World Bank Office Manila
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Quarterly Update

November 2008

The World Bank quarterly update provides an update on recent economic and social developments and policies in the Philippines, and present findings from ongoing World Bank work on Philippines. The update is produced by a team from the Manila office with support from the Philippines country team. Questions and feedback can be addressed to David Llorito (*dllorito@worldbank.org*).

Overview

Philippine economic performance has decelerated in 2008. Growth in the first half slowed to 4.6 percent from over 7 percent last year. Higher food and fuel prices have caused real household income to decline, pushing private consumption growth to its lowest level in years. Public sector consumption and investment spending were even weaker, contracting in real terms. Similarly, the services sector also slowed. Growth to date has been buoyed instead by private investment and non-factor service export on the demand side and agriculture and manufacturing on the supply side.

Rising inflation has brought significant hardships to the poor. Monthly headline inflation since June have risen to decade-high levels, and the inflation faced by the poor is rising even faster given the large share of food in their consumption basket. The government has responded by postponing its balance budget goal this year to allow for spending increases in infrastructure, social protection, and subsidies.

In addition, the recent global slowdown arising from the financial turmoil has also taken its toll on the performance of the external sector, notably through merchandise exports and foreign investment inflows. Slower growth in partner countries and higher oil and food prices have bloated the trade deficit. Remittances, however, have remained robust, and have kept the current account in moderate surplus. Direct investment inflows have diminished but remain positive so far. Portfolio investment has been more adversely affected by the financial market turmoil and global risk aversion. Nonetheless, the overall balance of payments has remained in surplus and enabled the country to continue to accumulate international reserves.

Despite the twin challenges of slower growth and higher inflation, the situation is expected to remain manageable. The Philippines is in a better position to weather the uncertainties brought about by the recent global slowdown and escalating fuel and food prices given the fiscal and other reforms it has undertaken in the last several years. With the appropriate fiscal and monetary policies, short-term growth prospects can be improved while inflationary pressures contained. Nevertheless, a significant slowdown in the economy is likely, and growth is projected to slow to 4-4.5 percent this year, and 3-4 percent next year.

It is in this light that the Philippines must consolidate its fiscal position and improve revenue efficiency so as to limit fiscal risks and increase the quality of spending. Increasing tax revenues remains the key immediate challenge. Without it, the budgeted higher infrastructure, social services, and social protection spending may not be feasible. New tax policies and better tax administration are needed to raise revenues to more sustainable levels. In the area of tax policy, improving the structure and rates of tobacco excises and rationalizing fiscal incentives can boost revenues and have social and economic benefits. Institutionalizing third party data sharing with the BIR and enhancing tax enforcement activities can have a significant and immediate impact on compliance. On the expenditure side, improving spending quality and its composition—and in particular the targeting of the social safety net, and capital spending efficiency—are paramount to improve the social, human, and physical capital of the economy in times of challenging global prospects.

Recent Economic Developments

Philippine economic growth has decelerated in 2008. Higher food and fuel prices have caused real household income to decline, pushing private consumption growth to its lowest level in years. Public sector consumption and investment spending were even weaker, contracting in real terms. Rising inflation has brought significant hardships to the poor. The government has responded by postponing its balance budget goal this year to allow for increases in infrastructure and social protection spending and subsidies to the poor. The recent global slowdown has also taken its toll on the performance of the external sector, notably through merchandise exports and foreign investment inflows. Despite these challenges, the economy is expected to remain resilient and manageable. In the short-term, the Philippines is expected to weather the crisis but growth will nevertheless slow down significantly. In the long-term sustainability of growth remains dependent on improvements in the investment and governance climate.

Real sector performance

Economic growth decelerated in 2008, after posting the strongest growth in three decades last year. From 7.2 percent in 2007, GDP growth slid in the first quarter to 4.7 percent and again in the second quarter to 4.6 percent.[1] The slowdown in the second quarter was rooted in rapidly rising inflation which reduced household real income, and to some extent last year's high GDP base due to higher government spending.[2] As oil and food prices soared worldwide, domestic household consumption grew at a slower rate of 3.4 percent in contrast to its average growth of 5.4 percent in the previous 21 quarters. Growth in the consumption of almost all commodity groups weakened and has been most pronounced in food consumption which grew at a much slower rate of 2.7 percent from 4.9 percent in the first quarter and 6.3 percent last year. Households also consolidated their spending on fuel, light, and water which dropped by 1.3 percent. Government spending was even slower despite earlier pronouncements by the administration to pump-prime the economy and increase spending for infrastructure and social protection, and subsidies to the poor. Public consumption and investment contracted by 5.9 and 6.4 percent respectively in real terms. Expansionary fiscal policy, as a means to stimulate the economy, was therefore underutilized and contributed to the lackluster performance of the economy. In the third quarter, government spending has picked up, and government reported a higher deficit in the months of August and September.

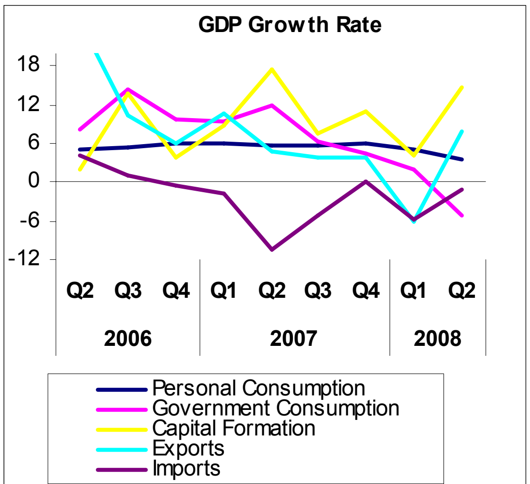
Unexpectedly, higher growth of capital formation and exports cushioned overall growth. Capital formation grew at a respectable rate of 14.7 percent in the second quarter as private construction and investments in durable equipments held up well despite the weakening economic environment. Private construction, mainly residential and office buildings grew by a hefty 25 percent in the second quarter, tracking higher growth in the real estate sector and lifting first half growth to 21.7 percent. The 4

[1] First quarter growth was subsequently revised downwards from 5.2 percent.
[2] Second quarter growth in 2007 was 8.3 percent.

percent growth in durable equipment spending was driven by investments in vehicles, mining and construction machineries, and other specialized machineries. Changes in stocks have turned positive from negative last year and while it has the effect of pulling up investment growth, it nevertheless reflects the slowdown in economic activity. Exports of goods and services rebounded in the second quarter, growing by 7.7 percent, from a slump in the first quarter. As expected, non-factor services, which include the fast growing business process outsourcing industry, grew by 18.3 percent, driving growth in external demand (Figure 1).

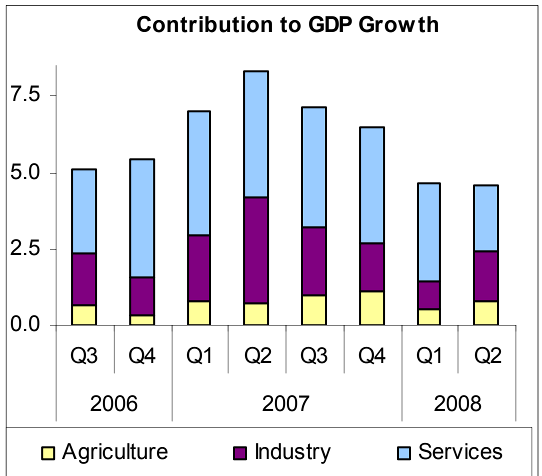
On the production side, growth was buoyed by better than expected crop harvest and higher production in the manufacturing sector. Gross value added in agriculture expanded by 4.9 percent in the second quarter, the highest growth among the three sectors. Encouraged by higher commodity prices, domestic production of rice, corn, and banana registered double-digit growths while sugarcane production was exceptionally strong with a growth of 111 percent. The manufacturing sector unexpectedly grew at a higher 6.1 percent, the highest in 13 quarters, and was supported by strong growths in food manufacturing, and to a lesser extent, beverage, basic metals, chemical and chemical products, and footwear and apparel manufacturing. Productivity, however, remains low.

Figure 1



Source: National Statistical Coordination Board

Figure 2



Source: National Statistical Coordination Board

The services-led growth story in the last seven years appears to have taken a backseat. The services sector, which comprises more than half of GDP and employs more than half of the total workforce, posted its weakest growth in the second quarter—4.3 percent compared to 4.9 percent in agriculture and 4.8 percent in industry (Figure 2). Only the real estate and private services sub-sectors, which include the fast growing business process outsourcing (BPO) industry, posted higher than average growth in the second quarter. The rest of the services sub-sectors, most notably trade and transportation, communication, and storage were adversely affected by subdued demand because of higher prices. The much slower growth of the financial sector at 2.4 percent deserves some mention, as it has been one of the fastest growing sub-sectors in the last five years—with double-digit growth in 13 out of 18 quarters. The decline in financial sector profits, in particular treasury earnings, has begun to eat up the gains posted in the previous quarters given higher risk aversion and tightening of global credit markets.

The slowdown in the economy has begun to affect the labor market. Although the rate of unemployment improved in the first three quarters of 2008 to 7.6 percent—slightly lower than last year's 7.7 percent—the bulk of the improvement is traced to the contraction in the labor force participation rate, from 64.3 to 63.3 percent, and the increase in the number of unpaid family workers, which comprised 11.2 percent of total employment and is prevalent in agriculture and private households. Moreover, the high value-added manufacturing sector shed some 130,000 jobs. The good news, however, is the underemployment rate improved to 19.9 percent from 20.8 percent last year.

Inflation and monetary conditions

After a period of falling inflation in the last three years, rapidly accelerating inflation resurfaced this year. Higher food and oil prices were initially muted by the strong peso which appreciated by nearly 20 percent in 2006-07. In early 2008, inflation breached the central bank's 4-5 percent target as world food and oil prices surged. Inflation continued to escalate, reaching double digit levels by June. In August, inflation reached a peak of 12.5 percent before falling in September to 11.9 percent, bringing year-to-date inflation to 9.2 percent (Figure 3).

