Economic Report

SENATE ECONOMIC PLANNING OFFICE

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THE PHILIPPINE ECONOMY IN 2007
and Prospects for 2008

The Philippine economy capped the year 2007 with a GDP growth of 7.3 percent, its highest in 31 years. The government and private institutions, however, are in agreement that this feat will be difficult to replicate in 2008 as the Philippines faces three major challenges - the growing risks of US recession; the rapid rise of the peso; and the escalating prices of oil in the world market. The key challenge lies in mitigating the impact of these risks.

The domestic economy expanded by 7.4 percent in the fourth quarter of 2007, bringing the full year gross domestic product (GDP) growth to 7.3 percent, in line with the high end of the government's target of 6.9 to 7.3 percent. It was also the fourth consecutive year of over 5 percent growth, rarely seen in the Philippines' economic history of boom and bust cycle. The gross national product (GNP) also saw a substantial increase from 6.1 percent in 2006 to 7.8 percent with the continued inflow of remittances from abroad.

Backing the 2007 growth were the record-breaking performance of services, particularly its finance, trade and private services subsectors; the higher than usual growth of industry; and the robust expansion of the farm sector. On the demand side, strong consumer and investment spending largely supported the 7.3-percent GDP growth, the country's highest in 31 years.

The services sector, whose growth peaked at 9.0 percent in the fourth quarter of 2007, finished with an 8.7 percent full-year growth, its highest ever. With the exception of government services, all subsectors registered significant increases.

The trade subsector, which grew by 9.8 percent from 6.1 percent in 2006, benefited from the increased spending on consumer durables brought by election-related activities in the first half of the year, and the continuous expansion and opening of new malls. Communication companies also reported higher revenues and wider subscriber base as they introduced new products such as Smart Bro, Globe Visibility, and mobile landlines. Globe Telecom alone reported 20.3 million subscribers in 2007, a 30.0-percent increase from 2006.

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The SEPO Economic Report is a quarterly publication of the Senate Economic Planning Office. Its purpose is to provide the Senators and Senate Officials useful information on the current state of the Philippine economy. The SEPO Economic Report is also available at www.senate.gov.ph.

Table 1. 2007 Gross Domestic Product Growth Rate (at constant prices, in %)		
	2006	**2007**
Production side		
Agriculture, fishery & forestry	3.8	5.1
Agriculture & fishery	3.9	5.0
Forestry	-4.0	12.2
Industry	4.5	6.6
Mining & quarrying	-6.1	25.0
Manufacturing	4.6	3.3
Construction	7.3	19.5
Electricity, gas and water	6.4	7.2
Services	6.7	8.7
Transport., comm., & storage	6.3	8.2
Trade	6.1	9.8
Finance	11.4	12.3
ODRE	5.7	6.0
Private services	6.9	8.8
Government services	4.7	3.3
Expenditure side		
Personal consumption	5.5	6.0
Gov't consumption	6.1	10.0
Capital formation	2.7	9.3
Fixed capital	1.4	9.5
Construction	5.5	18.0
Durable equipment	-1.8	2.7
Breeding stocks & orchard dev't	-0.4	4.6
Exports	11.2	3.1
Merchandise exports	11.3	2.0
Non-Factor services	10.6	8.6
Less : Imports	1.9	-5.4
Merchandise imports	1.4	-6.6
Non-Factor services	10.2	15.2
GDP	5.4	7.3
GNP	6.1	7.8

Source: National Statistical Coordination Board

The upsurge in banks' credit lending, the four-fold increase in insurance's growth, and the continued boom in the stock market, aided the 12.3-percent growth of the finance subsector. With the decline in interest rates, the outstanding loans of commercial banks, thrift banks, and rural banks (net of reverse repurchases) rose to 6.9 percent from January to November 2007, from 4.4 percent in the same period in 2006. The banking system's asset quality also continued to improve as non-performing loan ratio fell to 5.3 percent as of October 2007. Moreover, banks remained adequately capitalized with average capital adequacy ratio of 19.3 percent as of end-June 2007, which was above the statutory level set by the Bangko Sentral ng Pilipinas (BSP) at 10.0 percent and the Bank for International Settlements' standard of 8.0 percent.

