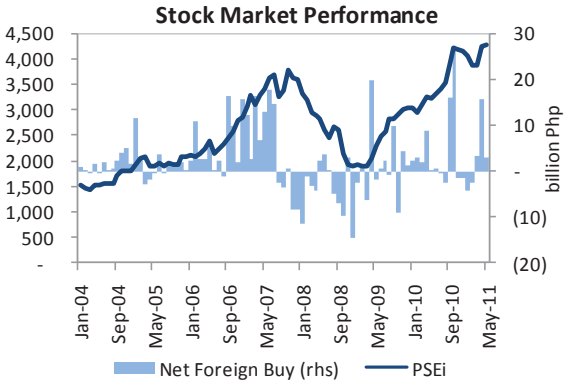
Source: Bangko Sentral ng Pilipinas (BSP).

Figure 13. Ample liquidity and inflation concerns have steepened the yield curve from both ends



Source: PDEX.

Figure 14. PSEi forging ahead thanks to foreign appetite for Philippine equity



Source: CEIC.

Financial Markets

12. **Ample liquidity remains in the Philippines.** The Philippines successfully issued US$1.5 billion worth of global bonds in March, creating a new 15-year benchmark for the country's dollar bonds.[8] The issuance came after two successful issuances of global Peso bonds in September 2010 and in January 2011. The issuance brought the country's overseas debt sales to US$2.75 billion, exceeding the US$2.5 billion originally planned by the government. In line with increased global concerns about inflationary pressures in emerging markets, sovereign spreads for the Philippines crept up in Q1 with spreads widening by 56 basis points (bps) in March reaching 184 bps (the widest since October 2010), up from this year's low of 128 bps in early January. The domestic yield curve steepened in April with the short-end tilting downward on account of increased liquidity (Figure 13). At end-May, balances in the short-term special deposit accounts (SDA) of banks kept with the BSP reached PhP1.50 trillion. SDAs have grown rapidly over the past year reflecting both ample domestic liquidity but also the very favorable yield (4 percent) on offer as compared to government bonds (Figure 13).

[8] The bonds were priced at 99.495 percent with a coupon of 5.5 percent.

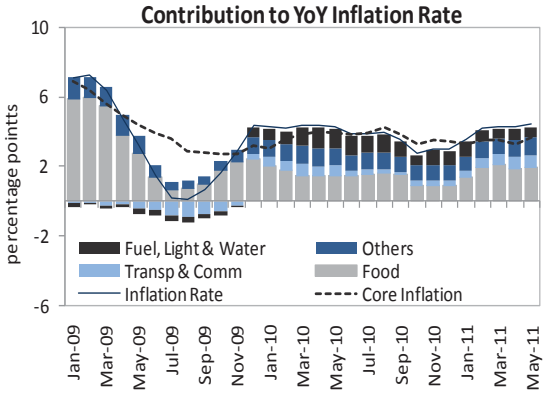
End-May SDA balances are near twice last year's level of PhP835.2 million, and almost triple of the pre-crisis level of PhP558.2 million in September 2008.

13. **Similar to regional peer performance, the Philippine equity market is reaching new highs** (Figure 14). After stagnating at the 3,900 level in the first quarter, the Philippine Stock Exchange index (PSEi) closed at a six-month high of 4,335 points in May despite some cautionary investor behavior over sovereign debt woes, political instability and natural disasters abroad. Foreign investments continued to flow in signaling positive market sentiment on the country's economic fundamentals. In April, net foreign buying rebounded to PhP15.6 billion after some profit-taking took place in Q1.

Monetary Policy

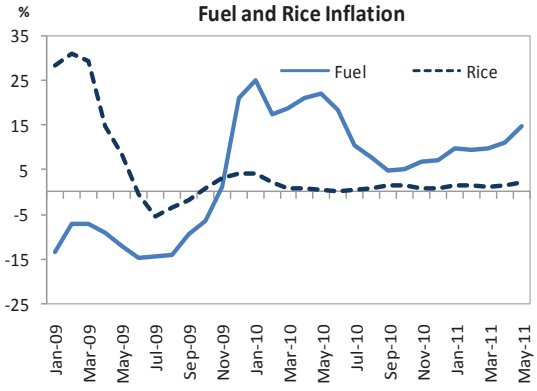
14. **Headline and core inflation have risen since 2011 but remain contained within the Bangko Sentral ng Pilipinas (BSP) target and below regional peers' inflation** (Figure 15). Supply pressures, and in particular increasing fuel and food prices and the resulting secondary effects such as increases in transport prices were key drivers of the uptick in inflation, to 4.5 percent, in May (the highest rate since May 2009)—Figure 16. Headline inflation has gradually increased since January, with year-to-date inflation at 4.2 percent, but remains within the BSP target range of 3 to 5 percent. Price increases among food items[9]—though below price pressures seen in neighboring countries—were due to crop/aquaculture damage from adverse weather conditions, as well as elevated prices of imported selected food products. Food inflation contributed 2 percentage points to overall inflation in May. Transport and communication inflation, at 9.7 percent in May against 4.4 percent in January, stemmed from (mostly regulated) transport fare hikes in Q1. Core inflation has been rising moderately since the beginning of the year, reaching 3.7 percent in May. Increases in the minimum wage in five regions have broadly followed pace with inflation. Effective in May, the National Capital Region's minimum wage was increased by 5.4 percent.

Figure 15. Rising but still moderate headline and core inflation



Source: Bangko Sentral ng Pilipinas (BSP).

Figure 16. Fuel prices on the rise, but staple product prices such as rice remain flat



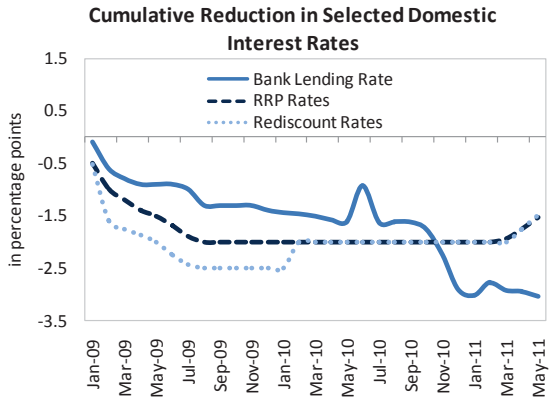
Source: National statistics Office (NSO).

15. **The BSP tightened policy rates twice in 2011 to curb inflationary pressures and expectations but retains an accommodative policy stance**. The Monetary Board of the BSP

[9] Food price inflation rose to 4.2 percent in May, up from 3.0 percent in January 2011.

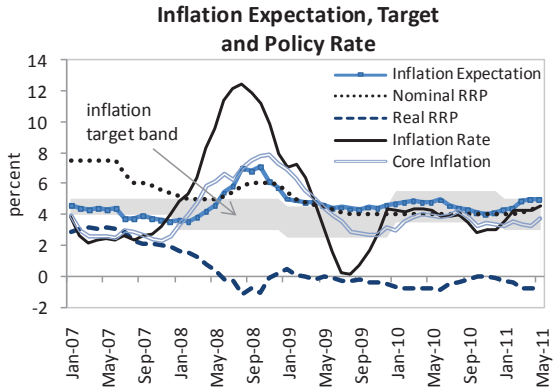
raised its policy rates twice this year concerned with the upward shifts in inflation expectations shown by most surveys. As a result, key policy interest rates were raised by a total of 50 bps to 4.5 percent for the overnight borrowing or reverse repurchase (RRP) facility and 6.5 percent for the overnight lending or repurchase (RP) facility. These rates had been set at historical lows since August 2009 when they were cut by 200 bps from December 2008 to August 2009 (Figure 17). The BSP also raised the regular bank reserve requirement by 1 percentage point to 20 percent on June 16. Notwithstanding the real appreciation of the peso and some unwinding of the policy measures introduced at the onset of the global financial crisis, monetary policy remains accommodative in the Philippines as real policy rates have been broadly negative since mid-2009. A credible inflation targeting regime and limited exposure to recent international food price increases—thanks to favorable domestic developments[10]—has enabled this sustained stance to be consistent with anchored inflation expectations (Figure 18).

Figure 17. Policy and bank lending rates remain well below pre-crisis level



Source: Bangko Sentral ng Pilipinas (BSP).

Figure 18. Sustained negative real policy rates along with anchored inflation expectations



Source: Bangko Sentral ng Pilipinas.

Fiscal Policy

16. **In sharp contrast to the large deficit accumulated in the run up to the 2010 election, the NG fiscal balance posted a surplus from January to April 2011** (Table 9 page 37). The switch from a 1.5 percent of (annual) GDP fiscal deficit in January-April 2010 to a small surplus in the same period of 2011 was mostly driven by expenditure restraints (1.2 percentage points of GDP in lower spending). Primary (i.e., non-interest) spending was the key source of savings compared to the 2010 period, thanks to lower capital outlays, maintenance and operating expenditures—due to significant non-recurring spending that took place in January-April 2010[11]—and spending on personal services. Interest payments dropped by a

[10] As far as the sensitive rice prices is concerned, for example, strong domestic production, good planting intentions, record stockpiles of rice, and domestic wholesale prices significantly above international prices have ensured that domestic retail prices remained subdued. For further details, see the Special Focus on "Food Prices in the Philippines" of our January 2011 *Philippines Quarterly Update* for details.

[11] Government spending during the first quarter of 2010 was on non-recurring items such as rehabilitation efforts on Ondoy and Pepeng typhoon affected areas and preparatory activities for the 2010 automated elections.

significant 0.4 percentage points of GDP between the two periods due to a combination of lower debt stock, and more favorable interest rates and exchange rates.

17. **Capacity constraints along with cautiousness among spending agencies and project implementation delays were key factors containing primary spending** and disrupted the intended frontloading of the 2011 budget. The release by the Department of Budget and Management (DBM) of two-thirds of the programmed PhP1.645 trillion NG budget for 2011 was aimed at providing relief to the economy at a time of rising fuel and food prices.[12] Despite this front-loading of releases on DBM's side, implementation of programs and projects has been slow due capacity constraints and to more caution exercised by agencies in planning and spending allotted funds.[13] The DBM aims to identify implementation bottlenecks to speed up spending and reduce the backlog of projects and programs lined up for the remainder of the year. A pick-up in government spending is, therefore, expected from Q2 onwards. Meanwhile, government flagship programs such as the 4Ps's conditional cash transfer program is proceeding ahead of schedule, with 63 percent of the targeted 2.34 million households (60 percent of poor households nationwide) for 2011 already receiving cash grants.

PROSPECTS

Output and Demand

18. **Short- and medium-term prospects remain favorable for Philippines growth; we maintain our growth forecast of 5.0 percent for 2011 and 5.4 percent for 2012** (Table 8 page 36). Notwithstanding the national accounts revision,[14] Middle East turmoil and Japan's disaster, Q1 growth performance was in line with our annual projection and a normalization of growth towards potential. Prospects on the supply side remain favorable with manufacturing and construction projected to benefit, among others, from the end of the trade disruption linked to Japan's disaster and its post-disaster reconstruction for the former, and solid growth forecast for the business process outsourcing for the latter. Increasing mineral prices[15] will provide incentive to fast track investment and/or increase production in the mining sector. The strong performing subsectors of the services sector in Q1 are expected to remain robust throughout the year based on industry leading indicators. The agriculture sector is projected to continue being a net contributor to growth.[16] On the demand side, fiscal policy is projected to be looser for the rest of 2011 compared to the January to April period which was tighter than expected. Net exports are projected to recover due to a combination of a technical rebound in exports

[12] The remaining unreleased one-third of the budget is allocated for non-discretionary items such as interest payments and internal revenue allocation of local government units.