The decade-high inflation is primarily traced to escalating food prices. Food comprises about half of the CPI basket and thus has a strong impact on headline inflation. Food prices have increased at double digit rates since April, triggered primarily by the steep increase in the international price of rice. The government's now-abandoned practice of announcing large tenders of rice imports may have also contributed to the spike in the international price of rice. At the local level, there were reports of domestic rice hoarding and speculative pricing by traders, more prevalent in areas outside the National Capital Region, which have contributed to higher retail prices. At its peak, rice price increases reached 50 percent in July before descending to 45 percent in August and 37 percent in September.

At the same time, fuel prices, especially diesel oil, increased sharply in the second quarter and have brought significant hardship to the transport sector and commuters. To mitigate the rise in fuel prices, the government gradually removed the tariff rate on oil and asked oil companies to cross-subsidize diesel oil, which is the dominant fuel used by public transport. An increasing number of public vehicles have converted to the cheaper liquefied petroleum gas (LPG). Buses powered by compressed natural gas (CNG) have also begun service. Falling fuel prices since the beginning of September has offered some relief and enabled the government to resume levying the tariff on imported fuel in October.

Table 1. Selected Economic Indicators

	2004	2005	2006	2007	2008 (YTD)
Growth, inflation and unemployment (percent)					
Gross national product	6.9	5.4	5.5	8.0	5.7 c/
Gross domestic product	6.4	5.0	5.4	7.2	4.6 c/
Inflation (period average); 2000 base year	6.0	7.6	6.2	2.8	9.2 d/
Inflation (end period); 2000 base year	8.6	6.6	4.3	3.9	11.9 f/
Unemployment /1	11.9*	7.9	8.0	7.3	7.6 b/
Savings and investment (percent of GDP)					
Gross national savings	18.6	16.6	19.0	19.7	18.1 c/
Gross domestic investment	16.7	14.6	14.5	15.3	16.1 c/
Public sector (percent of GDP)					
National government balance	-3.8	-2.7	-1.1	-0.2	-0.5 c/
Total revenue	14.5	15.0	16.2	17.1	16.3 c/
Tax revenue	12.4	13.0	14.3	14.0	14.6 c/
Total spending	18.3	17.7	17.3	17.3	16.8 c/
Consolidated public sector balance	-4.8	-1.9	0.2	0.6	-1.1 a/
Nonfinancial public sector debt	95.2	85.9	73.9	61.1	60.7 a/
National government debt	78.2	71.4	63.8	55.8	56.6 h/
Money and credit (year-end percent change)					
M3	10.3	10.3	22.7	10.6	9.8 e/
Credit to the private sector	4.9	-0.3	6.6	8.5	19.0 e/
Balance of payments					
Merchandise exports (percent change)	9.8	3.8	15.6	6.4	4.1 c/
Merchandise imports (percent change)	8.0	8.0	10.9	8.4	15.5 c/
Current account balance (percent of GDP)	1.9	2.0	4.5	4.4	2.0 c/
International reserves					
Gross official reserves (billions of dollars)	16.2	18.5	23.0	33.8	36.7 f/
Change in reserves (billions of dollars)	-0.9	2.3	4.5	10.8	5.8 f/
Gross official reserves (months of imports)	3.6	3.8	4.2	5.7	5.7 f/
External debt					
Total (billions of dollars) /2	54.8	54.2	53.4	54.9	54.8 h/
Total (percent of GDP) /2	63.1	54.8	45.4	38.1	33.8 h/
Debt service ratio (G&S and income) /2	13.8	13.5	12.0	9.8	10.6 h/
Exchange rate (peso/dollar, period average)	56.0	55.1	51.3	46.1	43.3 g/
Real effective exchange rate (2000 = 100)	86.2	92.3	102.5	112.3	121.4 c/
Stock market index	1823	2096	2412	3443	2800 g/

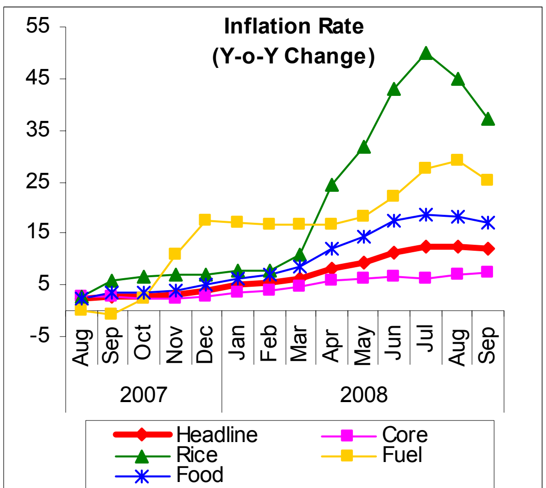
Source: Government of the Philippines, World Bank, IMF

1/ Annual average; using new definition adopted in 2005 ; based on 2000 census
2/ Reported by BSP
a/ Jan-Mar
b/ Jan, Apr and Jul average
c/ Jan-Jun
d/ Jan-Sep
e/ As of Aug
f/ As of Sep
g/ Jan 2 -Oct 17, 2008
h/ As of Jun

As inflationary pressures mounted, core inflation has doubled since the start of the year. Without respite from the rising prices of basic commodities, prices of other goods have also risen rapidly, pushing up core inflation from less than 3 percent in 2007 to 7.5 percent in September 2008. In an effort to control spillovers, the central bank increased policy rates thrice since June (see discussion below).

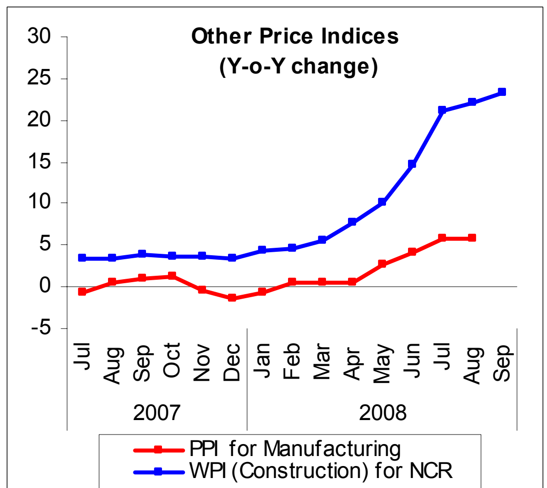
In line with the rising consumer price index, nominal wages have increased. As of June, all 17 regions have been granted wage hikes by the regional boards of the National Wages and Productivity Commission. The increases in the regional minimum wages, however, have been less than the increases in regional year-to-date inflation, resulting in a decline in the minimum wage rate in real terms. For instance, the National Capital Region (NCR) was granted a 6 percent increase in June, but this was lower than the September year-to-date inflation of 7.2 percent. And since minimum wages cannot be increased more than once in a year (barring exceptional circumstances), higher inflation in the succeeding months, averaging close to 9 percent between June and September, has further eroded real wages.

Figure 3



Source: National Statistics Office

Figure 4



Source: National Statistics Office

Production costs have also picked up. Growth in the producer price index (PPI) of the manufacturing sector had remained almost flat in the first four months of the year but rising input prices on the international market and rising nominal wages have filtered into the production sector, giving rise to higher PPI inflation beginning May. From less than 1 percent between January and April this year, PPI inflation jumped to 5.8 percent year-on-year in July and August. In particular, manufacturers of food, petroleum products, basic metals, iron and steel, and non-ferrous metals had to grapple with fast-rising production costs. Similarly, the construction materials wholesale price index started to pick up in April (Figure 4). The August year-to-date construction wholesale price inflation in NCR reached 12.7 percent compared to an average of 4.4 percent in 2007 as the prices of fuels, lubricants, and steel increased.

With inflation breaching the central bank's original and revised targets, policy rates were hiked to contain inflation. From a relaxed monetary stance last year to mitigate the expected slowdown in growth following the onset of the subprime crisis, the Monetary Board hiked the 7 percent policy rate by 25 basis points on June 5, 2008 after seeing the May inflation of 9.5 percent, a nine-year high. The hike in policy rate was initially modest given expectations that upside inflationary risks would be tempered by the global economic slowdown. However, further increases in the inflation rate in the succeeding months prompted a second hike in policy rates by 50 basis points on July 17 and another 25 basis points on August 28. In October, the Monetary Board left key policy rates unchanged after considering the improved inflation outlook and developments in the global financial market.

Monetary growth has slowed in 2008. Growth in M3 (broad money) slowed to 9.8 percent in August from 11 percent in 2007 and over 23 percent in 2006. The authorities had used various tools since 2006 such as special deposit accounts to mop up excess liquidity. At the same time, banks have been encouraged to lend more and reduce their holdings of government securities. In addition, the government has cut down on the issuance of securities following improvements in its fiscal position. Also, holding of government securities will eventually have higher risk weights under Basel II. Relatively low lending rates, despite the hike in policy rates, have also helped increase lending activity. Growth in loans outstanding of universal and commercial banks (net of RRPs[3]) rose gradually in the last 12 months, reaching 22.1 percent in June with significant increases in both commercial and consumer lending. Lending to utilities, trade, and the transportation, communications and storage sectors comprises 60 percent of new commercial net lending in the year ending August while credit card loans comprised 80 percent of the increase in consumer lending. The rapid growth in credit gives some reason for concern, as credit growth during a period of economic slowdown could lead to higher defaults in the future.