Meanwhile, the insurance subsector grew almost four times at 24.8 percent from 6.6 percent in 2006 on the back of increased life insurance payments whereas capital raised from initial and secondary public offerings in the Philippine Stock Exchange in 2007 amounted to P97.25 billion, higher by 34.4 percent compared to the P72.3 billion raised in 2006.

Private services expanded by 8.8 percent in 2007, from 6.9 percent in 2006 driven by the hefty growth of business process outsourcing (BPOs), hotel and restaurants, recreational, and personal services. According to the Contact Center Association of the Philippines (CCAP), the call center industry still enjoyed a 57.0-percent revenue growth in 2007 despite the strong peso.

Higher tourist arrivals of 3.1 million in 2007 propped up the growth of the hotel and restaurant subsector. Similarly, the real property market remained bullish at 6.0 percent, from 5.7 percent in 2006 amidst the favorable interest rate environment.

Industry grew higher than the usual, with the full-year growth of 6.6 percent, from 4.5 percent in 2007. The strong performers in the industrial sector were mining and quarrying, and construction. Mining and quarrying posted a 25.0-percent growth from negative 6.1 percent in 2006 buoyed by the higher demand for coal, copper and gold.

The government's aggressive infrastructure spending in 2007 and the recovery of private construction pulled up the overall construction growth to a hefty 19.5 percent in 2007, from 7.3 percent in 2006.

The growth of manufacturing, for the third year in a row, continued to decline. One of the biggest losers was the electrical machinery subsector as lower demand for electronics from abroad pushed down electronic production. As in the past, food manufactures and beverage industries contributed the most to manufacturing's output.

Table 2. 2007 Manufacturing's Winners and Losers' Contribution to Manufacturing's Growth (in ppt)

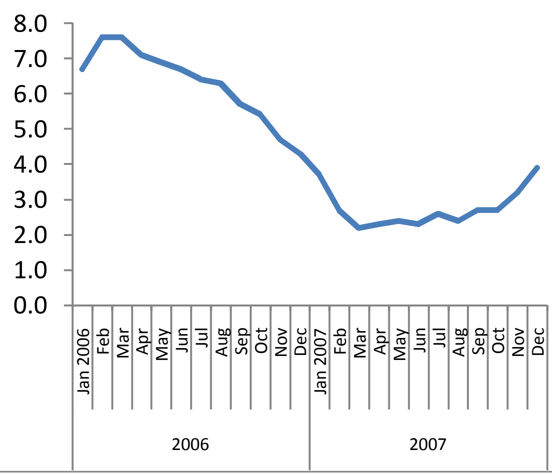
Winners	
Food manufactures	2.17
Beverage industries	0.44
Products of petroleum & coal	0.4
Misc. manufactures	0.28
Non-metallic minerals	0.25
Losers	
Electrical machinery	-0.72
Chemical & chemical products	-0.24
Tobacco manufactures	-0.11
Rubber products	-0.03
Machinery except electrical	-0.02

Source: National Statistical Coordination Board

Meanwhile, the generally cooperative weather, sustained use of high quality seeds and organic fertilizers, improved agricultural facilities and new strategies to address the dry spell were instrumental in bringing about agriculture's higher growth of 5.1 percent in 2007 against 3.8 percent in 2006. Palay and other crops posted positive increases of 6.0 percent and 7.0 percent, respectively in 2007, from 5.0 percent and 0.1 percent, respectively in 2006. Fishery, driven by the increased demand in seaweeds, milkfish and tilapia, increased by 6.9 percent in 2007 compared to 5.9 the year before. Forestry likewise rebounded from its negative growth of 4.0 percent in 2006 to 12.2 percent in 2007 as log production in CARAGA, the country's biggest source of logs, increased.

As expected, consumption spending again led the growth on the demand side, and contributed 4.72 percentage points to the GDP. Encouraged by the generally low inflation rate, which averaged 2.8 percent (Figure 1) and the higher inflow of remittances which amounted to P759.3 billion, private consumption grew by 6.0 percent in 2007 compared to 5.5 percent in 2006.