[13] For example, the Department of Public Works and Highways (DPWH) has suspended spending on road rehabilitation until substantive appraisal has been performed for the projects. Further, a number of lump-sum funds have remained unreleased pending the submission or approval of special budget requests and additional documentation to comply with the government's fiscal accountability and transparency program.

[14] See Special Focus section on page 33.

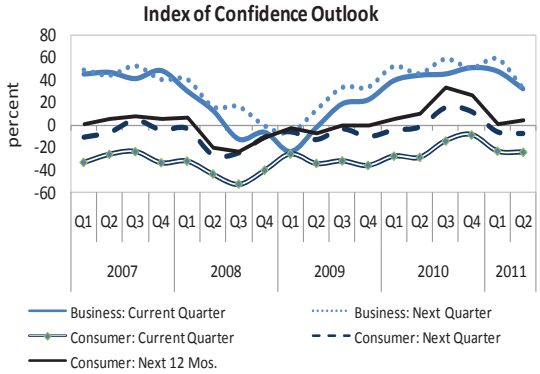
[15] Prices of gold and silver are expected to grow by 20 and 33 percent, respectively, according to the World Bank's June 2011 *Global Economic Prospects*.

[16] This is due to a combination of a base effect as the El Niño phenomenon brought severe droughts in 2010, and the positive impact on agricultural yields in 2011 from La Niña-induced precipitations.

that were affected by Japan's earthquake-tsunami-nuclear event combined with a potential boost in exports of goods and services (including labor exports) to Japan as Philippines companies and workers contribute to the reconstruction of afflicted areas. Private consumption is projected to be buoyed by strong wage growth and employment among relatively well paid and formal sectors (e.g., the BPO) while counter-cyclical remittances[17] will no longer sustain consumption growth.

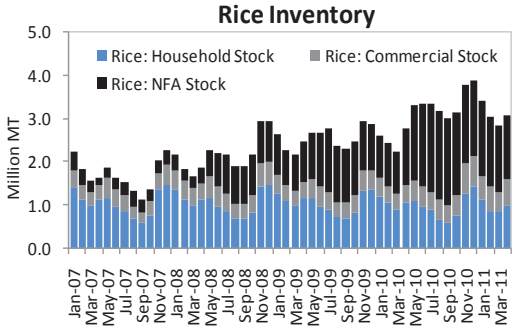
19. **Investment is projected to continue strengthening in 2011 and onwards** (Table 8 page 36). As a ratio of GDP, investment is projected to rise[18] from 20.5 percent in 2010 to 21.5 percent in 2011 in part due to improved medium-term economic prospects. While the investment-to-GDP ratio is higher with the revised and rebased GDP, that ratio remains at a relatively low level in the region and has been declining since 2003. Foreign investments have also been persistently modest, both in relation to GDP or total investment, but also as a proportion of the pool of FDI in the region. The government's ongoing Public-Private Partnership (PPP) program aims to address the low level of investment and boost potential growth as it would relieve key infrastructure bottlenecks and spearhead private investment. The good governance practices introduced in the 2011 budget[19] contribute towards improving investor confidence. While business sentiment remains positive as of Q2 2011, the rise in commodity prices, geo-political tensions in the MENA and the disaster in Japan dented the confidence of both consumers and businesses (Figure 19); these are projected to be temporary.

Figure 19. Recent commodity price hikes dampen consumer and business sentiment



Source: Bangko Sentral ng Pilipinas (BSP).

Figure 20. Rice stocks remain strong and far larger than targets



Source: Bureau of Agricultural Statistics (BAS).

20. **Risks around our growth forecast for 2011 are evenly balanced.** Given the high volatility of recent international commodity prices and their impact on consumers and firms, these represent an important source of both downside and upside risk for the economy. While business confidence has dampened in light of various external shocks that took place in early 2011—the MENA and Japan events, rising commodity prices—domestic investment represent an important upside potential given the strong focus and early gains of the Aquino

[17] The real peso value of remittances is projected to be negative in 2011.

[18] Notwithstanding the large upward revision stemming from the revised national accounts—see Special Focus section on page 33.

[19] See the Special Focus on "The 2011 National Government Budget: Structural Reforms and Consolidation" of the World Bank's September issue of the *Philippines Quarterly Update*.

administration in tackling corruption and improving the investment climate. Downside risks reside with weaker-than-expected remittances (in real peso terms); this could arise from a stronger than expected appreciation of the peso (due, for example, to renewed strong capital inflows into emerging markets), or weaker dollar remittance flows[20] as the continued weakness in the labor markets of countries with large Filipino workers or residents impacts deployment and the incentive to remit. Weak growth in the United States of America or among European countries would also negatively impact the Philippines. In the US, risks include the uncertainty surrounding the end of the Federal Reserve's QE2 program as well as the debt ceiling on the Federal debt. In the European Union, risks relate to the crisis among the peripheral countries and contagion effects. Given the stronger fundamentals than at the onset of the global financial crisis, even a return to large external shocks should be manageable for the Philippines.

Employment and Poverty

21. **As the economy is projected to return to its pre-crisis normal throughout 2011, so are its labor market and poverty dynamics, at least in the short-term**. In the Philippines, the 2000s were characterized by strong average economic growth and a rise in both inequality and poverty incidence. Recent SWS poverty surveys and economic growth data reveal that this lack of inclusive growth remains pervasive and is projected to remain over the short-term. Critical and significant reform measures have been introduced by the Aquino government to break the positive poverty-growth correlation in the Philippines. The full benefit of these reforms would accrue over time. For example, the 4Ps conditional cash transfer program is expected to buttress their recipients from short-term hardship through a life line cash transfer—social protection motive—but the poverty reducing part of the program (increasing and protecting the human capital of the poor's children so as to break inter-generational poverty linkages) will take longer to deliver its full impact.

22. **Segmented and dual labor markets are expected to continue over the short-term**. Weak or non-integration of labor markets across space and sectors generates dual labor markets: e.g., formal/informal, skilled/unskilled, full time/part-time, permanent/temporary, and high/low pay and benefits. Net job creation of formal/skilled/full time/permanent/high pay is expected to be strong, to a large extent thanks to the business process outsourcing (BPO) which is expected to create another 80,000 new full time positions in 2011.[21] Agriculture, on the other side, is also expected to become a large source of net job creation—after having destroyed an average of 73,000 jobs for several quarters due to El Niño's impact. These jobs would provide large opportunities for the low and semi-skilled workers.

Balance of Payments

23. **The current account surplus is projected to narrow as the trade deficit expands and slower deployment of overseas workers impacts remittance inflows**. Philippine exports are facing a general weakness in its major destination countries. The strengthening of

[20] For 2011, the nominal dollar value of remittances is projected to be 8 percent higher than in 2010. This assumes the turmoil in the MENA region does not spill over to Saudi Arabia and/or the United Arab Emirates as these contain a significant Filipino population (Table 2)

[21] The Business Processing Association of the Philippines (BPAP) projects an annual baseline growth of 15 percent for the period 2011-2016. As of end-2010, total employment in the BPO industry reached 525,000, a 24 percent growth from previous year.

the real value of the peso vis-à-vis these key markets over the past twelve months is also impacting export growth. Imports, meanwhile, have been strong reflecting both the strength of domestic demand and an increase in the value of fuel imports. These are projected to widen the trade deficit to 6.2 percent of GDP in 2011 (Table 8, page 36). In addition, exports of services also showed signs of weakness as indicated by the sharp contraction in the first quarter. The growth of current transfers as well as the net factor income from abroad is projected to continue slowing down, in part due to lower overseas deployment that, ultimately, would lower the growth rate of remittance inflows.[22] The current account surplus is projected to narrow to 2.7 percent of GDP from 4.2 percent in 2010.

Table 1. The share of MENA and Japan in the Philippines' international trade

	Share to Total Exports			Share to Total Imports		
	MENA 1/	MENA with unrest 2/	Japan 3/	MENA 1/	MENA with unrest 2/	Japan 3/
2007	1.0	0.3	14.5	14.1	0.6	12.4
2008	1.2	0.3	15.7	15.4	0.7	11.8
2009	1.3	0.3	16.2	7.7	0.5	12.4
2010	1.1	0.2	15.2	8.6	0.4	12.3
2011 4/	1.1	0.3	16.3	…	…	…

1/ includes Algeria, Bahrain, Egypt, Iran, Iraq, Israel, Jordan, Kuwait, Lebanon, Libya, Morocco, Oman, Palestinian territories, Qatar, Saudi Arabia, Syria, Tunisia, United Arab Emirates, Yemen, Djibouti, Mauritania, Somalia, Sudan.
2/ includes the following countries: Bahrain, Sudan, Libya, Yemen, Iran, Iraq, Tunisia, Egypt, Lebanon, Oman, Algeria, Jordan.
3/ Excluding Okinawa.
4/ As of January through March 2011.

Table 2. MENA's share of total overseas Filipinos and remittances

	Geographical breackdown of overseas Filipinos (OF)				Remittances
	Permanent	Temporary	Irregular	Total	from OF
Number of overseas Filipinos (millions)	4.1	3.9	0.7	8.6	
Remittance inflows (billions of USD)					18.8
	(in percent of total overseas Filipinos)				(percent)
Total	47.3	45.0	7.7	100.0	100.0
Americas	36.9	3.0	1.9	41.8	42.8
MENA: others	0.0	25.3	1.1	26.4	14.5
MENA: with unrest countries 1/	0.0	1.9	0.3	2.3	1.3
Asia	3.1	6.4	3.0	12.5	9.4
Europe	3.6	3.6	1.2	8.4	10.5
Oceania	3.6	0.8	0.1	4.5	1.2
Sea-based workers	-	3.9	-	3.9	20.3
Africa	0.0	0.2	0.0	0.3	0.0

Source: Commission on Filipinos Overseas, Bangko Sentral ng Pilipina. Data on overseas Filipinos are from 2009 while those on remittances are for 2010.
1/ Includes the following countries: Bahrain, Sudan, Libya, Yemen, Iran, Iraq, Tunisia, Egypt, Lebanon, Oman, Algeria, Jordan

24. **The impact of the turmoil in the MENA region should remain tractable for the Philippines provided the turmoil does not spread to larger countries in the region.** While

[22] Overseas job contracts processed by the Philippines Overseas Employment Agency (POEA) through May 2011 have shrunk by 9 percent compared to the same period in 2010. The latter, combined with a slowdown in the growth rate of remittances from across all regions could reflect some sluggishness in the world labor market.

the MENA turmoil increased the international price of oil products, the impact should remain manageable for the Philippines. Direct exports to countries with unrest account for 0.2 percent of merchandise exports (mostly fruits and other food products) and 0.4 percent of imports (which are mostly oil-related). About 8 percent of total Philippines imports are oil-related but originate from other MENA countries—Table 1. In terms of impact on overseas Filipinos and on remittances, the impact is projected to be minimal as the countries currently affected by the turmoil account for only 2.3 percent of total stock of overseas Filipinos and 1.3 percent of total remittances sent to the Philippines. However, since 16 percent of total remittances and 28.7 percent of total overseas Filipino workers are from the MENA region, a spreading of the turmoil would represent a significant downside risk for remittances and net factor from abroad and potentially compel the return of many of the 2.5 million Filipinos living in the region (Table 2).

25. **While the disasters in Japan had a negative short-term impact on the Philippines, the medium-term net impact is uncertain but likely small**. In 2010, Japan was the Philippines' top export destination (15 percent of total exports) and import origin (12.3 percent). Most of these imports are machinery, mechanical appliances, electrical machinery and equipment, vehicles and their parts; some of which are electronic parts which are re-assembled in the country and re-exported back to Japan. According to the Semiconductor and Electronics Industries of the Philippines Inc. (SEIPI), export of its members for 2011 will remain subdued in Q2 but is projected to increase in the second half of the year.