Fiscal performance

Tax effort, which fell below expectations in 2007, improved significantly in the first half of 2008. The VAT reform had boosted tax effort to 14.3 percent of GDP in 2006 from 13 percent in 2005. Weaker tax administration and macroeconomic developments such as a stronger currency, however, pushed back tax effort to 14 percent of GDP in 2007 and cast some doubt on the sustainability of the government's fiscal program. In late 2007, both the Bureau of Internal Revenue (BIR) and the Bureau of Customs (BOC) began to focus on the reforms in addition to meeting monthly collection targets. These reforms included scaling up the use of third party information to detect tax evaders and non-registrants, and the control of smuggling, in particular petroleum and cars. As a result, tax effort improved in the first quarter of 2008, and continued to improve in the second quarter, although higher prices, notably for oil appear to have been the main driver of the second quarter results. Tax effort in the first half is estimated at 14.6 percent of GDP from 13.8 percent a year ago.

[3] Reverse repurchases (RRPs) are bank's placement at the central bank.

At the same time, government spending was lower than planned, and helped keep the deficit in check. The late passage of the budget as late as April, low absorptive capacity of several agencies, and the pending rationalization plan, which generally prohibits the hiring of new staff all contributed to the slow growth in government spending.[4] In the first half, primary spending grew by 6 percent while interest payment grew by 8.7 percent given higher borrowing spreads and interest rates. Total spending grew by only 6.7 percent versus a tax revenue growth of 18.5 percent. Consequently, the deficit in the first half was well contained at P18 billion and was equivalent to less than 0.2 percent of estimated GDP for the whole year.

The hike in food and fuel prices and slower growth has prompted the government to increase spending. In May 2008, the government announced that it was prepared to provide as much as P93.6 billion (1.3 percent of GDP) in additional spending to help the poor cope with rising fuel and food prices. The additional spending for infrastructure, subsidies, and social protection are to be financed by higher tax revenues and new borrowings. Of the P93.6 billion in additional spending, P18.6 billion is expected to be sourced from 'windfall' revenues from the VAT on oil, which as of July amounted to about P9.2 billion. The remaining P75 billion which is equivalent to 1 percent of GDP would be sourced from additional borrowings. A portion of the new borrowing requirements was financed from the July retail treasury bond offer, which amounted to P70 billion (0.9 percent of GDP). The remaining balance of \$500 to \$750 million is expected to be sourced from a combination of official development assistance and bond offering. Earlier in the year, the government raised \$500 million in ROP bonds which completed its external borrowing requirements net of ODA under the original balance budget framework.

The latest fiscal accounts have begun to show higher overall spending. Consistent with the government's plan to increase spending, primary spending grew by 21 percent in the third quarter (Figure 5). Tax revenues, however, grew at a much slower pace of about 10.6 percent given lower collections by the BIR (Figure 6). Collections from the BOC, however, remain strong, aided in part by higher oil prices. Lower than programmed tax revenues are expected in the second half from the implementation of Republic Act (RA) 9504 which increases personal and additional exemptions of individual taxpayers and exempts minimum wage earners from the personal income tax. With total revenue growth easing to 2.6 percent in the absence of new privatization receipts, P35.3 billion was added to first half deficit, bringing the September year-to-date deficit to P53.4 billion or P18.3 billion higher than program (0.7 percent of full year GDP). Privatization receipts for the year are estimated between 0.2 and 0.4 percent of GDP.

But disbursements on short-term mitigating measures have been slow so far. Of the P18 billion allocated to social protection and subsidies from the "*Katas ng VAT*"

[4] The Department of Finance recently explained that one factor behind the weak spending was that agencies benefit from under spending since a portion of the "savings" can be used to supplement staff compensation in the form of bonuses.

program, only about P4 billion has been released for the following projects: 1) P2 billion in cash transfers to electricity lifeline users (i.e. consumers of less than 100 kwh of electricity per month); 2) P1 billion in scholarship grants and interest-free loans to poor students; and 3) P1 billion for demand-side management programs such as the conversion into energy-efficient light bulbs and provision of low interest loans to jeepney drivers who wish to convert their engines into the cheaper and more environment-friendly LPG-fired engines. Two other tranches of P4 billion each to be spent on subsidies for small power users, rehabilitation of infrastructure affected by typhoon, livelihood and loans to families of transport operators, cash assistance to senior citizens not covered by pension, upgrade of provincial hospitals, and financial assistance to small farmers, have yet to be released in full.

Figure 5

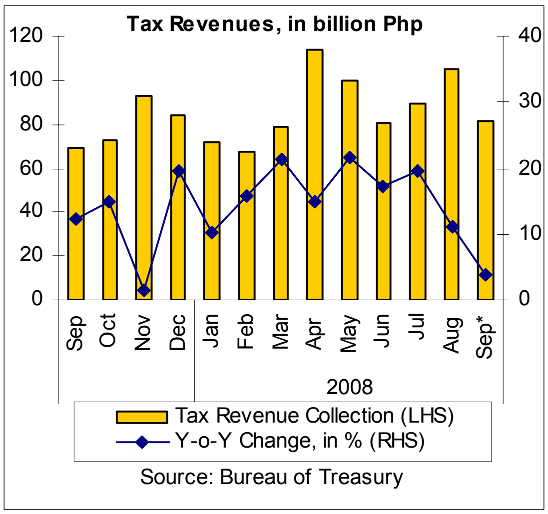
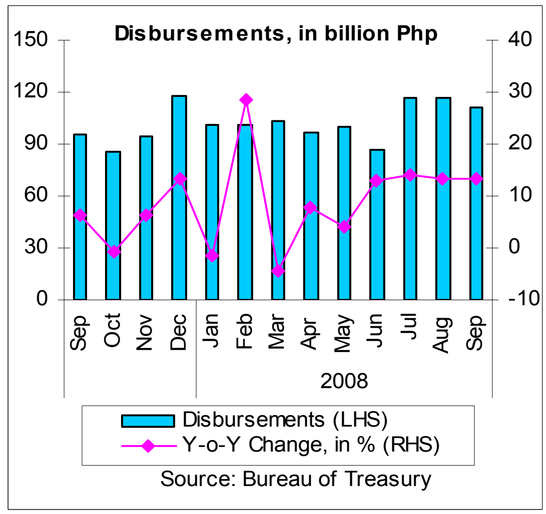


Figure 6



Note: * BOC and BIR collection only

External sector performance

Though clearly hit by the global slowdown, the external sector remained resilient. In the first half of 2008, a BOP surplus of $1.9 billion was recorded. The current account also remained in surplus at 2 percent of GDP. Although the trade deficit was much higher at about 6.9 percent of GDP, rapid growth of remittances kept the current account balance in check. The capital and financial accounts maintained a respectable surplus despite net outflows of portfolio investment following the increase in market volatility.

Foreign trade performance has been hit by the global slowdown and rising prices. The first half trade deficit ballooned to $6.4 billion from $3.2 billion in the same period last year. Nominal imports, in dollar terms, expanded at a fast rate of 15.5 percent in the first half, with significant contributions from oil, cereals, fertilizers, and iron and steel imports. The increase in cereal imports reflects the rapid inflation of food prices and the government's move to stock up more rice in view of the food crisis felt earlier this year. Demand for fertilizers was also propped up by the government's intensified support to the agriculture sector through the FIELDS program, which provides for bigger fertilizer subsidy to farmers. Higher demand for office and residential buildings has continued to push up iron and steel imports, although the large increases in international prices posed concerns for the construction and real estate industries going forward.

Consistent with the experience of other countries, export growth in the first half moderated to 4.1 percent from 7.1 percent last year. While preliminary export data for July-August indicate an uptick from 1 percent last year to 5.4 percent, the country's top export, electronics, remained sluggish as demand for high tech products fell worldwide and as competition intensified among global manufacturers of semiconductors, reflecting falling Philippine export productivity. Export of garments also dropped with increasing competition from other low-cost manufacturers after the US lifted the quota. The depreciation of the peso by about 18 percent between January and October this year has been a relief to exporters and has helped bigger exporters cope with falling demand but has yet to encourage smaller exporters that have closed shop last year to reopen.

Inflow of remittances remains strong although the pace of growth has slowed. Notwithstanding the global economic slowdown, the country continues to deploy overseas workers at astonishing speed. In the first eight months of the year, deployment rose by 26.4 percent to more than 884,000 as demand persists, especially in sectors like education and health. Moreover, the destination of overseas workers has become more diversified. Recent bilateral talks with host countries have also opened up new employment opportunities abroad for Filipinos. The rapid growth of overseas Filipinos and the huge amount of remittances they send back has encouraged more local banks to expand their international presence. These expansions have also brought more overseas Filipinos into contact with various financial products, thereby increasing the share of remittances channeled to investments. It is estimated that about 30 percent of remittances are now being invested in housing.[5] Against this backdrop, the central bank recorded the highest monthly inflow of remittances in June, $1.5 billion or 30 percent higher than last year. However, in the succeeding months remittances started to register slower growth, from 24 percent in July to 10 percent in August. This brings the August year-to-date inflows to $10.9 billion or 17.2 percent higher relative to the level a year ago.

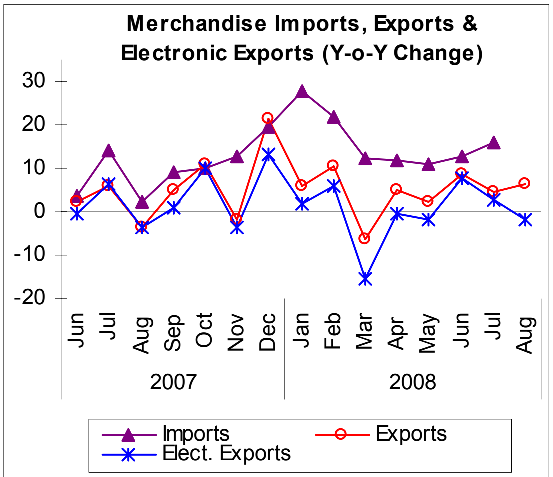
Total capital inflows remain solid even as foreign investors turned cautious. Net direct investment in the first half stood at $742 million and is much higher than the $1.4 billion in net outflows recorded in the same period last year.[6] Although net inflows were higher, direct investments by non-residents declined by 57.9 percent to $813 million from $1.9 billion in the same period last year. The decline was even more pronounced in July as direct investment inflow dropped by 70 percent. Net placement of equity capital accounted for about 94 percent of total net inflows in January-July. Several sectors, such as financial intermediation, hotels and restaurants, real estate, and construction appear more upbeat with greater net equity investment inflows this year compared to last year, although the sustainability of their growth is doubtful. Portfolio investment was more

[5] Global Property Guide (as reported in the Philippine Daily Inquirer, May 8, 2008).