Fig. 1. Inflation Rate, Jan. to Dec. 2006-2007 (in %)



Source: Bangko Sentral ng Pilipinas

Investment spending also provided growth momentum to the economy in 2007. Capital formation surged to 9.3 percent, benefiting from the infrastructure projects of both national and local governments. As an indication of future business activities, companies also bought durable equipment, which registered a positive growth of 2.7 percent in 2007 from a negative 1.8 percent in 2006.

The year 2007 has proven to be a tough year for the exports sector as it wrestled with the effects of the strong peso and the low electronic demand in the US brought about by its slowing economy. Overall exports weakened to 3.1 percent, a substantial drop from 11.2 percent in 2006. Merchandise exports, in particular, plummeted to 2.0 percent from 11.3 percent in 2006.

With the low demand for electronic products, imports were likewise affected. It contracted to 5.4 percent in 2007 compared to a positive growth of 1.9 percent in 2006.

Table 3. 2007 Exports' Winners and Losers

Winners	**Growth (%)**	**Contribution (in ppt)**
Finished electrical machinery	21.1	2.56
Semiconductors	3.6	0.52
Transmission apparatus	56.8	0.17
LPG	131.7	0.09
Prepared tuna	35.4	0.05
Losers		
Electrical machinery	-12.2	-1.11
Chemical & chemical products	-30.7	-0.34
Tobacco manufactures	-10.0	-0.25
Rubber products	-100.0	-0.24
Machinery except electrical	-9.5	-0.18

Source: National Statistical Coordination Board

Even with the decline in export earnings, OFW remittances and higher capital inflows sustained the balance of payments position (BOP). BOP posted a surplus of US$8.6 billion in 2007, higher than the US$3.8 billion posted in 2006. This drove the gross international reserves to reach a historic level of US$33.7 billion by the end of 2007 compared to US$23.0 billion by the end of 2006. The US$33.7 billion international reserves can now cover 5.91 months of average imports of goods and payment of services and income.

On the fiscal side, the national government posted a deficit of P9.4 billion in 2007, an improvement from a deficit of P64.7 billion incurred last year, and well below the earlier target of P63 billion pesos. Citing the country's improved fiscal performance and macroeconomic fundamentals, credit ratings agency Moody's upgraded its outlook on the country's capacity to pay its obligations from *stable* to *positive.*

The sustainability of the fiscal situation, however, remains doubtful as the improvement in fiscal balance is not attributed to an improved revenue collection. Rather, it is attributed to spending cuts and a rise in privatization receipts and interest savings.

Government spending, traditionally reined in to meet fiscal targets, is 3.3 percent lower than the programmed P1,181.8 billion.

Although actual government revenue of P1,134.6 billion is P15.9 billion more than programmed, tax collection agencies have failed to meet their goals. The Bureau of Internal Revenue missed its target by P54.3 billion, collecting a total of P711.6 billion. The Bureau of Customs, on the other hand, collected P210.5 billion, P17.7 billion short of its target. Tax effort for 2007 dropped to 13.9 percent from 14.3 percent in 2006, way below the government's tax effort target of 15.7 percent for 2007.

Table 4. National Government Fiscal Position (in P billion)

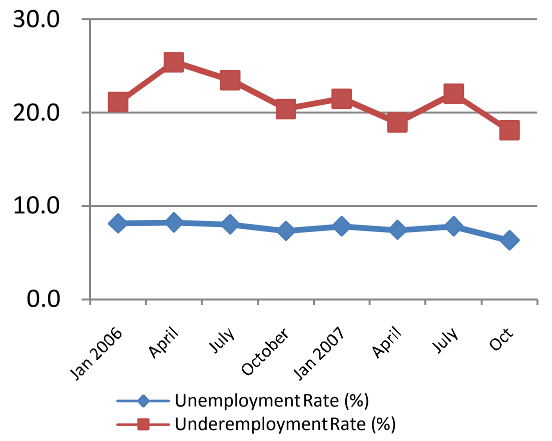
	Revenue	**Expenditure**	**Surplus/ (Deficit)**
2003	639.7	839.6	(199.9)
2004	706.7	893.7	(187.6)
2005	816.2	962.9	(146.8)
2006	979.6	1,044.4	(64.8)
2007	1,134.6	1,144.1	(9.4)