Monetary Policy

26. **Inflation is projected to peak at mid-year and to remain within the BSP target range for the year average** (Table 8 page 36). Our baseline inflation projections—an average inflation rate of 4.8 and 4.5 percent for 2011 and 2012, respectively—rely on two key factors. First, a stabilization of international commodity prices for the rest of 2011 from their current (elevated) level, as described in our June 2011 *Global Economic Prospects*. For 2012, commodities are expected to decline moderately from their 2011 level (e.g., oil prices are projected to average US$107.2 per barrel in 2011, and US$102.1 per barrel in 2012[23]). Without pressure from international commodity prices, domestic food price inflation is expected to remain moderate thanks to a combination of good harvests and important buffers of critical food items such as rice (about 3.1 million tons of rice was stockpiled as part of the food security reserve as of April 2011—Figure 20; this represents about 150 days of consumption, which significantly exceeds the total (public and private) stockpile target of 90 days excess as well as the reserves available at the onset of the 2008 food crisis).[24] Second, is an assumed paced unwinding of the accommodative monetary policy stance.

27. **The balance of risks to our inflation forecast is moderately on the upside.** A large upward shock to commodity prices is the most damaging and highest likelihood risk. Surprise increases in regulated prices and in tax policy in 2012 could also push up headline inflation. The former could, for example, include surprise increases in electricity prices should the

[23] Simple average of Dubai, Brent and West Texas intermediate.

[24] With reserves significantly exceeding targets, the government plans to only import 35 percent of rice imported in 2010 (i.e., 2.45 million metric tons). As of May 2011, the government imported about 200,000 tons and awarded import rights for the 660,000 metric tons of rice to the private sector in 2011.

Energy Regulation Commission (ERC) eventually approve the longstanding charge for stranded costs provided in the EPIRA law, or prices and tariffs for products and services delivered by Government-Owned and Controlled Corporations (GOCCs) as the government continues its efforts to increase cost recovery within these companies. Regarding the latter, while no specific tax policy changes have been announced, the election pledge of President Aquino of no new taxes and no tax increases in the first 18 months of his mandate ends at end-2011. Given the ambitious and desirable spending programs envisioned in the 2011-2016 Philippines Development Plan (PDP), and the commitment to reduce the fiscal deficit, revenue mobilization has to be materially strengthened. Eventually, tax policy measures have to be introduced; the inflationary impact of these would depend on the specific measures introduced, their timing and scope.

Fiscal Policy

28. **The fiscal balance is projected to improve notably in 2011 thanks to downward revision to total expenditure and despite continued revenue mobilization challenges** (Table 9 page 37). Compared to the overall fiscal deficit of 3.5 percent of GDP in 2010, we project the fiscal balance to improve by 1.1 percentage points—ahead of the government's medium-term path for reducing the deficit to 2 percent of GDP by 2013. Most of the fiscal improvement (61 percent or 0.7 pp of GDP) will stem from reduced spending. Forty percent of the spending contraction is projected to come from interest payments owing to a combination of lower debt level, a strong Peso, and continued low interest rates. Savings on tax expenditures and subsidies, as rice imports and GOCC losses are estimated to be lower in 2011. Unless structural reforms are undertaken to reform the NFA, tax expenditures and subsidies are projected to increase notably in 2012 as the low NG spending on these items for 2011 reflect to a large extent the excess rice imports that took place in the first half of 2010 which have enabled 2011 rice imports—at 0.8 million tons—to be significantly below annual averages of about 1.5 million tons).

29. **Save for tax policy changes, revenue mobilization is projected to remain well below pre-global recession level, mostly due to permanent tax erosion introduced since 2008.** The revised GDP series reveal that the tax effort actually declined from 2009 to 2010 despite economic growth reaching a three decades growth rate and strong profitability of the corporate sector (this profitability pushed the Philippines Stock Exchange index to record highs in 2010). For 2011, some buoyancy is expected from income taxes—as profits and wage growth in the formal sector are projected to be strong—and from customs collection—given strong imports, including from oil. However, these will be partly offset by the continued decline in excise tax collection. With unchanged tax policy measures expected to be introduced in 2011, increases in the tax effort will rely on the capacity of the tax administration (the Bureau of Internal Revenue and the Bureau of Customs) to raise both voluntary and involuntary tax compliance. The revival of key compliance programs by the BIR since July 2010 such as the Run After Tax Evaders (RATE) program and, more importantly, the successes in securing convictions through the court system for a few RATE cases should, if sustained over time, generate notable improvements in tax compliance. As a result, we project the 2011 tax effort to improve by 0.2 percentage points of GDP to 12.3 percent of GDP (Table 9 page 37). Tax policy measures are needed to push the tax effort to a level consistent with the government's 2011-2016 Philippines Development Plan objectives.

30. **The under-spending through April likely reflects the enhanced transparency and accountability standards introduced in the 2011 budget and will take time to unwind.** While the Department of Budget and Management (DBM) had disbursed rapidly the budgetary allocations to line ministries and agencies, these proved unusually slow in using these allocations. The new transparency and accountability standards introduced in the 2011 NG budget require agencies and departments to disclose the details of their budgetary execution.[25] Hence, agencies likely paid greater attention to the execution of their budgets, the assessment of cost assumptions of their programs and streamlined their systems and processes to improve fund absorption. As department and agencies will likely need some time to adapt their systems and practices to reflect this more demanding environment, under-spending for 2011 as a whole is a risk.

31. **The sustainability of the non-financial public sector debt continues to strengthen, in part due to improved debt structure by the Department of Finance.** A debt sustainability analysis reveals that debt is broadly sustainable as the country can withstand a diverse and strong variety of shocks, large and combined shocks would remain more challenging. However, given robust projected nominal GDP growth, and to a lower extent a stronger Peso, debt ratios are projected to steadily decrease (e.g., NG debt is projected to decline from 52.4 percent of GDP in 2010 to 50.1 percent in 2011 and to 41.5 percent in 2014). The Department of Finance has also used the favorable environment of low domestic interest rates and low international spreads to strengthen the debt structure by lengthening the debt maturity profile.[26]

Crafting a new (inclusive) normal

32. **To a large extent, the Philippines has likely already moved to a new normal, with more robust and less variable growth**. Prior to the Global Recession, the country was perceived and shown to be a "high beta" country as weak fiscal positions and recurrent political crises would expose the country to shocks and volatility. The Global Recession showed the extent to which the country's economic fundamentals have improved, especially on the balance of payments side[27], financial system side, but also on the fiscal front. The November 2010 of the country's sovereign foreign currency rating by Standard and Poor's and a similar upgrade by Moody's this June[28]—which for both agencies was the first such upgrade for the Philippines since 1997—are testament to this new normal.

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[25] See the Special Focus on "The National Government Budget: Structural Reforms and Consolidation" of the September 2010 *Philippines Quarterly Update* for details of the structural reforms introduced in the first budget of the Aquino government

[26] For example, from June 2009 to December 2010, the average maturity for domestic liabilities rose from 5.45 years to 6.66 years in the same period, while those of foreign debts increased from 10.8 years to 11.37 years.

[27] The large shocks that hit the economy—the 2008 food and fuel crisis, the global financial crisis, the collapse in global trade—have shown how resilient the country's external position was to either supply or demand shocks. The current large foreign exchange reserves provide the country with a significant buffer against shocks.

[28] The Philippines rating was upgraded by one-notch from Ba3 to Ba2 with stable outlook, placing its foreign and currency ratings just two notches below investment grade. Both Standard and Poor's and Fitch also rate the Philippines two notches below investment grade.

33. **The challenge is now to move the economy to a new normal, one that generates inclusive growth—i.e., growth that all citizens participate in and benefit from.** Achieving this objective requires robust and steadfast inroads into structural weaknesses. To craft a new—more inclusive—normal for the Philippines and its citizens, a two-pronged strategic approach was advocated in a recent World Bank report.[29] This consisted in:

- *Taking actions that enhance the income-earning opportunities of the poor.* This encompasses actions designed to both promote faster growth and the employment intensity (including that of the low and semi-skilled workers) of the growth process. For the former, addressing the main constraints to growth is critical.[30] For the latter, eliminating barriers to factor mobility is critical. Those in the labor market deserve further attention, both because labor is the poor's main asset and the Philippines' labor market legislation appears to be among the most rigid in the region.

- *Assisting households to participate in markets and benefit from growth by enhancing their human capital.* Greater efforts are needed to improve access to education, health, and social protection services, particularly among the poorest populations and in the poorest regions.

34. **One year into office, the Aquino government has taken important steps in crafting a new normal for the country**. Notable measures to eliminate constraints to growth include (1) improving the transparency of the public sector budget and of public financial management, to improve governance and the public's perceptions of governance;[31] (2) launching a high priority and ambitious Public-Private Partnership program to address not only infrastructure bottlenecks but also to help foster the development of inclusive sectors such as tourism (e.g., regional airport development combined with partial Open Sky agreements would enable international tourists to reach tourism hot spots in the Philippines directly, rather than having to connect through Manila's congested airports[32]) In terms of boosting and protecting human capital of the poor and vulnerable, a major measure was a reshuffling of social protection resources away from wasteful and ineffective programs and towards the targeted and efficient 4Ps conditional cash transfer program. By end-2011 the 4Ps is budgeted to cover 60 percent of the poor.

35. **To craft a Philippines that delivers inclusive growth, a steady focus on reforms will be needed but so will additional resources**. As indicated in the 2011-2016 Philippines Development Plan (PDP), to increase and protect human capital of each and every Filipino so that they can be fully engaged and benefit from the development of the country, major spending programs are needed. Two such programs include lengthening the education curriculum from 10 to 12 years, as is the international norm, and introducing universal health

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[29] World Bank, 2010, *Philippines: Fostering More Inclusive Growth*, Washington DC.

[30] These are (1) a vulnerable fiscal situation; (2) inadequate infrastructure, particularly in transport and electricity; and (3) a weak investment climate due largely to governance concerns.

[31] As detailed in our September 2010 *Philippines Quarterly Update*, the 2011 National Government budget contains significant measures aimed at improving spending efficiency, transparency and accountability of the budget

[32] A first partial Open Sky agreement with Malaysia was signed in June 2011 allowing Malaysian and Philippine carriers unlimited flights to all secondary international airports within the two countries.

care. To finance these programs as well as deliver on the 2011-2016 PDP goal of reducing the fiscal deficit, a significant increase in revenue is necessary. To achieve this needed revenue mobilization, the strategy of the government has been to first increase tax compliance through enhanced tax and customs administration. Ultimately, however, tax policy changes would also be needed to complement the compliance-enhancing administrative measures.

36. **Philippines history reveals that large revenue mobilization efforts seldom occur outside of fiscal crises; yet such mobilization is required**. As a report by Nobel laureate Paul Krugman stressed out two decades ago: mobilizing sufficient tax resources has been a perennial challenge for the Philippines (Krugman et al., 1992).[33] Since peaking in 1997, the tax effort has been significantly lowered, mainly due to a combination of discretionary tax eroding measures and weak buoyancy of the tax system. While a significant tax package was passed in 2005 under the 13th Congress, a total of 36 tax eroding laws were passed by the next Congress (June 30, 2007—June 30, 2010).[34] This represents an average of one tax eroding law every month (excluding trade agreements).[35] The tax effort has been particularly affected by a generous and widening system of tax incentives, a reduction in the CIT rate in 2009 (a sunset clause from the 2005 tax package[36]), decreased excise collection account for almost two-third of the decline in the tax effort between 1997 and 2008, in part due to non-indexation of specific rates to inflation, lower effective tariffs, and VAT base erosion.