[6] An outflow of $3 billion was recorded in June last year following the acquisition by a resident company of shares of a power company abroad.

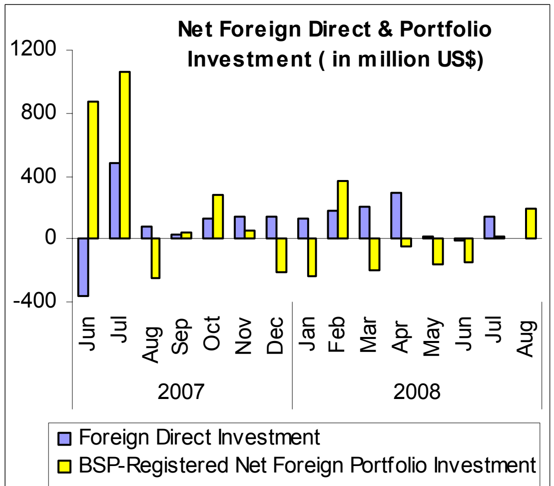
adversely affected by continuing risk aversion, recording a net outflow of $520 million in the first nine months, a trifle compared to $3.4 billion in net inflows last year. Placements in the stock market, peso denominated government securities, and money market instruments were offset by higher outflows from peso bank deposits amounting to $2.3 billion. The other investment account turned positive in the first half to $643 million from a deficit of $632 million last year as residents pulled out their investments abroad.

Figure 7



Source: National Statistics Office

Figure 8



Source: Bangko Sentral ng Pilipinas

The BOP surplus has contributed to a higher reserve position. Gross international reserves rose to $36.7 billion in June from $33.8 billion in end 2007. In July, reserves had inched up to $36.9 billion before falling back to $36.7 billion in August and September following some devaluation in gold reserves, the peso defense notwithstanding. The latest GIR level can cover 5.8 months of imports of goods and payments of services, and income and is also equivalent to 4 times the country's short-term external debt.

Financial markets

Domestic financial markets have been resilient despite the turbulence in the international financial markets. With the exception of a handful of banks, the banking system as a whole was mildly affected by the financial turmoil. At any rate, the Philippine banking system remained adequately capitalized as of June 2008 with a capital adequacy ratio (CAR) of 15.5 percent on a consolidated basis.[7] Total assets increased to over P5 trillion with a notable increase in cash—seen as a buffer to market volatility. Investments, however, declined with lower investments in government securities because of lower issuance of government bonds and the higher risk weights that below investment grade foreign currency denominated government securities will carry under Basel II.

[7] The 2007 CAR is lower than the CAR posted in end 2006 due to the shift of banks to the Basel II framework starting July 2007.

Non-performing loans have fallen to below 5 percent in end-2007 and continue to drop towards its pre-crisis level of about 3 percent.

The impact of the global financial turmoil on the Philippines has been seen mainly in the decline in stock market and asset prices, a rise in the spreads on its international bonds, and some depreciation of the peso. Following the strong appreciation of the peso in 2007, the currency depreciated by about 18 percent year to date against the US dollar. However, the depreciation masks some of the pressures on the exchange rate as the authorities have also been intervening in the foreign exchange markets—notably in the swap markets—to support the peso. Stock market prices have declined by 45 percent since the end of 2007; a decline that is comparable to other East Asian economies. The October auction of the benchmark T-bill saw rates jump by 150 basis points from the last auction in July (the July auction saw a 200 basis points increase in rates). Borrowing spreads, which had fallen below 200 basis points last year, jumped to over 800 basis points in October.

As in other countries in the region, the Philippines has implemented measures to deal the pressures in the domestic financial markets. In particular, the Philippines has approved a circuit breaker rule to halt trading in the stock market if the benchmark index drops by 10 percent from the previous day and is considering quadrupling the deposit insurance threshold combined with a capital injection (of P45 billion) into the deposit guarantee fund. On its part, the central bank has allowed a change in accounting rules to enable banks to avoid mark-to-market losses on their government bond holdings, eased its rules on the 100 percent asset cover of bank's foreign currency deposit units, and opened an inter-bank dollar-denominated borrowing and lending facility to manage liquidity constraints of banks. The Bankers Association of the Philippines has also come out with self-restraining measures to help the central bank manage the shock to the domestic financial system.

For emerging markets like the Philippines, there are several potential channels of vulnerability through which they could be affected by the current turbulence in the global financial markets: a) Direct exposure to sub-prime related distressed credit products of the US and Europe, or to other structured credit and other related derivatives, or direct exposure to troubled US or European banks; b) Exposure to increased investor risk aversion leading foreign investors to move to cash and safer fixed income positions. Countries that are especially vulnerable include those with: high external debt burdens, high foreign participation in local debt and equity markets and more generally large current account deficits; c) Fundamental factors associated with external financing needs—whether reflecting sovereigns with large and rising external financing needs, banks with large (short-term) external funding needs or corporations reliant on external funding for refinancing debt coming due or to fund planned growth and possible repercussions on the domestic economy arising from these; d) Exposure to a slowdown in global economic growth—developing countries with high-income country trade orientation and or reliance on workers' remittances inflows are particularly vulnerable.

The Philippines' direct exposure to subprime related distressed credit products appears to be limited with the exception of a handful of banks. For the banking system as a whole, the holdings of subprime linked securities amount to 0.2 percent of their assets and exposure to the collapsed Lehman Brothers range from 0.3-0.4 percent of total assets. Overall exposure to structured products is estimated at about 2 percent of banking sector assets. The loss associated with decline in sovereign bond prices was greater, albeit still contained.

Of potential concern is the relatively large external financing needs, given the still large stock of external debt—although the reserve cover is relatively comfortable. At present, banks' loan-to-deposit ratio is relatively low at 56 percent which reduces the risk of being affected by developments in the wholesale market. Corporations have also deleveraged considerably—with average debt/equity ratios of around 0.4-0.5 (although this still renders them vulnerable to developments in the stock markets). Although the reserve cover (reserves to short term debt at residual maturity) is at present relatively comfortable at 5, a further worsening of the global financial conditions, could, given the overall gross financing needs (including the repayments of maturing medium and long-term debt) and the potential for the reversal of the stock of foreign portfolio holdings, exert great pressures on reserves and ultimately on exchange rates and interest rates.

Arguably the greatest impact of the global financial turmoil however is likely to come from the slowdown in global economic growth. As discussed in the section on macroeconomic prospects, growth in remittances—which has supported both the balance of payments position, real estate investments, and consumption growth—is likely to slow considerably next year, as is export growth. Based on current projections of global growth, Philippine growth is likely to moderate further next year to around 3-4 percent.

Efforts to increase the country's savings rate and improve access to finance have progressed with the recent passage of the Personal Equity and Retirement Account Act and the Credit Information Systems Act. In August 2008, the president signed the Personal Equity and Retirement Account (PERA) into law. The PERA law aims to promote capital market development and increase savings among the citizenry by establishing a legal and regulatory framework for retirement plans. Under the law, a taxpayer may set up a voluntary retirement account that invests in PERA investment products such as unit investment trust fund, mutual fund, and insurance pension products, among others. The law also prescribes tax incentives such as a 5 percent income tax credit and tax exemption of income earned from the investment (up to the prescribed maximum amount) if these are not withdrawn before age 55. The law will take effect in January 2009.

In addition to the PERA Law, the President recently signed the Credit Information System Act to facilitate access to capital, especially for small and medium enterprises. The law creates a corporation whose primary purpose is to receive and consolidate basic credit data, act as central registry of credit information, and provide access to reliable, standardized information on credit history and financial conditions of borrowers. The proposed law requires bank, quasi-banks, their subsidiaries and affiliates, life insurance companies, credit card companies, and other entities that provide credit facilities to submit credit data and updates of their clients.

Poverty and social update

Poverty increased in 2006 despite higher growth in recent years. Between 2003 and 2006, GDP growth averaged 5.4 percent and was higher than historical trends. Despite this, the latest poverty estimates show that between 2003 and 2006 poverty headcount increased from 30 to 32.9 percent, back to its level in 2000. The magnitude of poor population rose to its highest level in 2006 at 27.6 million Filipinos.

Alternative measures of poverty also show the same trend. Between 2003 and 2006, the World Bank's new poverty measure, the $1.25 a day poverty line at 2005 purchasing power parity (PPP) prices, shows an increase in the poverty headcount from 22 to 22.6 percent. Poverty estimates based on a consistent basic needs approach also show an increase from 26 to 28.1 percent.[8] Moreover, self-rated hunger has shown gradual increase since 1998 and rose to an all-time high of 19 percent by end 2006.[9] Figure 9 shows the trend according to various measures. The special focus section of this report gives an overview of the new World Bank poverty line.

Wide regional disparity is also observed. Geographically, the National Capital Region and the two adjacent regions (CALABARZON and Central Luzon) which account for more than half of GDP, receive a disproportionately large share of infrastructure spending, and have per capita incomes above the national average, have consistently recorded the lowest poverty headcount as a share of population. On the other hand, the poorest regions (ARMM and Caraga) have per capita incomes of only 50-60 percent of the national average and receive a very small share of total investments. These regions also have the highest incidences of poverty (Figure 10).

Poverty in the Philippines is largely found in rural areas and is linked to low-income agricultural-based livelihoods. It is estimated that as of 2006, three quarters of the poor reside in rural areas.[10] These estimates also show that rural poverty increased from 12.1 percent in 2003 to 14.4 percent in 2006 and that poverty among agricultural households is about three times higher than poverty in other sectors. However, with urbanization, the share of poor population living in urban areas increased from 22.7 percent in 2003 to 25.2 percent in 2006.