Source: Bureau of the Treasury

The higher-than-programmed government revenue is attributed to the considerable amount culled from privatization. Privatization receipts amounted to P90.6 billion, without which the deficit could have stood at P100 billion. Selling state-held assets could help meet fiscal targets in the short run, but could worsen financial position once the government runs out of assets to sell.

On the labor front, the National Statistics Office reported that unemployment went down to 6.3 percent in October 2007 from 7.3 percent a year ago (Figure 2). Underemployment also dropped to 18.1 percent from 20.4 percent last year. New jobs generated for the year totaled 767,000, a big improvement from 483,000 in 2006 but still way below the one to 1.5 million jobs targeted every year. Moreover, the quality of the jobs generated is in question as most of them are temporary in nature.

Fig.2. Unemployment and Underemployment Rates, Jan. 2006 to Oct. 2007, in percent



Source: National Statistics Office

The latest self-rated poverty survey conducted by the Social Weather Station (SWS) showed that poverty perception of families eased in the fourth quarter of 2007 compared to the third quarter in the same year. According to the SWS, around 46.0 percent of Filipinos regard themselves, as "mahirap" or poor. This is lower than the 52.0-percent perceived poverty incidence registered in October 2007. Hunger also eased. The self-rated food poverty of 34.0 percent in December 2007 is actually the lowest since June 2004 at 35.0 percent. According to the National Statistical Coordination Board, an average–sized family of five should earn P6, 195 monthly or P204 a day to meet their basic food and non-food needs in 2007.

PROSPECTS FOR 2008

Government and private institutions are in agreement that that the Philippines will find it difficult to replicate the exceptional growth it registered in 2007.

For 2008, the government projects the GDP growth to be between 6.3 percent and 7.0 percent. Barring any major weather disturbance, agriculture is expected to maintain its 5.0-percent growth this year. Industry, which posted a 6.6-percent growth in 2007 is estimated to expand between 6.4 percent and 7.1 percent. Meanwhile, the growth of services is anticipated to decelerate from 8.7 percent in 2007 to 6.6 percent to 7.3 percent this year. Among its subsectors, finance, real estate and private services will likely suffer the most.

Table 5. GDP Growth Forecasts for 2008, Selected Institutions (in %)

INSTITUTION	2008 GDP growth
Development Budget Coordinating Council	6.3-7.0
Multilateral Institutions	
World Bank	6.2
Asian Development Bank (ADB)	6.0
International Monetary Fund (IMF)	6.0
Other Private Institutions	
Action Economics	5.0
ATR Kim-Eng	7.6
Bank of the Philippine Islands	6.1
Barclays Capital	6.5
Banco de Oro-EPCI*	6.8
Citigroup	6.5
Credit Suisse	5.6
Deutsche Bank	6.3
Economist Intelligence Unit (EIU)	5.0
HSBC	5.9
ING Bank	6.2
Merrill Lynch	6.6
Standard Chartered	4.1
Thomson IFR	5.0
UBS	5.5
Average	6.13

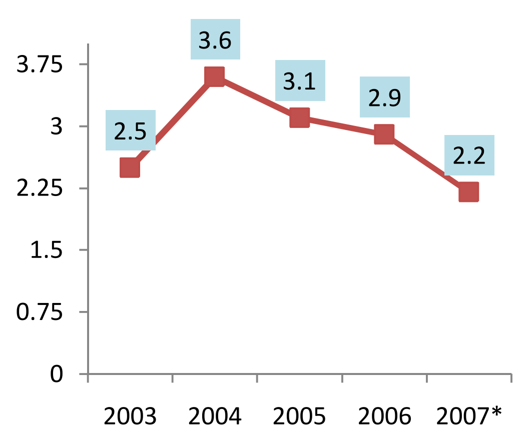
** BPI's and Banco de Oro-EPCI's 2008 GDP estimates are the midpoint of their official forecasts.*

With the exception of domestic brokerage house ATR Kim Eng, most multilateral organizations and private institutions similarly predict that growth will likely moderate this year as the Philippines faces three major challenges --- the growing risks of a US recession; the rapid rise of the peso; and the escalating price of oil in the world market. The average GDP growth forecast of the 18 institutions that released their projections for 2008 is 6.1 percent, just slightly lower from the low-end of the government's growth targets.