37. **To deliver on its priority spending agenda the Government's PDP targets a 4 percentage points of GDP increase in revenue from 2010 to 2016**. To achieve these goals, the Department of Finance (DoF) has already (1) submitted a revised fiscal incentives rationalization bill to Congress and has identified it as a priority bill, (2) is supporting a bill aiming to rationalize and increase excises on tobacco and alcohol, and (3) is supporting a Fiscal Responsibility bill which, inter alia, includes a provision that Congress can only propose revenue or expenditure measures if they simultaneously introduce offsetting measures that are fiscal neutral for the budget. While enacting these bills—in the version submitted/supported by DoF—would significantly improve the tax effort, further tax policy changes would be needed to arrive at the quantitative revenue goal set in the PDP. To help craft a new (inclusive) normal, these tax policy reform could be guided by the following core objectives:

(1) Increasing the tax effort to the level required in the PDP;

(2) Improving the efficiency of the tax system so as to provide a more growth-friendly environment for businesses to strive, especially small and medium-sized businesses

[33] "A limited revenue base has constrained the ability of the government to undertake socially necessary spending, especially on infrastructure. And tax collection is an area in which the Philippines conspicuously underperforms its neighbors" Paul Krugman et al., 1992, "Transforming the Philippine Economy".

[34] Alonzo, Emmanuel M., 2011, "Fourteenth (14th) Congress Grant of Tax Perks—An Evaluation," *Tax Bits*, Vol. 2(5), January-February, Senate Tax Study and Research Office (STSRO), Manila.

[35] These include the corporate income tax rate reduction to 30 percent, PERA law, tourism incentives, implementation of the ASEAN Trade in Goods Agreement, of the Japan-Philippines Economic Partnership Agreement, tax incentives in Bataan and Aurora economic zones, abolition of DST on secondary trading stocks, and Real Estate and Investment Trust.

[36] The original 2005 reform plan was to accompany the tax rate reduction by an elimination of fiscal incentives to maintain revenues constant. The elimination of fiscal incentives did not take place, however, so revenues fell.

for which tax compliance is more daunting than large companies; in many countries, SMEs are the largest source of net job creation.

(3) Improving the overall progressivity (equity) of the tax system. The large reduction in the tax effort since 1997 has been accompanied with a notable decrease in the revenue intake from taxes that are progressive, such as excise collection from petroleum products (see Box 1 of the February 2010 *Philippines Quarterly Update* for a detailed analysis of the issues and some recommendations[37]), or from a reduction in the progressivity of specific taxes such as the personal income tax; and

(4) Simplifying what has become a complex tax system. Simplicity would generate important benefits in terms of administration of the tax system but also taxpayers' compliance costs. Opportunities for corruption should also be reduced. This would result in an improved business and investment climate.

[37] Key findings are that raising revenue through petroleum excises would (1) generate minimal economic distortions (i.e., "efficient" taxes); (2) predominantly impact well-off Filipinos (consumption is strongly "progressive" in the sense that the richer households are, the higher the share of petroleum products consumption in their total spending); (3) reduce bad side effects of consuming petroleum products ("negative externalities") such as traffic congestion, accidents, but also pollution which creates health hazards and environmental damages—the Philippines under-taxes compared to the rest of the world a major source of global warming; and (4) be easy to administer provided effective border controls are in place.

SPECIAL FOCUS

Poverty and Inequality in the Philippines[38]

38. 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.

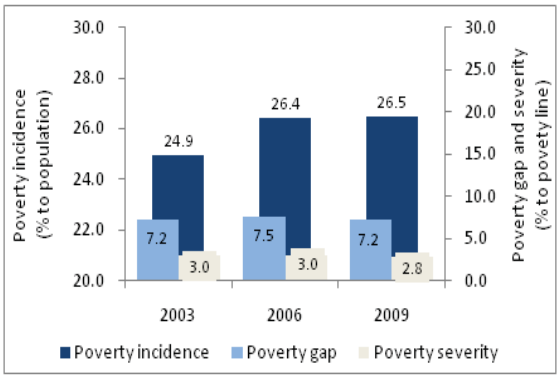
39. **In contrast with previous trends, household per capita incomes grew from 2006 to 2009; remarkably, rural and poorer households strongly outperformed** (Table 3). The latest (2009) Family Income and Expenditure Survey (FIES) reveals that overall household per capita income rose by 4.4 percent during the period 2006-2009. While modest, this is in contrast with the 3.4 percent decline in real incomes that took place during the 2003-2006 period. Interestingly, rural areas significantly outperformed urban ones with a 7.2 percent overall increase compared to 3.0 percent, respectively. Also remarkable—and consistent with the rural area outperformance—was that increases in per capita were strongest for poorer households than richer ones.

Table 3. Per capita incomes, 2003-2009

	Per capita income			Change	
	2003	2006	2009	2003-06	2006-09
	(In 2000 peso)			(percent)	
Philippines	27,046	26,133	27,295	-3.4	4.5
Urban	37,687	35,924	37,018	-4.7	3.0
Rural	16,788	16,615	17,805	-1.0	7.2
Income Group					
Q1 (Poorest)	6,207	6,174	6,715	-0.5	8.7
Q2	10,993	10,628	11,285	-3.3	6.2
Q3	17,110	16,459	17,263	-3.8	4.9
Q4	27,881	26,926	27,882	-3.4	3.5
Q5 (Richest)	73,043	70,481	73,335	-3.5	4.0

Source: World Bank staff based on the FIES 2003, 2006, 2009.

Figure 21. Overall Trends in Poverty, 2003-2009



Source: WB staff estimates using FIES 2003, 2006, 2009.

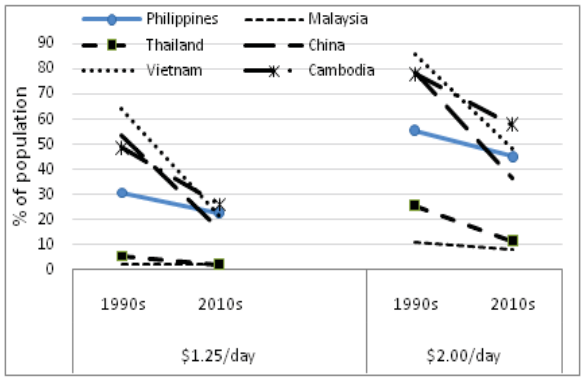
[38] For more details, see the "Poverty Profile of the Philippines: 2003-2009" prepared by Rashiel Velarde as a background paper for the *Social Protection Program Review* (forthcoming). Poverty estimates are based on the revised poverty thresholds released in February 2011 by the National Statistical Coordination Board.

40. **However, despite a resilient economy and the general increase in household incomes, poverty incidence and headcount did not decline through 2009**. Since 2003, despite good average economic growth, the proportion of poor households in the total population has risen continuously. At the national level, poverty incidence increased by 1.5 percentage points between 2003 and 2006, and inched further in 2009 (Figure 21). Given rapid population growth, rising poverty incidence translates in a large increase in the number of households falling into poverty: about 2.4 million people from 2003 to 2006 and another 1 million during 2006 to 2009.

41. **Notwithstanding the stead rise in poverty incidence, some improvements occurred in the overall poverty gap and severity of poverty from 2006 to 2009** (Figure 21). The average income shortfall of the poor declined from 7.5 percent of the poverty line in 2006 to 7.2 percent in 2009. This has also translated into a slight improvement in the overall severity of poverty. These figures suggest that while growth in 2006-2009 benefitted those in the lower income groups—possibly thanks to the growing coverage of the 4Ps conditional cash transfer program—it was not enough to prevent those just around the poverty line from falling into or staying out of poverty.

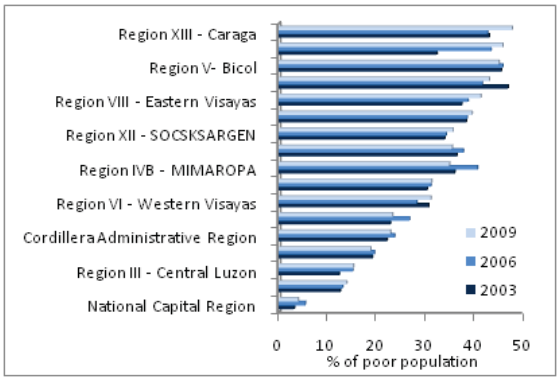
42. **The 2009 poverty estimates confirm that poverty, and especially poverty dynamics, in the Philippines remains worse than its neighbors'**. Comparing countries in the East Asia and Pacific region based on the international poverty line $1.25/day, the Philippines only rates better than Cambodia (Figure 22). Using the $2.00/day line, the Philippines is also better off than Vietnam. However, on both internationally-comparable measures, the Philippines fares lower than Malaysia, Thailand, and China. China's $1.25/day poverty had declined dramatically over two decades to a third of what it was in 1993.

Figure 22. Poverty in East Asia and Pacific



Source: World Bank, World Development Indicators 2010

Figure 23. Poverty Incidence in the Regions, 2003-2009



Source: WB staff estimates using FIES 2003, 2006, 2009.

43. **Poverty remains highly concentrated in rural areas.** Although an equal share of the population live in urban and rural areas, a disproportionate share of the poor are found in rural areas. In 2003, close to 80 percent of poor Filipinos live in rural areas. While this proportion has decreased, 75 percent of poor households in the country are located in rural areas as of 2009. Poverty in rural areas is about twice as high as the national average and more than three times that in urban areas (Table 4).

Table 4. Poverty in Urban and Rural Areas, 2003-2009

Area of residence	Poverty Incidence			Poverty Gap			Poverty Severity		
	2003	2006	2009	2003	2006	2009	2003	2006	2009
	(% of population)			(% of poverty line)			(% of poverty line)		
Urban	11.3	12.9	13.2	2.7	3.2	3.1	1	1.2	1.1
Rural	38.1	39.5	39.4	11.6	11.7	11.2	4.8	4.7	4.4

Source: WB staff estimates based on the FIES 2003, 2006, and 2009 (NSO) and official poverty lines (NSCB).

44. **Across sectors, households that rely on agricultural income are significantly more likely to be poor than households working in other sectors**. In 2009, less than a quarter of the population derives most of their income from agriculture. However, they account for half of the country's poor. This share to the total poor population has declined since 2003 so that a growing number of poor households work in non-agricultural sectors. This is consistent with the finding that poverty incidence in urban areas is increasing more rapidly than in rural areas where agriculture is concentrated. The poverty gap and severity among agricultural households are at least twice as high as the national average and at least four times as high as those who are mainly dependent on non-agricultural incomes (Table 5).

Table 5. Poverty among Agricultural and Non-agricultural Households, 2003-2009

Area of residence	Poverty Incidence			Poverty Gap			Poverty Severity		
	2003	2006	2009	2003	2006	2009	2003	2006	2009
	(% of population)			(% of poverty line)			(% of poverty line)		
Agricultural household	54.6	57.1	56.8	17.7	18	17.1	7.7	7.6	7.1
Non-agricultural household	14.3	16	17.1	3.5	4	4.1	1.2	1.4	1.4

Source: WB staff estimates based on the FIES 2003, 2006, and 2009 (NSO) and official poverty lines (NSCB). Agricultural households are those whose incomes from agriculture-related activities account for more than 50 percent of total household income.

45. **The poorest households are found among those engaged in entrepreneurial activities in forestry and hunting** (among non-wage earners). This is the case regardless of the poverty measure used (incidence, gap, and severity). Three in four people who belong to households whose head derives his/her main employment from forestry and hunting are poor. This is nearly four times as high as those who are earning entrepreneurial incomes from other activities. Households who belong in this segment of the population earn only 75 percent of the income required to meet their daily food and non-food needs.

46. **From 2006 to 2009, poverty in urban areas increased more rapidly, became more severe, and contributed more to the continuous increase in poverty.** The share of poor people living in urban areas rose faster between 2006 and 2009 than in rural areas. During this period, poverty in urban areas contributed to the overall increase in poverty at the national level. In addition, while the poverty gap and severity of poverty declined over the years in rural areas, they worsened in urban areas (Table 4). Poverty gap in urban areas widened to 3.1 percent of the poverty line in 2009 from 2.7 percent in 2003 while it declined to 11.2 percent from 11.6 percent over the same period in rural areas. These suggest that although poverty is concentrated in rural areas, poverty in urban areas is worsening rapidly.