Growth has translated into lesser poverty reduction in recent years because of high levels of inequality and vulnerability. The pace of poverty reduction in the Philippines is muted when compared to the record of its Asian neighbors. Estimates show that the Philippine's growth elasticity of poverty is greater than unity but this has declined

[8] Balisacan, A. (2008) "Poverty Reduction: What We Know and Don't?" University of the Philippines Centennial Lecture Series.
[9] Social Weather Station. "July 2008 Report on Self-Rated Poverty and Hunger."
[10] Balisacan (2008)

in recent years.[11] High rates of inequality and vulnerability to shocks partly explain the disconnect between the recent experience in growth and poverty reduction. The country's Gini coefficient remains high relative to its neighbors in the region (45.8 percent in 2006), and large variation in economic opportunities persist at the sub-national level. It is also estimated that 45 percent of Filipinos are vulnerable to poverty[12], and that half of poor households succumbed into poverty because they are unable to protect themselves from income shocks.[13] The conflict in Mindanao and the high frequency of natural disasters (typhoons in particular) are among the main causes of vulnerability. Box 1 discusses the Mindanao conflict while Box 2 discusses typhoon disasters in the Philippines.

Moreover, higher inflation relative to income growth contributed to the increase in the poverty headcount between 2003 and 2006. While nominal income rose by 17.5 percent between 2003 and 2006, cumulative inflation was higher at 21.1 percent, translating into a 3.6 percent decline in real family incomes between 2003 and 2006. Nominal income, in the form of wages, salaries, and household operating surpluses, did not grow as fast as previously experienced to counteract the increase in prices.[14]

Figure 9

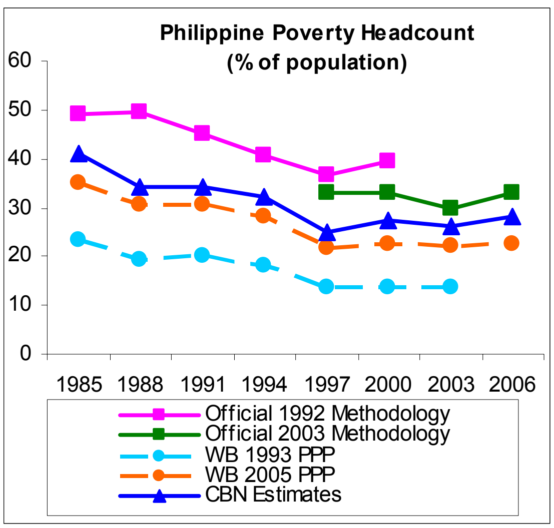
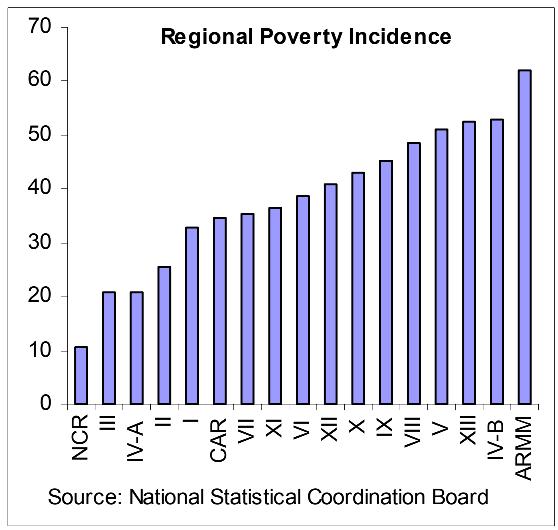


Figure 10



The recent spike in inflation has caused significant hardships to the poor. It is estimated that up to three million people may have fallen below the poverty line in the last two years due to rising prices. Recognizing the need for better social protection to the

[11] Ravallion, M. (2001) "Growth, Inequality, and Poverty: Looking Beyond Averages." World Development, 29: 1803-15; Cline, W.R. (2004) "Technical Correction" in Trade Policy and Global Poverty, Institute of International Economics." Washington DC.
[12] NAPC and NSCB. (2005) "Assessment of Vulnerability to Poverty in the Philippines."
[13] Reyes, C. (2002) "The Poverty Fight: Have We Made an Impact?"
[14] Although inflation in the eighties and the nineties was generally higher than inflation in recent years, income growth back then was even higher, thus offsetting the effect of higher prices on real income.

poor and vulnerable groups in light of the recent global crisis, the government has increased the budget of existing social protection programs, launched new transfer programs, and took steps to ensure that such programs are well-targeted. The impact of rising inflation on the poor is explored further in the fourth section of this report.

Box 1. The Conflict in Mindanao

On August 10, 2008, the government's military launched an offensive against a group of Moro Islamic Liberation Front (MILF) fighters in the Province of North Cotabato after the latter occupied a number of villages in the province and defied the former's order to vacate the areas. The MILF said the action of this group manifested their frustrations over government's failure to sign the Memorandum of Agreement (MOA) on Ancestral Domain which was scheduled to be signed on August 5, 2008 in Malaysia. The territory issue has been the main bottleneck that has dragged the peace talk between the government and the MILF.

Soon the conflict grew and escalated to six other provinces (Lanao del Sur, Lanao del Norte, Maguindanao, Shariff Kabunsuan, Saranggani, and Basilan). In its September 14, 2008 update, the National Disaster Coordinating Council (NDCC) reported that at least 59,274 families or 292,827 persons are listed as Internally Displaced Persons (IDP) and are being provided with humanitarian assistance. Evacuation centers numbering more than a hundred have been established. It also reported that 71 people have been killed and 99 injured. Reports from other sources show higher numbers of people affected by the conflict. Meanwhile, many people in affected villages have stopped working on their farms and engaging in other economic activities for fear of getting caught by cross-fires. Children have temporarily stopped going to schools and there is uncertainty as to when classes would resume. Damages to farmlands, agricultural facilities, and other physical infrastructures have been reported although there are no figures as of writing. Both government and non-government organizations have directed their services and resources for relief and rehabilitation.

Concerned about the potential negative impact of conflict on the economy, the Department of Finance has said it will conduct a study on the impact of the Mindanao conflict on the government's revenue collection and spending program to determine the appropriate action needed to address the country's financial needs. In its 2005 study, the World Bank estimated that on average, the annual economic cost of the war in 1975-1982 and in 1997-2001 was about $200 million or 0.3 percent of GDP (measured using 2001 GDP).

The current conflict in Mindanao is part of the long-running conflict associated with the struggle of the Moros for self-determination. Moros are Mindanao Muslims who have struggled against foreign colonization and the Philippine government's assimilation since the Spanish colonial era. They, together with the indigenous peoples or *Lumads*, used to occupy most of Mindanao.

The more contemporary form of this conflict started in the late 1960s when the Philippine government's army officials ordered the killing of 28 young military trainees after they refused the order to conduct covert operations in Sabah, Malaysia. Soon after, the Mindanao Independence Movement (MIM) was formed. A year later, the Moro National Liberation Front (MNLF) was organized and took the lead in the campaign for an independent Moro state in the south. Alongside their campaign for independence, the Moros also resisted government policies that ushered in logging and mining activities in Mindanao and influx of Christian settlers from Luzon and the Visayas.

The declaration of Martial Law in 1972 heightened the conflict into open hostilities between the government and the Moro rebels. This resulted in displacements of hundreds of thousands of civilians. Four years after, the government sought the intercession of Libya to facilitate a ceasefire agreement with the MNLF and the dropping of the latter's secessionist agenda in exchange for the creation of an autonomous region for the Muslims in Mindanao. This initial agreement finally saw its substantial form in 1987 when the new Philippine Constitution provided the legal basis for the creation of the autonomous region. However, the succeeding Act of Congress (RA 6734) received strong protest from the Moros as it required holding of a plebiscite among the 13 provinces they were claiming. As Christians had become the majority in most of the 13 provinces, only four provinces voted for inclusion and became part of what is now the Autonomous Region in Muslim Mindanao (ARMM).

In 1984, a breakaway group of the MNLF, now known as the MILF, was formed. Unlike the MNLF, the MILF distinguished itself by espousing a goal to create an Islamic State in Mindanao and Palawan. Thus, when the MNLF forged a peace agreement with the government in 1996, the MILF was not part of it. The Government of the Republic of the Philippines (GRP) – MNLF war was said to have claimed more than 100,000 lives and displaced millions of people.

In 2000, the Estrada administration declared an all-out war against the MILF which saw the killing of hundreds of people and displacement of about a million people. When Estrada was ousted by a people power, the new government reversed the approached by declaring an all-out peace policy. This paved the way for the forging of a ceasefire agreement with the MILF in 2001. However, another breakout of hostilities between the government and the MILF occurred in 2003 over an allegation that the latter was harboring terrorists. This conflict displaced about a million people.

Since the signing of the ceasefire agreement in 2001, there has been a significant drop in armed hostilities between the two groups. The presence of the International Monitoring Team headed by the Malaysians was credited for this dramatic change. When the Malaysian contingent started pulling out in May 2008 concerns that armed conflicts would rise again increased among the people.

At the request of President Arroyo to the World Bank in 2003 to help with peace and development in Mindanao, a World Bank administered multi-donor trust fund was set up with contribution from Australia, Canada, New Zealand, and the World Bank. Later, Sweden, the European Union, and the United States joined. The trust fund provided funding for the Mindanao Trust Fund-Reconstruction and Development Program (MTF-RDP) which was divided into two phases: Phase 1 (on-going) is focused on capacity-building for and provision of technical assistance to local organizations, local government units, and community groups, including learning-by-doing activities in conflict-affected barangays through the implementation of community and local sub-projects. Phase 2 (time to be determined) will comprise a scaled up implementation of the program in conflict-affected areas, provision of technical assistance, and continuation of capacity building for implementing groups.