Threats to Economic Growth

US economic slowdown. The weakening of the US economy which can possibly lead to a recession is considered the biggest risk to the Philippines' economic outlook for 2008. Amidst the fallout from the subprime mortgage crisis, the US economy grew by 2.2 percent in 2007, a significant departure from its relatively robust expansion in the past three years (Figure 3). Both the World Bank and the International Monetary Fund forecast the US economy to grow even slower this year at 1.9 percent. US investment banks such as Goldman Sachs and Merrill Lynch's projections are less sanguine at 0.8 percent,[1] predicting a further deepening of housing and credit problems alongside the pressure of increasing oil and food prices.

Fig.3. US Real GDP Growth Rate, 2003-2007 (in percent)

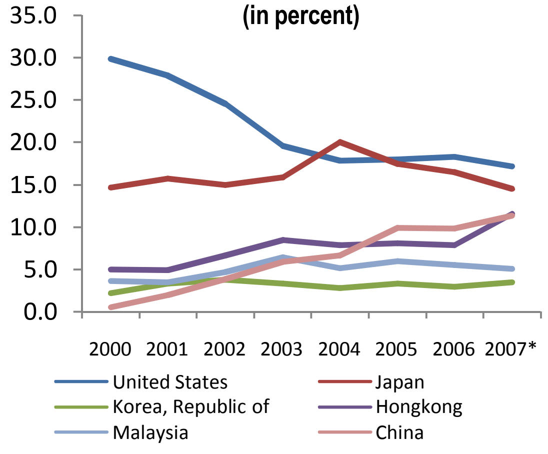


**preliminary*
Source: US Bureau of Economic Analysis

According to the National Economic and Development Authority, a 1.0-percent drop in the GDP of the US results in a mere 0.1764-percentage point decline in the growth of the Philippines' GDP. The government is optimistic that the impact on exports will not be as severe as the US no longer dominates the Philippines' merchandise export market.

With the Philippines' increasing trade with its Asian neighbors, particularly China and Hong Kong, the share of exports to the US to total exports lessened significantly, from 30 percent in 2000 to 17.0 percent in 2007. In contrast, from barely one percent (0.6 percent) in 2000, the share of exports to China swelled to 11.4 percent in 2007 while that of Hong Kong's grew from 5.0 percent to 11.6 percent in the same period. There has also been a considerable increase in the share of Philippine exports to Malaysia and the Netherlands (Figure 4).

Fig.4. Distribution of Philippine Exports by Country of Destination, 2000-2007 (in percent)



**As of January to November 2007*
Source: National Statistics Office

It must be noted though that China and the other economies in the world have strong linkages to the US. The US receives a fifth of all Chinese exports, making it the second largest destination for Chinese-made goods after the European Union.[2] Hence, it is possible that a marked slowdown in one of China's biggest markets will also translate to a downturn in China's import demand.

[1] Goldman Sachs sees US 'falling into recession' *Philippine Daily Inquirer*, January 10, 2008

[2] "US slowdown threatens Chinese export growth" *Financial Times,* http://www.ft.com/cms/s/0/007f09b4-93b5-11dc-acd0-0000779fd2ac.html

The impact of the US slowdown on the Philippine's export of non-factor services is expected to be minimal. According to the Business Processing Association of the Philippines, the US slowdown will likely translate to lower profit margins for BPO firms, but, overall, will have little effect to the Philippine BPO industry. The CCAP even looks at it as an opportunity for the Philippines to corner more businesses as firms abroad try to cut costs and resort to outsourcing. Nonetheless, the CCAP is keeping their revenue growth target for 2008 at 35.0 percent to 40.0 percent, down from last year's 57.0 percent. Currently, the US market comprises 85.0 percent to 90.0 percent of the local call-center industry.[3]