47. **Across the regions of the Philippines, ten of the seventeen administrative regions experienced an increase in poverty incidence during 2006-2009** (Figure 23). Of these, seven regions showed steady increases in poverty incidence since 2003. Caraga (Region 16), which posted the highest poverty incidence in 2009, also recorded the highest increase in the share of poor population (5 percentage points) between 2006 and 2009. Meanwhile, MIMAROPA (Region 4B) registered the biggest drop in poverty incidence as the share of poor population declined from 40.7 percent to 35 percent between 2006 and 2009.

48. **The poorest regions in the Philippines are concentrated in Mindanao** (Figure 23). The top 3 poorest regions in 2009 were also the poorest three years earlier. Two of these three are located in Mindanao—CARAGA (Region 16) recorded the highest proportion of poor population in 2009 and ARMM (Region 15) recorded the second highest proportion. Bicol (Region 5) in Luzon, which used to be the poorest region in 2006, now ranks the third poorest. With the exception of Davao Region (Region 11), poverty incidence in all other regions in Mindanao is above one-third of the population. Mindanao accounts for less than a quarter of the total population of the Philippines but holds about 40 percent of the country's poor.

49. **The most economically active regions continue to have the least contribution to total poverty.** NCR, Central Luzon (Region 3) and CALABARZON (Region 4A) together hold nearly 40 percent of the total population in the country, 50 percent of national GDP, but only account for 15 percent of the total poor population. Poverty incidence in each of these regions is less than one-fifth of their total population. NCR, in particular, which holds about 13 percent of total population or close to 11.5 million Filipinos contributes only 4.2 percent, equivalent to less than half a million people, to the total number of poor people in the country in 2009.

The Services Sector in the Philippines[39]

50. The services 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.

51. **The Philippines, despite high and sustained growth over the 2000s, failed to generate inclusive growth**. Inclusive growth can be defined as growth that is broad-based across sectors and inclusive of a country's entire population. Not only did high and sustained growth fail to reduce poverty during the 2000s, but poverty incidence and income inequality actually rose from 2003 to 2009. Promoting employment and productivity growth in manufacturing and agriculture clearly have a key role to play, but as the share of employment in services reaches over half the workforce, services must play an important role in moving the Philippines onto an inclusive growth trajectory.

52. **Growth driven through services can contribute to sustainable and inclusive growth.** Services can contribute to sustainable development through the direct provision of environmental services or through reducing the environmental footprint of manufacturing and agriculture by improving the efficiency of transportation. International trade in some services, such as business and IT services, can be conducted at a lower energy intensity than trade in manufactured products (Kalirajan et al, 2010[40]). Employment and productivity growth in services can build inclusive growth through direct and indirect channels. The direct benefits of promoting services development for absorbing labor supply are clear given the sector's size. However, inclusive growth requires not just a rise in employment but also an increase in productive employment. For this to occur, the services sector has to move up the value chain, particularly by moving away from less formal, low wage services. Productivity improvements and growth in the quality and variety of services provided in the economy can then generate several indirect linkages between services development and inclusive growth.

Services in the Philippines and inclusive growth—performance to date

53. **The service sector in the Philippines is large by regional standards and has driven aggregate GDP growth and economic stability through the 2000s**. The share of services in the Philippines GDP has reached over 50 percent of GDP, well above the comparable level of the East Asia region as a whole but roughly comparable to other countries at its income level (Figure 24). Within the country, however, there is substantial regional divergence in the importance of services, with levels particularly high in Metro Manila. Over the last decade, the

[39] For further details on this topic, see Chapter 5 of the World Bank's *2011 Philippines Development Report* entitled "Generating Inclusive Growth to Uplift the Poor".

[40] Kalirajan, K., Anbumozhi, V., & Singh, S., 2010, "Measuring the Environmental Impacts of Changing Trade Patterns on the Poor," *ADBI Working Paper* No. 239.

service sector has contributed the majority of real GDP growth in the economy (Figure 25). An increasing share of services GDP is coming from private services, with trade the other main service sub-sector (Figure 26). The rise in private services incorporates the growth of the domestic and offshoring business processing outsourcing (BPO) sectors. Services provision by overseas foreign workers (OFWs) also makes a substantial contribution to the Philippines external balance. In 2010, remittance flows reached US$19 billion or 9.4 percent of GDP.

54. **The service sector is critical to employment growth**. McKinsey[41] highlighted the role of services in employment growth across income levels. In middle-income economies, from 1995-2005, services accounted for 85 percent of employment growth. Similar trends are seen in the Philippines (Figure 27). Growth in employment through recent quarter has originated from services with the share in overall employment rising to over 50 percent (Figure 28). Within services wholesale and retail trade contributed the most to employment growth. The highest sub-sectoral growth rates were seen in mining and quarrying, electricity gas and water, real estate, rent and business activities. However, given their low weighting in total employment these high growth sectors made only limited contribution to aggregate employment growth. The largest contributions to employment growth came from wholesale and retail trade.

55. **However, labor productivity in services remains well below that in manufacturing** (Figure 29). Services labor productivity has persistently been less than half of that of manufacturing (but twice that of agriculture). Furthermore, those services sectors making the greatest employment contributions to growth, such as trade, have seen limited labor productivity growth in recent years. This suggests that the employment growth associated with services has not all been associated with a rise in productive employment (although sectors such as transportation, storage and communication made strong contributions to overall employment growth and exhibited labor productivity improvements)—Figure 30.

56. **Real wages in the services sector as a whole are higher than average, but more dispersed**. Average wages in services are around twice that in agriculture. However, reflecting the significant differential in skill mixes across services sectors (e.g., from retail through finance), the dispersion in wages within services is significantly higher than in other sectors. Thus in terms of inclusive growth, not all service sectors are created equal. Some can provide greater employment gains while others can provide greater real wages.

57. **Households employed in the services sector have tended to have lower poverty rates than those employed in other sectors**.[42] Factors behind this difference include the higher wage distribution for services and the concentration of services employment in cities. But, the poverty rate tracked up from 2000 to 2009, although no more in proportional terms for services households than for manufacturing ones. As the share of services in total employment has risen so has the share of the poor whose household head works in services.

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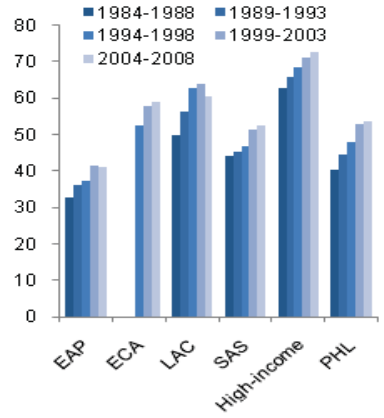
[41] McKinsey Global Institute, 2010, *How to Compete and Grow: A Sector Guide to Policy*, McKinsey Global Institute.

[42] For details, see World Bank, 2010, *Philippines: Fostering More Inclusive Growth*, Washington DC.

Figure 24. The service sector is relatively large in the Philippines…

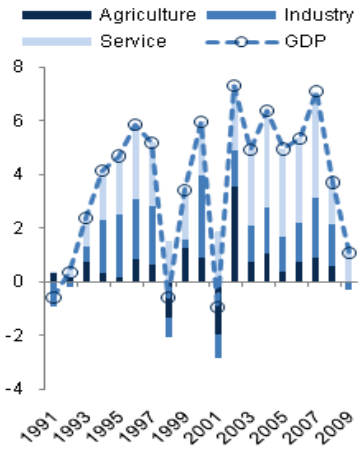
Services to GDP, percent



Sources: WDI and World Bank staff.

Figure 25. …contributing to the majority of growth in the 2000s

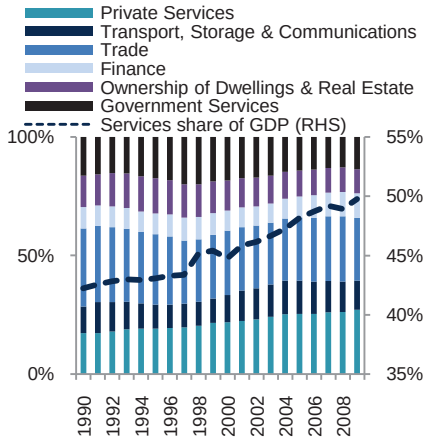
Contribution to real GDP growth, percent



Sources: CEIC and World Bank staff.

Figure 26. …with private services contributing the majority of growth

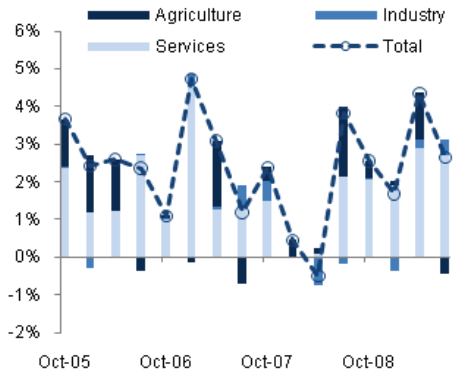
Share of total services GDP Share of GDP



Sources: CEIC and World Bank staff calculations.

Figure 27. The service sector has also driven recent employment growth…

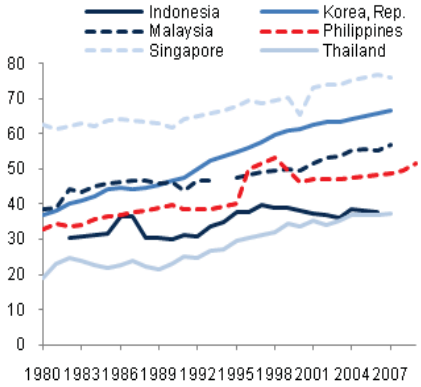
Contribution to year-on-year employment growth, percent



Sources: CEIC and World Bank staff calculations

Figure 28. …and now accounts for around 50 percent of total employment

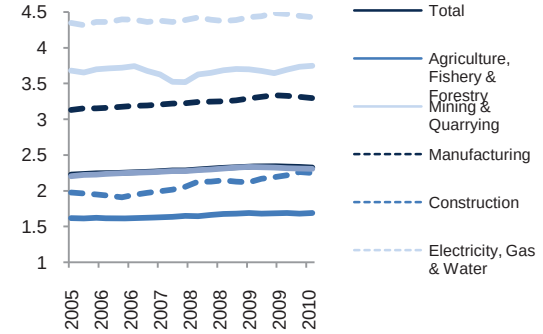
Share of total services employment Share of total employment



Note: Data to 2008 from WDI. Philippines data calculated from quarterly averages of national data. Sources: WDI, CEIC and World Bank staff calculations.

Figure 29. Labor productivity in services has risen but remains well below manufacturing

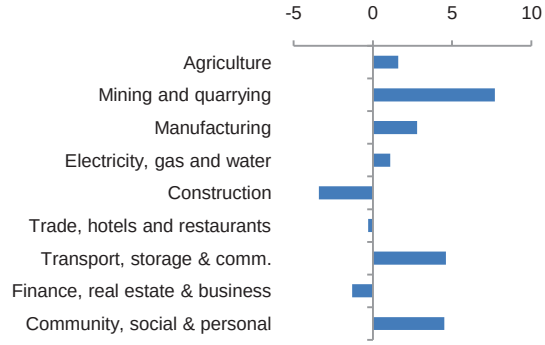
Ln real GDP per worker, in thousands of 1985 peso



Note: Data is 4-quarter rolling GDP divided by rolling employment.
Source: CEIC and World Bank staff calculations.