The recent conflict has not put a stop to the MTF-RDP activities because the thrust of the program of building local capacity on the ground has allowed the local implementing agencies and their partners to continue with the community driven development activities in areas not affected by fighting. However, any program in a conflict situation has to adapt to the continuously changing situation. There will be a shift of the MTF-RDP activities for the next few months to focus on the returning IDPs and help them with reconstruction of destroyed homes and livelihood. The Bank will coordinate closely with UN agencies that are providing humanitarian relief, and other international and local partners that are assisting with rehabilitation work in the area.

Sources:
1. S. Schiavo-Campo and M. Judd, *The Mindanao Conflict in the Philippines: Roots, Costs, and Potential Peace Dividend*, Social Development Papers, No. 24, The World Bank, February 2005.
2. *Joint Needs Assessment for Reconstruction and Development of Conflict-Affected Areas in Mindanao: Integrative Report, Vol. 1*, The World Bank, December 2005.
3. http://210.185.184.53/ndccWeb/images/ndccWeb/ndcc_update/ARMED_CONFLICT/sitrep26_complex.pdf
4. http://www.gmanews.tv/story/115891/Finance-dept-to-study-impact-of-Mindanao-conflict-on-govt-collections
5. NDCC Update, National Disaster Coordinating Council, Philippines, September 14, 2008

Box 2. Typhoon Disaster in the Philippines

The Philippines has been identified as one of the most disaster prone countries in the world. Its natural disasters—which include floods, typhoons, and landslides, account for about 25 percent of natural disasters reported annually worldwide. Figures from the National Disaster Coordinating Council (NDCC) reveal that between 1990 and 2006, the country incurred an average annual direct damage to agriculture, infrastructure, and private property of around P19.7 billion (in real 2005 prices), which is equivalent to about 0.5 percent of GDP. An average of 1,009 lives is lost every year, with typhoons accounting for 74 percent of the fatalities, 62 percent of the total damages, and 70 percent of the agricultural damages. An average of 20 typhoons hit the country every year, five of which are expected to cause serious damages. Risks from climate change are further exacerbating the country's vulnerability to natural hazards, manifested in more intense rainfalls and stronger monsoon rains.

In June 2008, Typhoon Frank (Fengshen), the fifth typhoon to hit the country this year battered Metro Manila, Southern Luzon, the Visayas, and even many parts of Mindanao, which are rarely hit by typhoons. The provinces of Capiz, Aklan, Antique, and Iloilo in Region VI, and Leyte and Eastern Samar in Region VIII were severely affected. Meanwhile, the provinces of Maguindanao and Shariff Kabunsuan in ARMM, and Cotabato City and North Cotabato in Region XII were also affected by the monsoon rains induced by Typhoon Frank. Severe flooding, mudslides, and storm surges resulted in 557 fatalities, 826 injured individuals, and the displacement of around 4 million people in 58 provinces. NDCC placed the damage to public infrastructure (roads, bridges and schools) and agricultural production at P13.5 billion or 0.2 percent of GDP (measured using 2008 estimated GDP). Typhoon Frank also caused several sea vessels to capsize, including the MV Princess of the Star, which sank off the coast of Romblon. The ferry was carrying 866 crew and non-crew passengers; of which 173 were confirmed dead and only 56 survived. Operations are ongoing to retrieve not only the remaining bodies, but also 10 tons of endosulfan, a highly toxic pesticide that was being shipped by the ferry.

In the aftermath of Typhoon Frank, the Bank fielded a reconnaissance mission to Iloilo – a province rarely hit by typhoons – to review information on the nature and extent of the damage caused by the typhoon on the LGU water supply system and identify possible financial support for rehabilitation and reconstruction of damaged infrastructure. As a result of the preliminary discussions, the Bank is working with the Iloilo City Government on a proposal to support the post-disaster recovery planning for the City, through a proposed grant from the Global Facility for Disaster Reduction and Recovery (GFDRR). The GFDRR already supports an ongoing technical assistance program for the entire Philippines that aims to build capacities of local governments to manage the impacts of natural disasters.

Macroeconomic Prospects and Policies

Prospects

Growth in high income countries is slowing sharply as rising prices weigh on consumption and financial turmoil restrains investment. As of the second quarter, Japanese household spending dropped 1.9 percent while fixed investment fell 6 percent. In the Euro Zone, consumption and investment declined 0.6 and 4.6 percent respectively. Following recent events in the financial market, growth in Japan and the Euro Zone is expected to have eased further in the third quarter. Already the United States has seen its economy growing at a much slower rate of 0.3 percent in the third quarter from 2.8 percent the previous quarter. The October consensus forecast, which is collected from professional forecasters, shows deteriorating prospects for most high income countries. Growth in the US is now projected at 1.4 and zero percent respectively in 2008 and 2009. Euro Zone growth prospect is expected to decline in 2008 to 1.2 percent and further on to 0.5 percent in 2009. Japanese growth is projected at 0.7 percent in 2008 and 0.5 percent in 2009. The most recent global financial market turmoil has also pushed down the Bank's forecast (Table 2).

Growth in East Asia has also decelerated but is expected to remain robust, fueled mostly by domestic demand. Most countries in the region have shown impressive resilience in this turbulent environment, and growth in the region is expected to remain strong, albeit lower than in recent years. In some respects, the slowing of the regional economy is welcome, especially in China, where very fast growth has increased the likelihood of overheating, as illustrated by a dramatic increase in commodity prices last year and earlier this year and by inflationary pressures in a number of countries. The October consensus forecast expected China to grow at 9.8 percent in 2008 before slowing to 8.8 percent in 2009, while the rest of East Asia is projected to grow between 4.5 and 5 percent in 2008 before moving down slightly in 2009. Recent developments, however, will likely bring down projections further.

Table 2. The Global Environment
Percent change, unless otherwise indicated

	2006	2007	2008f	2009f	2010f
World GDP	4.0	3.7	2.8	1.3	3.2
United States	2.8	2.0	1.7	0.2	2.1
Japan	2.4	2.0	1.0	-0.1	1.9
Euro Zone	2.9	2.6	1.3	-0.4	1.7
World trade (volume)	9.8	7.4	5.9	-2.5	6.0
Oil price ($/bbl)	64.3	71.1	105.0	79.3	81.3
Non-oil commodity price index	29.1	17.0	26.5	-19.1	-6.0

Source: World Bank Development Economics Prospects Group (October 2008)

Rising inflation has complicated macroeconomic management in most developing countries. A combination of supply and demand factors has drastically pushed up the price of oil and food in the last ten months. Oil price, which grew by 10.6 percent in US dollar terms in 2007, reached historic highs in mid-2008 and is projected to grow by 47.7 percent on the average in 2008 before falling in 2009. Non-oil commodities will also see higher inflation of 26.5 percent in 2008 (from 17 percent in 2007) before deflating in 2009 and 2010. The combination of higher prices and slower growth has made the control of inflation especially more difficult this time around given the very little room for monetary tightening. Several countries that had relaxed monetary policy last year in response to the financial turmoil have reversed its stance to contain spillover and inflationary expectations at the cost of slower growth.

Escalating international food and fuel prices have translated into higher inflation for the Philippines. Under the base case scenario, which has inflation slowing down towards single digits by November average inflation would reach about 10 percent in 2008. Core inflation, however, is expected to be elevated for some more months before the full effect of monetary tightening is felt. A low case scenario where inflation persists at double digits until the end of the year would result in average inflation of 10.8 percent. This could be mitigated by a continued fall in fuel and food prices and a possible appreciation of the peso from stronger OFW remittances in the last quarter of the year.

The combined effects of the weaker global economy and higher prices have evidently affected Philippine macroeconomic outlook. As discussed in the previous section, personal consumption expenditure (PCE), which has been the main driver of growth, grew by only 3.4 percent in the second quarter—much lower than its 5.4 percent average in the last 21 quarters. With inflation even higher in the third quarter and global prospects worsening, PCE growth is expected to decelerate further in the third quarter especially given the higher PCE base in the third quarter of 2007.

Exports and private investments, which improved in the second quarter and drove growth, are not likely to be sustained and remain drivers of growth for long. Although the August year-to-date merchandise exports grew by 4.4 percent (in nominal terms), the July year-to-date import of electronic parts contracted by 7.6 percent and signals some slowdown in electronics export in the coming months. This projected fall in Philippine exports is also consistent with the projected slowdown in world trade volume to 5.9 percent in 2008 and negative 2.5 percent next year. The slowdown in world trade does not bode well for high technology Philippine electronics that ultimately end up in high income countries. Similarly, private capital formation, in particular private construction, is also unlikely to be sustained given declining market prices of real estates, slowing remittances—which until recently has contributed significantly to the boom—tightening credit conditions and higher interest rates, and overall declining investor confidence.

With the slowdown in PCE and uncertainties in exports and investments, growth in the remainder of 2008 could be buoyed by public expenditure. As discussed in the previous section, first half government expenditure—both consumption and investment—contracted due to the delay in budget approval, the delay in project implementation, and weak absorptive capacity in many government agencies. With some disbursement momentum gained in the third quarter, the government should be able to spend more, especially on public construction and other pump-priming and pro-poor subsidies to approach the revised deficit of 1 percent of GDP by year end.

Based on the above mentioned factors, Philippine growth in the second half of 2008 is likely to moderate further. Under a base case scenario, growth in 2008 is now projected at 4-4.5 percent, significantly lower than previously projected. Next year's growth is likely to be lower at 3-4 percent given the worsening global prospects.

On the external sector, the country's current account surplus is projected to be lower, but still positive. Fueled by a dramatic increase in the price of imported fuel and rice, the Philippine's import bill is projected to increase by 12.5 percent this year compared to a 3.8 percent increase in exports. Consequently, the trade deficit is expected to increase further to around 8.3 percent of GDP from 5.7 percent last year. Despite the higher trade deficit, stronger remittance inflows should protect the current account surplus from turning into a deficit. Remittances have maintained their strong momentum in the first eight months of 2008 and are likely to grow by no less than 9.5 percent for the whole year, although for next year a significant slowdown in remittances growth is expected.