Table 6. Net Foreign Portfolio Investments (in million US$)

	2005	2006	2007*
Total	3,621.0	3,205.0	3,685.0
North America	395.0	410.1	-4,663.4
of which: USA	391.9	407.0	-4,665.3
European Union	578.4	1,028.0	4,273.5
Other European Countries	60.5	-46.3	823.9
Japan	-2.7	20.2	282.5
ASIA	16.9	1.8	118.0
ASEAN	241.4	140.9	1,608.6
ANIES**	257.0	87.7	663.3
Australasia	16.5	-40.4	56.2
Central and South America	6.9	0.8	6.6
Others***	-107.0	785.2	515.8
** as of September*			

***Asia's Newly Industrialized Economies (South Korea, Hong Kong and Taiwan)*
****Bermuda, British Oceana, Cayman Islands, Channel Islands, Cook Islands, Europe (NES), Guam, Irian, Isle of Man, Mauritius, other countries, unclassified countries*
Source: Bangko Sentral ng Pilipinas

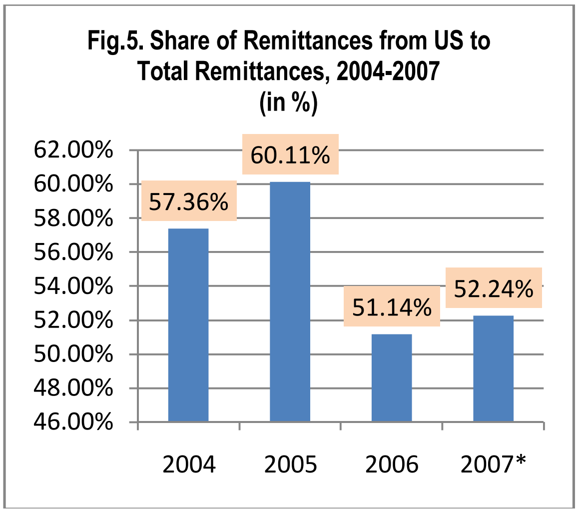
Meanwhile, the subprime crisis saw portfolio investments from the US sharply fall last year. As of September 2007, US$4.6 billion worth of portfolio investments from the US left the country, whereas in the same period in 2006, US$406 million of net inflow was registered. With the expected deepening of the housing and credit problems in the US, investment outflows from the US will likely be higher in 2008. Investments coming from other countries, however, might be able to compensate, on the assumption that the crisis will not spread to other regions. As of September 2007, hot money inflows from the European Union and the ASEAN showed a substantial increase (Table 6). As a result, the Philippines still managed to post a total net portfolio investment inflow of US$3.68 billion during in 2007, 15.0 percent higher than in 2006.

OFW remittances from the US, which comprise more than half (52.2%) of total OFW remittances coursed through banks, appear to be unaffected by the US slowdown in 2007. With still one more month to reckon with, remittance from the US in 2007 is already 4.0 percent higher than its full-year 2006 level. Total OFW remittances from January to November 2007 amounted to US$13 billion, posting an actual increase of 19.4 percent from 2006. For 2008, the BSP estimated remittance growth to be lower at 10.0 percent. Should the actual remittances decline, it will be a potential threat to the expansion of consumption spending, a major growth driver of the Philippine economy. Lower remittance flows may also dampen the demand for real estate properties which in recent years has been picking up because of the OFW families' increased spending power.

Oil price increase. Another risk to growth is the soaring prices of oil in the world market. The price of the benchmark Dubai crude increased dramatically, by 67.4 percent, from US$ 48.8 per barrel in January 2007 to US$ 92.6 per barrel in January 2008. As a result, domestic pump prices of unleaded gasoline and diesel have also risen, albeit at a slower rate. The average domestic retail price of gasoline increased by 24.0 percent, rising from P35.75/liter in January 2007 to P44.45/liter in January 2008. Meanwhile, average domestic

[3] Telephone correspondence with Mr. Jojo Uligan, Executive Director of CCAP

diesel prices grew by 21.0 percent over the same period, from P31.75/liter to P38.45/liter.