Figure 30. ...although labor productivity performance varies markedly within services

Annual growth in real GDP per worker 2000-2007, percent



Sources: Asia Productivity Organization Databook 2010.

58. **What are the channels through which services growth affects poverty?** Ghani and Kharas (2010) distinguish between direct channels, including the creation of new productive employment in services, and indirect channels whereby income is generated and then spills over to the rest of the economy. Other indirect channels include how the increased usage of intermediate services in other sectors may lead to growth in these sectors which in turn raises employment, wages and helps to reduce poverty. Importantly for the Philippines these channels can be thought of not only in domestic terms but also through the provision of services overseas through migration of labor and the resulting remittance flows. In addition to these income channels, if service sector developments lead to improvements in the quality, and a lowering in the relative price, of services that are consumed intensively by the poor, they can help to reduce poverty by enhancing the purchasing power of the poor.

59. **International empirical evidence reveals a relationship between services growth and poverty reduction**. Some of the argument why services have become more important relates to the reduction in informalities and non-tradabilities of the services sectors in developing countries. As services have turned to be more formal and more tradable domestically, specialization and market incentives can drive higher productivity as well as wages. This domestic service sector growth, along with the increasing tradability of services across borders, can feed into the direct and indirect channels linking services growth and poverty reduction. Informal and non-tradable services have also played a role in poverty reduction. For example, the flexibility of these sectors allows them to absorb workers migrating out of agricultural employment. This facilitates the demographic shift from rural to urban areas, which can enhance the agglomeration economies mentioned above.

60. **A sector's potential impact on wages and poverty reduction depends on its growth rate, size, and unskilled labor intensity**. The growth rate and size of the sector determine its contribution to overall GDP growth while its unskilled labor intensity provides an indication of its scope to enhance the employment prospects of the unemployed and lower skilled into which categories the poor tend to fall.

61. **The recent sectoral pattern of growth in the Philippines has been biased against the unskilled labor-intensive sectors** (World Bank, 2010, op cit). While the retail and wholesale trade services sub-sector has grown rapidly and is intensive in its employment of unskilled labor, other sub-sectors—e.g., finance, mining, and to a lower extent manufacturing, real estate, and utilities—have also posted strong growth but employ a limited share of unskilled labor. The combined growth performance of all sectors in recent years has not been strong enough to outweigh the negative influence yielded by the uneven sector growth pattern. The sectoral composition of growth appears to explain in part the observed lack of poverty reduction and the decline in real wages in recent years.

62. **Although services have made the dominant contribution to employment growth, this has not necessarily led to an increase in the average quality of jobs.** The services sector accounted for over 80 percent of the net rise in employment between 2003 and 2009, with retail trade sector over 30 percent. But, high earning opportunities in the some sub-sectors of the service sector have mostly benefited workers with relatively better human capital endowments. Around 70 percent of the workforce in the service sector is comprised of skilled workers, compared to 60 percent in manufacturing and only 26 percent in agriculture.

63. **Migration and remittance may also provide an important though complex linkage between services and poverty reduction in the Philippines.**[43] While the share of remittances in the income of poorer households is lower than for wealthier households, the indirect effects of remittances on inclusive growth may still be felt to the extent that remittances as a whole are used to fund domestic investment and consumption with spillovers across the economy.

Enabling services to contribute to inclusive growth

64. **Lessons from the BPO industry suggest a number of policy areas for action to facilitate further employment growth and upgrading the skills content of jobs**. As the industry continues its fast growth it will face more human resource constraints both in terms of technical and managerial staff. Private and public investments in training, skills and education can help to meet this demand. This investment in skills will also help to sustain industry growth by facilitating a swift response to new technology and business models. Easing barriers to inter-sectoral labor movements, can also play a role.

65. **Policies to facilitate agglomeration economies help promote inclusive services growth**. Agglomeration processes can lead to inter-industry linkages due to industrial clustering in certain regions. Allowing these agglomeration economies to develop requires investment in enabling infrastructure in transport and communications, in housing and in water and sanitation. Similarly enhancing geographic mobility of the labor force, can help to ease the labor market adjustment as the services sector develops.

66. **Facilitating foreign investment in the services industry could also assist its growth, if managed appropriately**. Foreign investment in services can bring best practices on managerial and production processes, bring about knowledge transfers and provide indirect linkages to new markets for domestic firms and transfer. But the probability and degree of success of opening of services to foreign investment, as well as other modes of trade, depends not only on their effective design and implementation but the presence of supportive institutional or structural characteristics, in particular the investment climate.

67. **Firm-level empirical analysis highlights the importance of the investment climate for services productivity and employment**. Drawing on the Investment Climate Assessment data for 2009, Escribano et al. (2010[44]) examine how investment climate dimensions affect the productivity of around 250 firms in the service sectors. Investment climate factors are estimated to account for around a quarter of aggregate productivity in services sectors. The real wage is the factor most associated with labor productivity of services. After the 65-70 percent contribution of real wages to aggregate labor productivity, the contribution of investment climate indicators is 25 percent for non-retail and 30 percent for retail (Figure 31). Within investment climate factors, red tape and informality plus quality, innovation and skills make the greatest contribution to aggregate labor productivity (Figure 32).

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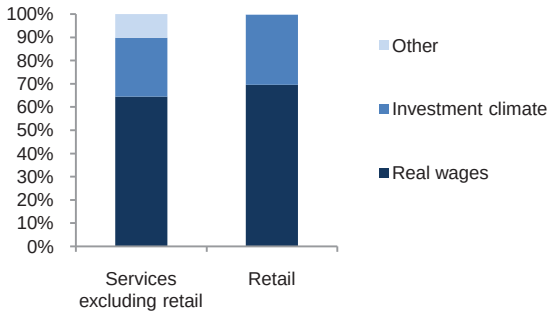
[43] Migration is a mode 4 channel of provision of trade in services, i.e. the presence of natural persons whereby services are supplied by nationals of a country in the territory of another.

[44] Escribano, A., de Orte, M. And Pena, J., 2010, "Firm's Investment Climate Determinants of the Philippines Services Sector Investment climate," mimeo Universidad Carlos III de Madrid.

Figure 31. Investment climate factors account for a quarter of the level of aggregate labor productivity…

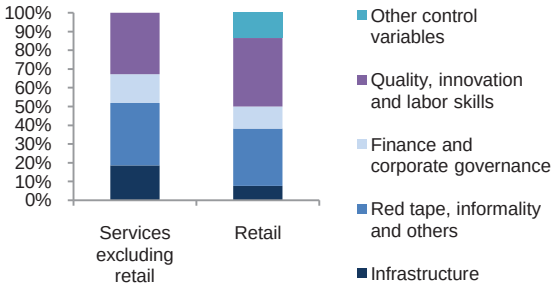
Contributions to aggregate labor productivity



Note: Based on estimated models of labor productivity using Investment Climate Assessment data for 2009.
Source: Escribano et al (2010).

Figure 32. …with red tape and informality plus quality, innovation and skills particularly important

Share of Investment Climate contribution to aggregate labor productivity



Note: Based on estimated models of labor productivity using Investment Climate Assessment data for 2009.
Source: Escribano et al (2010).

68. The services sector is already large and an important growth driver in the Philippines, however, it has not yet been a sufficient source of inclusive growth. Unshackling the constraints on services as a source of inclusive growth will require broad-based policy action, namely:

- *Providing high quality education for all* to meet the demand for skills as services move up the value chain. Private and public investment in training, skills and education is critical for the services sector to provide better paid jobs to a wider range of the population. It is also critical for the continued global competitiveness of the Philippines' services sector.

- *Facilitating agglomeration economies.* This requires investment in enabling infrastructure in transport and communications (especially connectivity), in housing and in water and sanitation. It also requires geographic mobility of the labor force.

- *Improving the investment climate.* Inclusive growth in the services sector requires improving labor productivity. Beyond skills and education, red tape, crime and security and an overall weak investment climate are key constraints to labor productivity

The 2011 National Accounts Revisions (1998-2010)

69. 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.

70. **The Philippines revised in May 2011 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. Prior to the revision, the Philippine SNA was largely based on the outdated 1968 SNA methodology.[45]

71. **In the medium-term, further improvements to the national accounts statistics are envisaged.** The government intends to shift from the fixed base year series to a moving base year series by applying chain volume measures to improve the accuracy of the GDP estimates. Adopting chain volume measures is a major recommendation of the 1993 SNA. Other components of the Philippine SNA will also be revised. A link series connecting 1998-2010 with the older years will be made available soon. Regional GDP and institutional accounts will also be revised in the coming months. Beginning the first quarter of 2011, GDP is estimated using the new methodology only. More information on the revisions can be found in the website of the National Statistical Coordination Board (NSCB) www.nscb.gov.ph

72. The major features of the revised and rebased Philippine System of National Accounts (PSNA) are the following:

- Use of a new base year (2000) for measuring constant price estimates

- Use of the new classification standards
    - 1994 Philippine Standard Industrial Classification (as amended)
    - 2004 Philippine Standard Commodity Classification
    - 2009 Philippine Classification of Individual Consumption Expenditure According to Purpose for consumption items that used to be under

[45] The SNA consists of a coherent and integrated set of macroeconomic accounts and tables based on internationally agreed concepts, classifications, and accounting rules. It provides a systematic statistical framework within which economic data can be compiled and presented for the purposes of economic analysis and policy making. Regular updates in the methodology are needed to better capture changes in the economy and improve accuracy of the estimates.

miscellaneous expenditures such as health, transport, communication, recreation, education, restaurants, and hotels

- Explicit measurement of the following subsectors in the production accounts:
    - Mango, pineapple, coffee, cassava, rubber, steam, business process outsourcing, among others

- Explicit measurement of a new set of principal Philippine merchandise exports and imports
    - Various electronics products, such as electronic data processing, consumer electronics, and telecommunications, are now explicitly measured
    - Medical and pharmaceutical products and metal ores and metal scraps

- Use of updated source data and new data such as:
    - Cost of production of agricultural commodities
    - Various surveys of IT enabled services
    - Various surveys on research and development and human resources
    - Revised balance of payments using BPM5
    - 2006 Census of Philippine Businesses and Industries
    - 2002 Census of Agriculture and Fishery
    - 2000-2010 updated building permits
    - 1998-2010 metallic production and value
    - 1998-2010 damaged houses from NDRRMC
    - Updated data on steam, energy, and water production from utility regulators
    - Various industry level data from industry associations and private corporations
    - Various data on government owned and controlled corporations

- Use of updated parameters and price/price indices from the recent business and price surveys. Examples include the use of
    - Intermediate consumption ratios of industries
    - Gross output per worker for estimating the unorganized sector
    - Transfer cost and cost per square meter for construction
    - Updated weighted average salary for overseas Filipino workers

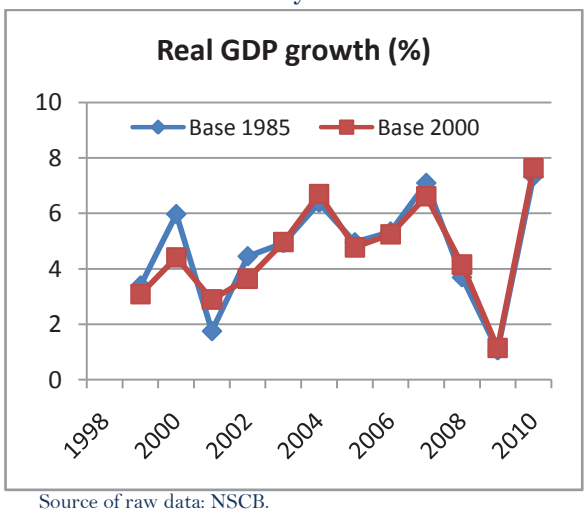
- Use of new concepts/definitions due to the adoption of the 1993/2008 SNA, such as:
    - Extension of gross capital formation to include military equipment, computer software and database, research and development
    - Treatment of monetization of gold as financial asset and excluded from exports
    - Valuation of merchandise exports and imports at Free-on-Board (FOB)
    - Transfer of freight and insurance from imports of merchandise goods to exports of services
    - Transfer of motor vehicle repair from other services to trade
    - Transfer of public education and public health services from government services to other services
    - Transfer of business activities from other services to real estate, renting and business services

73. Under the revised and rebased series, four notable points should be highlighted:

- Real GDP growth in recent years did not change much although some sectors exhibit large changes in growth;
- Investment is now much higher due to improved coverage and transfer of items previously booked under consumption (e.g., military expenditure);
- Nominal GDP is now about six percent larger. This results in lower values for statistics that are expressed as a percentage of GDP; and
- The use of supply-and-use table to balance the production and expenditure accounts has eliminated the large statistical discrepancy that was evident in the previous series.