Global uncertainties and risks will continue to pose threats to net foreign investment inflows. Net inflows of direct investments are expected to be minimal this year, as year-to-date FDI posted smaller net inflows compared to last year. For next year, this is expected to turn negative. Over the medium term, attracting significant inflows of FDI will depend on improvements in the investment climate. Consistent with global financial volatility, net portfolio investments are expected to be minimal as well. Net outflows in the first ten months could be reversed if the interest rate differential continues to rise in the coming months and if global prospects become less pessimistic. Overall, despite lower current account surpluses and lower capital inflows, the overall balance of payments will likely remain in surplus, and international reserves are projected to reach $36.6 billion or about 5.5 months of imports in 2008. In 2009, reserves could go slightly lower given lower inflows of exports and remittances.

The public sector's fiscal position is expected to remain manageable while the government undertakes counter-cyclical measures to protect the poor and sustain growth. As discussed earlier, the government announced in May its intention to postpone budget balance to 2010 and instead increase spending up to 1 percent of GDP to counteract the effects of the global slowdown and higher prices. Limiting the increase in the government's overall fiscal deficit hinges on achieving the programmed tax effort. The projected tax effort already factors in some revenue losses from the recent passage of a law that reduces the tax liability of individual taxpayers and the delisting of 500 large taxpayers from the roster of the Large Taxpayer Service in the BIR which had previously accounted for about 65 percent of total collections. For 2009, existing and programmed tax policy measures (e.g., a 5 percentage point cut in the corporate income tax rate) along with a projected economic slowdown entail a challenging environment for tax collection. Absent revenue-raising tax policy measures, better tax administration will be crucial in improving the tax effort to the budgeted level. So far, the reforms in tax administration initiated in 2007 appear to have contributed to the higher tax revenues in the first nine months of 2008.

Table 3. Medium-Term Macroeconomic Framework

	2006	2007	2008f	2009f	2010f
GDP growth	5.4	7.2	4.0-4.5	3.0-4.0	4.0-4.5
CPI inflation (average)	6.2	2.8	10.0	8.5	5.5
Merchandise export growth	15.6	6.0	3.8	2.0	3.8
Merchandise import growth	10.9	8.1	12.5	1.9	4.5
Remittances (transfers) growth	15.9	5.9	9.5	4.0	5.0
FDI (billions of dollars)	2.8	-0.5	0.5	-0.5	0.3
Portfolio investment (billions of dollars)	3.0	3.1	-0.2	0.3	0.6
International reserves (billions of dollars)	23.0	33.8	36.6	35.4	35.4
International reserves (months of imports)	4.3	5.9	5.4	5.1	4.8
(Percent of GDP)					
Gross domestic investment	14.3	14.8	14.5	14.0	14.4
Current account	4.5	4.4	1.5	2.1	1.6
Gross national savings	18.8	19.2	16.0	16.1	16.0
Trade deficit	-5.7	-5.7	-8.3	-8.1	-8.2
Non-financial public sector debt	73.9	63.4	58.4	56.3	54.3
External debt	51.4	43.3	40.1	38.2	36.2

Source: GOP for historical, World Bank for projections

Note: Forecasts for variables other than GDP growth are based on the lower end of the range of GDP growth forecasts.

Public sector debt in real terms is expected to fall further in the medium-term, albeit slower. From over 100 percent of GDP in 2003, the non-financial public sector debt is estimated to fall below 60 percent of GDP in 2008 and below 50 percent of GDP by 2012. The pace of debt reduction, however, is expected to be slower given higher projected deficits and borrowing spreads in the medium-term, due to a global re-pricing of risks, including to emerging markets. Borrowing spreads which have fallen from above 500 basis points in 2003 to about 200 basis points in end-2007 have jumped to 800 basis points in October.

Policies

Clearly, macroeconomic prospects have become more adverse for 2008 and are expected to be even more so for 2009 but the situation should remain manageable. The Philippines is in a good position to weather the uncertainties brought about by the recent global slowdown and escalating fuel and food prices, given the fiscal and other reforms it has undertaken in the last several years. In this context, it is important that the country continues to protect the sustainability of its fiscal sector to allow for better and more capital and social expenditure and that it ensures that monetary policy is appropriate to control inflationary pressures.

The authorities' challenge is to prevent inflationary pressures to perpetuate, while bracing the economy for the impact of a global slowdown. The demands on fiscal policy in this respect are going to be significant. Continued fiscal support for aggregate demand would be appropriate for next year, but fiscal sustainability requires continued improvements in revenues, which are already under pressure from policy decisions already taken, and from rapidly falling commodity and asset prices and a projected economic slowdown. Moreover, financing conditions in domestic and international markets have become more challenging, and privatization receipts for next year are likely to be more modest. In such an environment, moving rapidly ahead with tax policy and tax administration reforms, while seeking increased financing from more concessionary sources would ensure that higher spending on infrastructure and social spending is realized.

Monetary policy

An appropriately tight monetary policy stance is needed to contain spill over from food and fuel price increases into inflationary expectations. Since May, headline inflation has been higher than average lending rates and interbank rates, suggesting some room for monetary tightening. The central bank has prudently responded in the last five months by raising policy rates by a total of 100 basis points, and has indicated that it will continue to monitor the inflation outlook, and raise policy rates if needed to address inflationary risks. In its October meeting, the monetary board kept policy rates unchanged after the September inflation improved from its August peak but indicated that it will continue to craft appropriate monetary policy to safeguard price stability. This stance leaves little room for monetary policy to stimulate aggregate demand, which makes the role of fiscal policy more prominent, provided the latter does not unduly increase fiscal risks.

Administrative measures in response to inflation

To mitigate the impact of inflation on the poor, the government has increased the budget for social protection and subsidies to the poor. In 2008, a higher budget allocation was given to the Food-for-School Program (FSP) and the PhilHealth Indigent Program. The FSP budget was increased from P2.8 billion in 2007 to P3.3 billion in 2008. Under the PhilHealth Indigent Program, the national government's premium counterpart for the enrolment of indigents into the program was increased from P2.9 billion in 2006 to P3.5 billion in 2008 and is enough to cover up to 90 percent of eligible households.

In addition, the government allocated more funds during the course of the year to a series of safety net programs. An estimate of the spending on existing and new programs to contend with the food and fuel crisis over and beyond the amount allocated in the 2008 budget is P67.6 billion. As of mid-September 2008, the Department of Social Welfare and Development was allocated approximately P7.2 billion in supplementary funding for social protection programs. Many of these allocations were decisions made at the level of Cabinet and through pronouncements of the President, including in the State of the Nation Address. This reflects an explicit effort to scale up social assistance in the face of mounting distress. The programs that benefited from scale-up funds included food for school program, nutrition and breastfeeding programs, and other social protection programs aimed at assisting poorer households.

"Windfall" VAT revenues from higher oil prices have also been used to subsidize the poor's consumption. As mentioned in the previous section, P12 billion have so far been allocated to various programs, among others the cash transfers to electricity lifeline users, livelihood and loans to families of transport operators, and cash assistance to senior citizens not covered by pension. Moreover, the national government has allotted P8.6 billion in the first six months to distribute 14.8 million bags of state-subsidized rice to help low-income consumers cope with the global spike in rice prices.

There is scope for more efficient and well targeted forms of subsidies especially on rice. Until recently, National Food Authority (NFA) rice was accessible in many public markets and neighborhood stores and almost anyone can buy the rice, without need for being pre-qualified. The 2008 cost of this subsidy program is estimated to possibly be as high as P60.9 billion (US$1.3 billion)[15]. Evidence shows that it is not well-targeted to the poor. Based on the 2006 Family Income and Expenditure Survey, NFA rice accounted for only 13 percent of the total spending on rice by the poorest quintile. Moreover, much of the NFA rice is not consumed by the poor. Only 31 percent of the total consumption of NFA rice goes to the poorest quintile while as much as 41 percent leaks to non-poor households. The richest two quintiles accounted for 16 percent of total NFA rice consumed in 2006. The government has recently acknowledged this leakage and aims to limit the selling of NFA rice to poor households by selling only in *Tindahan Natin* outlets to identified Family Access Cards (FAC) beneficiaries. Though this approach is more desirable, it nevertheless suffers from some leakages as some FAC beneficiaries are determined by local government officials without the benefit of hard data (i.e. local household census). A better approach would be to design and implement a national targeting system to identify the deserving beneficiaries. The second special focus section of this report discusses efforts underway to improve targeting.

There is also scope in reducing the effective rice import tariff. Currently, rice import tariff stands at 40 percent and quotas apply as well. The government has generally stood steadfast in keeping rice tariffs high to protect domestic rice farmers and encourage domestic farming, but this has kept prices high and rice less accessible and affordable to poor Filipinos who comprise about one-third of the total population and are net buyers of rice.[16] For them, food comprises about 60 percent of household expenditures, with rice accounting for nearly a fifth of total expenditures, making the poor particularly

[15] Estimated based on the Department of Finance's assumption of 2.4 million metric tons of rice imports in 2008 at US$940 per metric ton, including freight costs, and sold at P18.25 per kilo.

[16] Despite higher retail prices, most farmers have not benefited as farm gate prices have not increased as much (in fact falling in the last four months). Rising input cost has also squeezed earnings of farmers.

vulnerable to price shocks. Although the government lifted rice tariff in April-May and replaced it with a service fee (P2 per kg) to encourage the private sector to import more rice, the number of takers were too few since the import cost was still too high. Ultimately, lowering effective rice tariffs can have an immediate benefit to the majority of the poor.

Tax policy and administration

Tax revenues need to grow to enable the government to respond aptly to the twin challenges of lower growth and higher inflation while reducing fiscal risks and maintaining fiscal stability.