As of January- September 2007
Source: Bangko Sentral ng Pilipinas

The steep rise in oil prices is expected to result in higher cost of utilities, food and other commodities, curbing consumption spending. For instance, inflation severely went up to 4.9 percent in January 2008, higher than the BSP's forecast range of 3.7 percent to 4.4 percent for the said month. The increase would have been higher if not for the appreciation of the peso which mitigated the upward pressure on prices. The BSP sees the inflation rate at 3.0 percent to 4.0 percent for the whole of 2008. While oil prices are expected to slightly fall from its present level due to the weakening of oil demand from the US, it will likely remain volatile for the rest of the year.

Peso appreciation. The peso was considered Asia's best performing currency in 2007 having advanced 19.5 percent to the dollar during the said period. Its ascent is expected to continue in 2008 with analysts forecasting the exchange rate to hit P38:US$1, or as high as P35:US$1 this year. The government assumption is more conservative at P40-P46:$1.

While the peso appreciation may be favorable to some sectors, it aggravates the situation of the exporters, who, as earlier mentioned, are already facing the threats of low external demand and high cost of inputs. The rise in the Philippine peso was an important factor behind the significant drop in merchandise export earnings in 2007 to 2.0 percent from a double-digit growth of 11.3 percent in 2006. It forced some firms, particularly in the textile and furniture sectors, to close shop. According to the Export Development Council, 34 firms have already shut down, citing peso appreciation as the reason. The Philippine Exporters Confederation has a higher figure -- 75 firms as of June 2007. On January 7, 2008, another textile firm, Laws Textile Ltd., issued a notice of closure, citing the high cost of production and lack of orders from buyers abroad. More than 1,000 workers are expected to lose jobs due to the said closure. Apart from the loss of export competitiveness, the strong peso has also been depressing the effect of remittances from the estimated 8 million overseas Filipino workers abroad.

The government bares that heavy pump priming will be its strategy to counter the impact of the US slowdown. The expected decline in exports and manufacturing activities, for instance, will be compensated by the continued growth of construction and durable equipment spending. The government plans to go on a "construction season" by building 10,000 classrooms and 3,000 kilometers of roads this year. It is also counting on the mining sector to push industry's growth. Meanwhile, to ease the impact of oil prices on the people, the government has implemented a mechanism allowing a one-percentage point reduction in oil tariffs. It is also looking at providing VAT refunds for small power consumers and accelerating 'open access' and retail competition in the electric power industry, among other measures.

Conclusion

The developments in the global environment are clearly the biggest hurdle for the Philippine economy in 2008. It is still possible, however, to mitigate their adverse impacts by stimulating the domestic economy and offering targeted programs for the poor while keeping inflation in check.

The 2008 budget is a potent instrument in providing that needed boost to the domestic economy. Under the said budget, the allocations for infrastructure and social services will increase substantially from 2007. The capability of the government to fund the budget and its pump priming activities, however, is contingent on its finances. Currently, the Philippines is experiencing a relatively healthier fiscal account and lower debt burden, though its revenue position remains in a precarious condition. Hence, revenue collection efficiency must be improved.

Moreover, there is a need to circumspectly monitor how the budget is actually spent. A World Bank study in 2001 revealed that as much as 20 percent of the budget is lost to graft and corruption. Among the World Bank's recommendations to combat corruption is the increase in public oversight, improvement of program performance monitoring and evaluation, simplification of public procurement procedures, limiting of congressional discretion over detailed line-items and the strict enforcement of public finance rules.

Lastly, political noise will likely still be present in 2008 with the continued allegations of corruption against the Macapagal-Arroyo administration. If the recent ouster of former Speaker Jose de Venecia is any indication, the political noise will probably be more pronounced this year. Hopefully, the extent of its impact on the economy will be kept at the minimum.

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