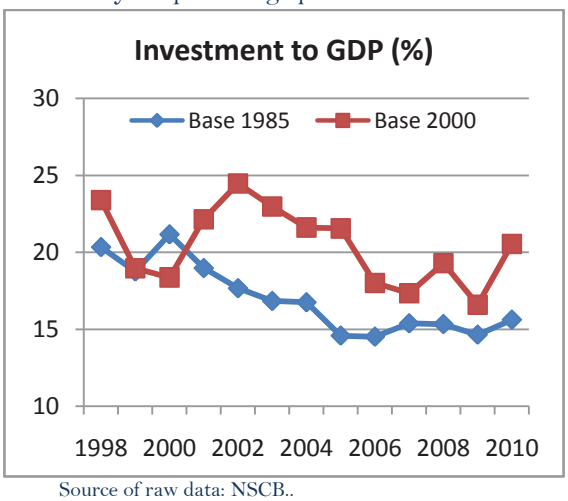
74. **Real GDP growth under the new series is not significantly different from growth under the old series** (Figure 33). Unlike revisions in other countries, which saw large changes in GDP growth, Philippine GDP growth, especially for the more recent years, saw little changes after the major revision because the old series already incorporates minor revisions (e.g., estimation of business process outsourcing industry output) for the more recent years without necessarily backtracking to the earlier years.[46]

Figure 33. GDP growth increases slightly in six out of 12 years



Source of raw data: NSCB.

Figure 34. Investment to GDP ratio is now larger by 3.4 percentage points of GDP



Source of raw data: NSCB..

75. **The small changes in GDP growth, however, mask large changes in growth at the sectoral level** (Table 6). In the expenditure accounts, fixed capital formation, durable

[46] This practice is evident is the narrower gap between the two series in the more recent years compared to the earlier years. In fact, changes in the economy were incorporate gradually in the last 15 years without backtracking all the way, resulting in various breaks in the series. Examples are 2000-2001 and 2003-2004. The new GDP new series solves the breaks by applying the changes all the way to 1998.

equipment, and imports saw higher average growth of at least 0.5 percent in the period 1998-2010 while government consumption, construction, and breeding stock and orchard development saw negative growth of at least 0.5 percent in the same period. In the production accounts, forestry and electricity, gas, and water saw higher growth of at least 0.5 percent while mining and construction saw negative growth of at least 0.5 percent. Changes in the growth of the real estate, renting, and business activities sector and other services sector are largely a result of realignment of subsectors between the two sectors.

Table 6. Decomposing real GDP growth (average growth during 1998-2010) 1/

	Old series	New series	Diff.			Old series	New series	Diff.
Expenditure accounts					Production accounts			
Private consumption	4.6	4.4	-0.2		Agri, fishery, forestry	3.4	3.5	0.1
Public consumption	3.4	2.5	-0.9		Agriculture and fishing	3.4	3.5	0.1
Capital formation	3.6	4.9	1.3		Forestry	-0.5	2.0	2.5
Fixed capital	3.3	4.0	0.7		Industry	4.3	4.0	-0.3
Construction	3.8	2.8	-0.9		Mining & Quarrying	11.5	10.9	-0.6
Durable Equipment	3.4	6.1	2.7		Manufacturing	4.0	3.8	-0.3
Breeding Stock & Orchard Dev't	1.6	0.9	-0.7		Construction	4.4	3.8	-0.6
Changes in Inventories	-162.0	69.1	231.2		Electricity, Gas and Water Supply	4.0	4.5	0.5
Intellectual Property Products		4.6	4.6		Services	5.5	5.3	-0.2
Exports	6.3	6.1	-0.1		Transport., Stor., and Comm.	6.8	6.9	0.0
Imports	3.9	4.8	0.9		Trade and Repair of Motor Vehicles, Motorcycles, Personal and Household Goods	5.6	5.8	0.2
					Financial Intermediation	6.3	6.5	0.2
Gross domestic product	4.7	4.6	-0.1		R. Estate, Renting & Bus. Actv't	3.4	5.0	1.7
Net Primary Income	14.9	12.6	-2.3		Public Administration & Defense: Compulsory Social Security	2.6	2.7	0.1
Gross national income	5.5	5.9	0.4		Other Services	6.9	4.7	-2.2

1/ There is a re-allocation of subsectors between the real estate, renting, and business activities sector and other services.
Source of raw data: NSCB.

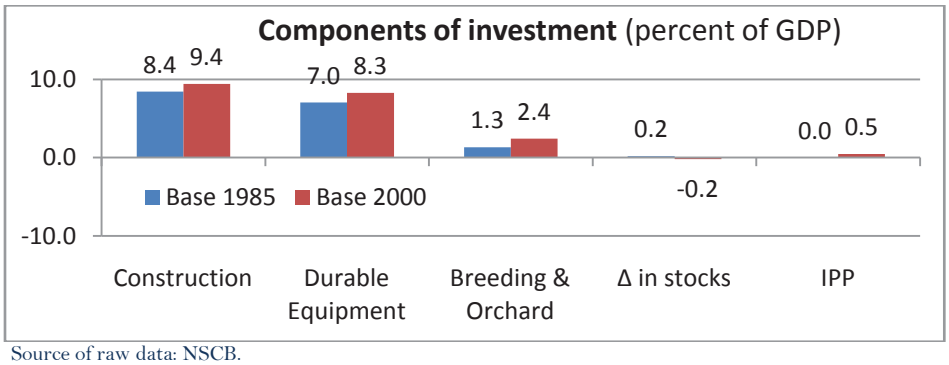
76. **Another notable change in the new series is that investment as a share of GDP is now significantly larger than originally estimated.** Under the revised and rebased GDP series, investment shows the biggest improvement from 17.1 to 20.4 percent of GDP on average in the period 1998-2009 (Figure 34). The driver of investment growth is equally distributed among the components of capital formation (Figure 35). Moreover, the new investment series correlates better with GDP. The correlation between real GDP growth and the investment-to-GDP ratio is now positive (0.12) from negative (-0.06) under the old series. This reversal partly solves the high growth-low investment paradox encountered when using the old series (Figure 36 and Figure 37). Nonetheless, the lower investment-to-GDP ratio compared to other countries in the region still points to the country's weak investment climate (Table 7). For the Philippines to invest more and accelerate growth, critical constraints in public finances, governance, and doing business would need to be addressed.

77. **Two key factors explain the higher investment numbers: classifications and statistics**. In terms of classifications, under the 1968 SNA, most military expenditures were booked under consumption and intellectual property products (IPP) such as research and development, artistic work, and computer software were mostly left out in GDP estimation. Under the 1993 SNA, most military expenditures[47] are now booked under investment and IPP

[47] The 1968 SNA recommended that all expenditures for defense purposes should be recorded as consumption. The 1993 SNA recommended that expenditures of a fixed asset-like nature that could be used for civilian purposes (e.g., military hospitals, transport vehicles, etc.) should be recorded as fixed capital formation and the remainder should be recorded as consumption expenditure. The 2008 SNA recommends that all defense expenditures of a fixed asset-like nature should be recorded as gross fixed capital formation.

are now explicitly recorded as a separate capital formation category. IPP, for example, contributes an average of 0.5 percentage points of GDP to the investment-to-GDP ratio. That the Philippines shifted to SNA 1993 later than other countries in the region (Table 7) suggests that previous cross-country comparisons of investments were not fully valid as the use of the old methodology intentionally underestimates investment. In terms of statistics, better source data make it possible to improve the accuracy of investment estimates. For example, revised data on building permits and availability of unit cost of construction have led to a rise in the value of construction. The same is true for breeding stocks and orchard development. In the near future, the conduct of the first enterprise-level survey to better capture corporate investments and profits would further improve the estimation of investment and the institutional accounts.

Figure 35. The larger investment to GDP ratio is largely equally distributed among the subcomponents of capital formation



Source of raw data: NSCB.

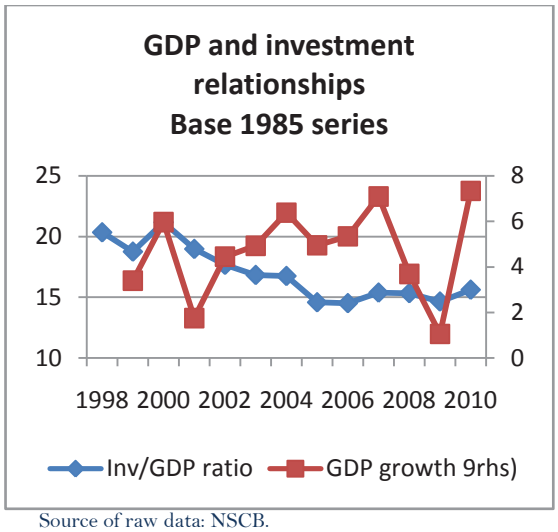
Table 7. Investment and SNA 1993 adoption

Country	Year SNA 1993 was adopted	Investment (% of GDP)
Philippines under SNA68		17.1
Philippines under SNA93	2011	20.4
Indonesia		23.2
Malaysia	2007	22.2
Vietnam	2008	34.6
Thailand	2012	25.0

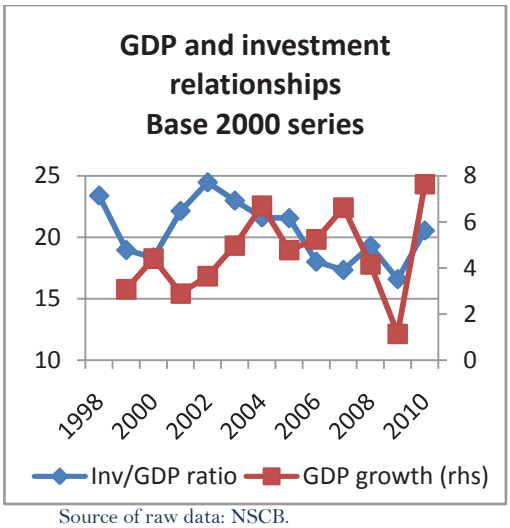
Source: World Bank staff.

Figure 36. GDP growth and investment-to- GDP ratio generally diverges between 2002 and 2007 under the old series

Figure 37. GDP growth and investment-to-GDP ratio generally follow the same trend between 2000 and 2010 under the new series



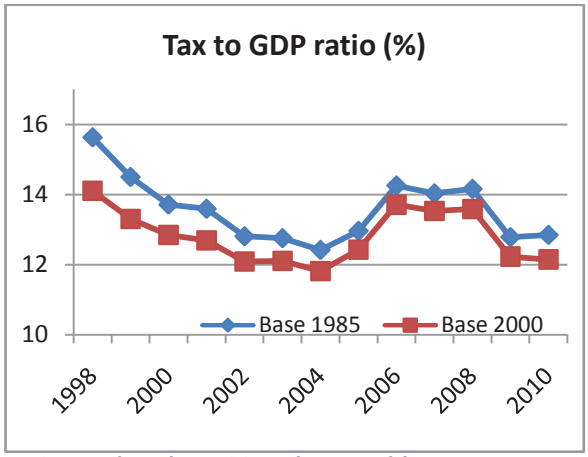
Source of raw data: NSCB.



Source of raw data: NSCB.

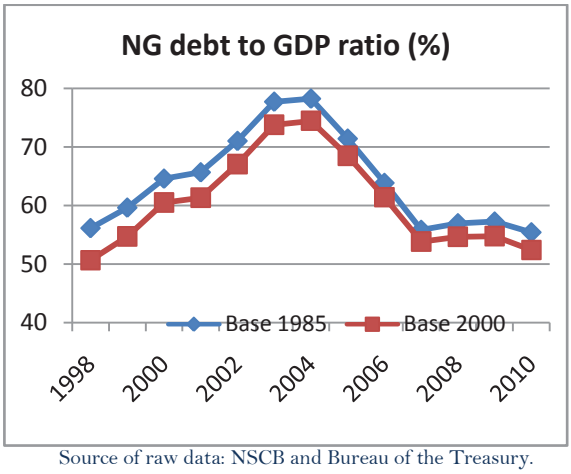
78. **Under the new series, nominal GDP is larger by an average of six percent in the period 1998-2010.** This is largely due to the broader coverage of the economy (aided by better source data), including better estimates of the informal economy and inclusion of IPP and emerging industries such as BPOs in national income accounting. As a result of the larger economy, many variables expressed in GDP terms are now lower. For example, tax effort in 2010 is now 12.1 percent of GDP compared to 12.8 percent of GDP under the old series and national government debt in 2010 improves from 55.4 to 52.4 percent of GDP (Figure 38 and Figure 39).[48]

Figure 38. Tax effort is lower by an average of 0.8 percentage points of GDP



Source of raw data: NSCB and Bureau of the Treasury

Figure 39. NG Debt to GDP is lower by an average of 3.5 percentage points of GDP



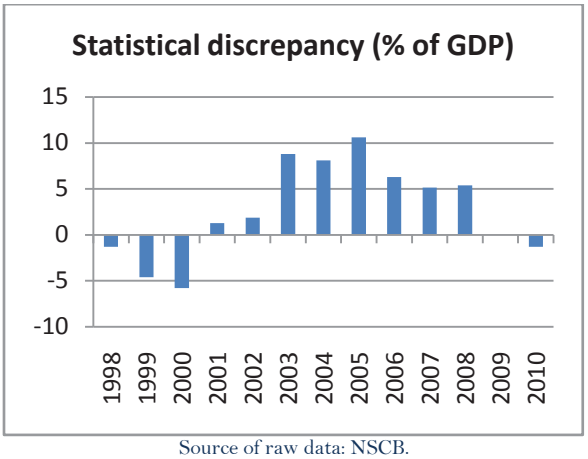
Source of raw data: NSCB and Bureau of the Treasury.

79. **Finally, the production and expenditure accounts are now balanced at the aggregate level thanks to the use of the supply-and use-table**. Prior to this methodological change, the expenditure accounts showed a statistical discrepancy of up to 10 percent of GDP (Figure 40). While small statistical discrepancies are to be expected because the production and

[48] The wider gap in the earlier years points to the fact that the bulk of the revision was applied to the earlier years as the more recent years have already been subjected to minor revisions.

expenditure accounts have different data sources and methodologies, very large statistical discrepancies in the Philippine national accounts became a cause of concern for policymakers. This is now resolved under the new methodology, which significantly minimizes the statistical discrepancy by balancing the supply of inputs with the use of inputs, thereby improving the accuracy of the GDP estimates.

Figure 40. Statistical discrepancy in the old series is as large as 10 percent of GDP



Source of raw data: NSCB.

Data Appendix

Table 8. Philippines: Selected Economic Indicators, 2007-13

	2007	2008	2009	2010	2011	2012	2013
	---------- Actual ----------			Prel. Act.	------- Projection --------		
	(percent of GDP, unless otherwise stated)						
Growth, inflation and unemployment							
Gross domestic product (% change)	6.6	4.2	1.1	7.6	5.0	5.4	5.5
Inflation (period average)	2.8	9.3	3.2	3.8	4.8	4.5	4.5
Savings and investment							
Gross national savings	19.6	16.7	22.1	24.8	24.2	24.6	25.1
Gross domestic investment	17.3	19.3	16.6	20.5	21.5	22.5	23.5
Public sector							
National government balance (GFS basis) 1/	-1.6	-1.5	-3.9	-3.6	-2.5	-2.0	-1.7
National government balance (Govt def)	-0.2	-0.9	-3.7	-3.5	-2.4	-1.9	-1.6
Total revenue (Govt def)	16.5	15.6	14.0	13.4	13.9	14.5	14.9
Tax revenue	13.5	13.6	12.2	12.1	12.3	12.9	13.3
Total spending (Govt def)	16.7	16.5	17.7	16.9	16.2	16.4	16.5
National government debt	53.9	54.7	54.8	52.4	50.1	47.3	44.2
Balance of payments							
Merchandise exports (% change)	6.4	-2.5	-22.1	34.8	7.4	7.8	8.5
Merchandise imports (% change)	8.7	5.6	-24.0	31.5	12.9	8.0	8.6
Remittances (% change of US$ remittance)	13.2	13.7	5.6	8.2	8.5	9.0	9.0
Current account balance	4.8	2.1	5.6	4.2	2.7	2.1	1.6
FDI (billions of dollars)	-0.6	1.3	1.6	1.2	2.0	3.0	4.0
Portfolio Investment (billions of dollars)	4.6	-3.6	-0.6	4.0	3.0	3.5	3.5
International reserves							
Gross official reserves 2/ (billions of dollars)	33.8	37.6	44.2	62.4	73.7	84.5	89.7
Gross official reserves (months of imports)	5.8	6.0	8.7	9.6	10.2	10.7	10.3
External debt							
Total 3/	44.1	37.4	37.3	35.9	33.4	32.4	31.2

Source: GOP for historical, World Bank for projections.
1/ Excludes privatization receipts and includes CB-BOL restructuring revenues and expenditures (in accordance with GFSM);
2/ Includes gold;
3/ World Bank definition. The difference with central bank data is that this includes the following: (1) 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 amounts of permanently assigned capital required of these banks; (2) Long-term loans of non-banks obtained without BSP approval which cannot be serviced using the foreign exchange resources of the Philippine banking; and (3) Long-term obligations under capital lease agreements.

Table 9. Philippines: National Government Cash Accounts (GFS Basis), 2008-11

	2008	2009		2010		2011		
	Year	Jan-Apr	Year	Jan-Apr	Year	Jan-Apr	Budget	WB proj.
	(in percent of GDP, unless otherwise stated)							
Revenue and grant	15.2	4.4	14.0	4.3	13.4	4.6	15.5	13.8
Tax revenue	13.6	3.9	12.2	3.9	12.1	4.0	14.1	12.3
Net income & profits	6.2	1.8	5.2	1.7	5.4	1.9	6.0	5.5
Excise tax	0.8	0.2	0.7	0.2	0.7	0.2	0.6	0.6
Sales taxes and Licenses	2.3	0.8	2.7	0.8	2.4	0.7	3.2	2.4
Other	0.8	0.2	0.6	0.2	0.7	0.2	0.7	0.7
Tariff (collection from the BOC)	3.4	0.8	3.1	0.9	2.9	0.9	3.5	3.1
Nontax revenue 1/	1.6	0.5	1.7	0.4	1.3	0.7	1.4	1.5
Grant	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total expenditure 2/	16.7	5.8	17.9	5.8	17.0	4.7	18.9	16.3
Current Expenditures	13.6	4.8	14.3	4.8	13.8	4.1	15.2	13.2
Personal services	4.9	1.5	5.2	1.6	5.2	1.5	6.0	5.4
MOOE	1.8	0.7	2.1	0.8	2.0	0.5	2.3	2.1
Allotment to LGUs	2.2	0.8	2.5	0.8	2.4	0.8	2.5	2.2
Subsidies	0.2	0.1	0.2	0.0	0.2	0.1	0.1	0.2
Tax expenditures	0.8	0.2	0.6	0.1	0.5	0.1	0.2	0.2
Interest payment	3.7	1.6	3.7	1.4	3.4	1.1	4.0	3.1
Capital Outlays	2.9	1.0	3.4	1.0	3.1	0.6	3.6	3.1
Net lending	0.2	0.0	0.2	0.0	0.1	0.1	0.2	0.1
Balance (GFS definition)	-1.5	-1.5	-3.9	-1.5	-3.6	0.0	-3.4	-2.5
Balance (Government definition)	-0.9	-1.4	-3.7	-1.5	-3.5	0.0	-3.2	-2.4
Primary Balance (GFS)	2.2	0.1	-0.3	-0.1	-0.2	1.0	0.7	0.6
Memorandum Items								
Privatization receipts (PHP billions)	31.3	0.5	1.4	0.1	0.9	0.7	6.0	6.0
CB-BOL interest payments (% of GDP)	0.2	0.1	0.2	0.0	0.1	0.0	0.1	0.1
Nominal GDP (PHP billions) 3/	7,721	8,026	8,026	9,003	9,003	9,911	9,045	9,911

Source: Department of Finance, Bureau of Treasury, and Department of Budget and Management;
1/ Excludes privatization receipts (these are treated as financing items, in accordance with GFSM);
2/ Data from the Department of Budget and Management; Allocation to Local Government Units excludes capital transfers to LGUs (these are in capital outlays);
3/ Nominal GDP under World Bank staff projections is based on World Bank staff estimate..

Selected Special Focus from Previous *Quarterly Updates*

January 2011 PQU: Robust Growth, Stubborn Poverty

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

Fiscal Risks in the Philippines. Fresh into office the Aquino government established a comprehensive assessment of fiscal risks and published the outcome in a Fiscal Risk Statement (FRS) in November 2010. Disclosure of fiscal risks generates important benefits in terms of lower and better managed fiscal risks, improved policies, and lower cost of financing. Fiscal risks have been prevalent in the Philippines and at times have generated large and unexpected fiscal costs. Important weaknesses in the Philippines public financial management framework have contributed to heightened fiscal risks. As the FRS reveals, while fiscal risks have abated in important areas they still remain sizeable in 2010.

Export of Services: Lessons from the BPO and Tourism Sectors. Services exports are rising strongly in the Philippines and provide an important source of diversification of the country's exports. The rapidly rising business process outsourcing sector is building on a cost-competitive platform built around an English-speaking, technology-savvy young labor force, readily available telecommunication infrastructure, and a favorable economic zone environment. Tourism could become an important source of diversification for the country but the sector is constrained by a weal investment climate, periodic security concerns, weak transport and tourism-related infrastructure, and air transport regulations.

September 2010 PQU: Stepping Up Reforms to Sustain Growth

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

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

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

Constraints to growth: the agribusiness value chain in Mindanao. Improving the competitiveness in agribusiness and agricultural commodities markets in which the Philippines enjoys strong comparative advantages is critical to fighting poverty and boosting rural incomes. A World Bank study of two key agricultural value chains in Mindanao—yellow corn and export bananas—reveals that both offer significant growth potential; yet they are facing critical issues in terms of their long-term viability and sustainability. These include average farm-level productivity well below international benchmarks, in large part due to infrastructure and logistics deficiencies.

June 2010 PQU: The Recovery Continues Despite Global Financial Turbulence

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

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

Economic development and peace: Mindanao. The European sovereign debt turmoil and the Philippines

February 2010 PQU: Layout the Exit Strategies

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

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

November 2009 PQU: Towards an Inclusive Recovery

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

July 2009 PQU: Sailing Through Stormy Waters

Consumption and remittances during the global recession ; Risks to the Philippines banking sector during the global recession

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