While maintaining fiscal stability is clearly a priority of the government, there are indications that tax effort might fall again in the absence of tax policy and administration reforms. Even maintaining the tax effort of the first half of 2008, wherein tax effort improved to 14.6 percent of GDP, is going to be a challenge. On the one hand, the surge in inflation and the slowdown in the economy are likely to take a toll in both income and VAT collection beginning the second half and windfall collection from higher oil prices are likely to fade as oil prices recede and consumers alter their consumption pattern. On the other hand, RA 9504 which exempts minimum wage earners from income taxes, increases the personal and additional exemptions of individuals, and allows self employed and professionals to choose the 40 percent optional standard deduction (OSD) in reporting business expenses is estimated by the Department of Finance to reduce tax revenues starting in the second half of 2008 by 0.2 percent of GDP. The tax revenue loss for 2009 is likely to be even bigger given the scheduled reduction in the corporate income tax rate from 35 to 30 percent on January 1, 2009 and the implementation of the PERA Law on top of RA 9504. The estimated tax revenue loss for 2009 from the three tax measures is estimated at 0.5 to 0.7 percent of GDP.

The Bureau of Internal Revenue has adopted several measures in the areas of registration, audit, and collection to improve revenues. These measures include recent initiatives to match data with local government units to uncover non-registrants and suspected tax evaders, new regulations to tighten controls over tax exemption removals, advancing the schedule of taxpayer audit, and ongoing roll outs of the integrated computerized system (ITS) to 30 revenue district offices. Moreover, with the close of the Tax Amnesty Law in May, which generated about P5 billion in revenues, the BIR has started to intensify the Run after Tax Evaders (RATE) Program.

Reforms in the Bureau of Customs are also underway following heightened media attention to smuggling. To address smuggling, especially automobile and oil, which appears to have worsened in the last five years, the President created a high level task force to address smuggling and collusion between customs personnel and importers. A number of customs agents have been charged with corruption under the Revenue Integrity Protection Service (RIPS) Program of the government. Likewise, the Run after the Smugglers (RATS) Program is also being intensified.

To prevent further erosion in the gains attained so far in fiscal consolidation, new tax policies and more systematic and sustainable tax administration are urgently needed. In the area of tax policy, increasing the excise tax rates of tobacco products and rationalizing fiscal incentives are foremost recommended since both have very strong economic and social cases on top of their revenue impact.

There is a great scope in improving the design and yield of tobacco excises. Philippine tobacco excise tax rates and excise burden are among the lowest in the world and the structure of excises is complex. Consequently, tobacco excise tax revenues are both low and have been declining as a percentage of GDP over the past ten years. If properly taxed, tobacco products can be a large source of revenues. Aside from the revenue benefits, health and social benefits from lower tobacco consumption are expected to be significant.

A first best option would involve shifting to a uniform and higher specific excise tax rate that is automatically linked to inflation thereafter. This option would guarantee that both excise incidence and burden will not fall over time. The government can expect to generate up to 1.3 percent of GDP in revenues under the first best scenario or 10 percent of tax collection. A second best option, if automatic indexation is not supported or rates cannot be agreed ahead of time, is to exclude specific rates from the law, and refer these to a schedule of rates, which is to become part of the annual budget submission to Congress. Rates can then be increased over time without changing the law.

The scope for rationalizing fiscal incentives is equally large. Tax incentives substantially reduce effective tax rates on corporate income. IMF staff estimates suggest that the rationalization bill supported by the DOF—phasing out tax holidays and instead offering a reduced corporate income tax rate or a 5 percent tax on gross receipts—would broadly retain the current effective tax rates while enabling the government to tap into tax redundancies (i.e. that is the provision of tax incentives for activities that would have taken place anyway even without the incentive) estimated at about 1 percent of GDP.[17]

In the area of tax administration, there is an immediate need to improve taxpayer compliance. Two reform areas appear promising given their track record of success if properly implemented and their potential to increase collection in the short-term. These are using third party information to expand the taxpayer registry to aid audit and enforcement, and intensifying anti-tax evasion and smuggling programs of the government (i.e., RATE and RATS).

Tax compliance can be expected to improve by accelerating and institutionalizing the use of third party information to expand the taxpayer registry and to improve enforcement of tax laws. One of the primary reasons for the low level of tax collection is the narrow tax base and the fact that the BIR's registration database captures only a portion of the taxable population. These in turn render all downstream tax processes such as audit, collection, and enforcement—all of which rely heavily on clean

[17] Reside, Renato (2006) "Fiscal incentives and investments in the Philippines" EPRA paper.

and up-to-date taxpayer information collected during registration and validated thereafter—difficult to implement. The absence of a clean and updated taxpayer database has also led to weak enforcement of tax laws.

The BIR can intensify its effort in expanding the tax base by fully integrating third party information into its standard business process and by implementing a credible enforcement program. In lieu of the various executive orders, regulations, and memoranda of agreement, the executive may want to consider a single comprehensive executive order that mandates all government agencies and selected private sector organizations (such as trade associations) to provide BIR with taxpayer information that is free of charge and provided in a timely manner.[18] Full implementation of the law would require field offices of BIR to quickly validate the findings of the data matching using third party sources. Experience in other countries suggests that systematic data matching and subsequent physical validation send a very strong signal to taxpayers to increase their compliance. In addition, significant gains in short term revenues can be expected by resuming the regular and frequent filing of highly publicized tax evasion cases (i.e. RATE). While the litigation process may take time, and the success of the tax evasion case depends on several factors, the signal that a high profile tax evasion case sends to the public can work to improve compliance and collection overall.

[18] Currently, several laws govern the exchange of data but all have limitations. For instance, Executive Order (EO) 53 is dated and not broad and strong enough in mandating automatic data sharing with BIR. EO 646, while laudable, is limited to local government units (LGUs).

Special Focus 1: New Purchasing Power Parities and Poverty in the Philippines

Rationale and methodology for revising global estimates

Countries use national yardsticks and household surveys specific to their country to measure poverty. If, however, the objective is to measure the extent of global poverty, a common yardstick adjusted for differences in cost-of-living across countries is required. The World Bank has been using the $1-a-day poverty line as one such yardstick since it produced the first set of global poverty estimates in the *1990 World Development Report: Poverty*. This section summarizes key findings of an update of the World Bank's estimates.

A major update has been carried out in light of improved data on the cost-of-living from the 2005 International Comparisons Program (ICP) and the availability of more household surveys. The yardstick for poverty in the new estimates is placed at $1.25-a-day at 2005 prices, which is derived as the average national poverty line used in the poorest 15 countries in the world. To assess progress in fighting poverty over time, all poverty estimates back to 1981 have been revised on a consistent basis using the new poverty line and new price data. It is important to note that lags in survey data availability mean that these new estimates do not include the effects of the recent rise in food and fuel prices.

To calculate country-specific poverty rates, the international poverty line of $1.25 per person per day is first converted into local currency units in the ICP base year (2005) using the revised PPP (purchasing power parity) adjustments derived from the 2005 ICP exercise. The poverty line for each country (which is the PPP-adjusted $1.25 per person per day in 2005) is then converted into equivalent poverty lines for other years, by adjusting for the prices prevailing at the time of the relevant household survey using the consumer price index (CPI) for that country. The poverty rate for a certain year is then calculated as the percent of population below the poverty line based on nationally representative household survey data on consumption or income.

The global picture

Results of this current revision indicate that with the new poverty measure more people are considered poor, but that poverty declined on the aggregate since 1981. The main reason is that the 2005 ICP data imply that past PPPs underestimated the cost-of-living in most developing countries. The new PPP estimates, which reflect improvements in international comparable price data, offer a more accurate picture of the cost-of-living in developing countries. The old data suggested that the number of poor people had fallen below one billion, but with the upward adjustment to the cost-of-living and the new poverty line of $1.25, 1.4 billion people in the world consume less than $1.25-a-day in 2005 prices.

Nonetheless, there has been progress for the poorest on the aggregate. Poverty incidence below $1.25-a-day in the developing world was halved, falling from 52 to 26 percent over 1981-2005. The trend decline in the poverty rate was one percentage point per year, and the number of poor fell by 500 million, from 1.9 billion to 1.4 billion. At this rate, the developing world as a whole is on track in attaining the first Millennium Development Goal of halving the 1990 poverty rate by 2015.

Implications for the Philippines

Based on the new 2005 PPP poverty estimates for the Philippines, five points are to be made. ***First***, revised estimates show, unsurprisingly, that with the new measure more people are considered poor. Previous estimates based on the \$1.08-a-day poverty line at 1993 PPP are not available for 2006. But estimates for 2003 using the old poverty line yield an incidence of 13.5 percent compared to the 22 percent for the \$1.25 line using 2005 PPPs (Table 4). This trend is similar to other countries in the region and the developing world as a whole. The upward revision in the numbers is mainly caused by the higher cost-of-living in most developing countries as implied by the PPP numbers. For the Philippines, the revision from the international \$1.08 line in 1993 PPP to \$1.25 in 2005 PPP implied that the new poverty line in local currency is 21 percent higher than previously estimated. This resulted in 8.5 percentage point increase in the share of the population living below \$1.25-a-day in 2003.

Table 4. Comparison of Old and New PPP Poverty Estimates for the Philippines and Select Countries

Region/Country	Survey Year	Poverty Incidence (%) \$1.08-a-day in 1993 PPP	Poverty Incidence (%) \$1.25-a-day in 2005 PPP
Philippines	1985	23.4	34.9
	1988	19.5	30.5
	1991	20.2	30.7
	1994	18.1	28.1
	1997	13.6	21.6
	2000	13.5	22.5
	2003	13.5	22.0
	2006	NA	22.6
Rural China	2005	16.8	26.1
Vietnam	2002	1.8	39.4
EAP	2005	9.0	17.9
Global	**2005**	**17.2**	**25.7**

Source: Chen and Ravallion (2008); NA - not available

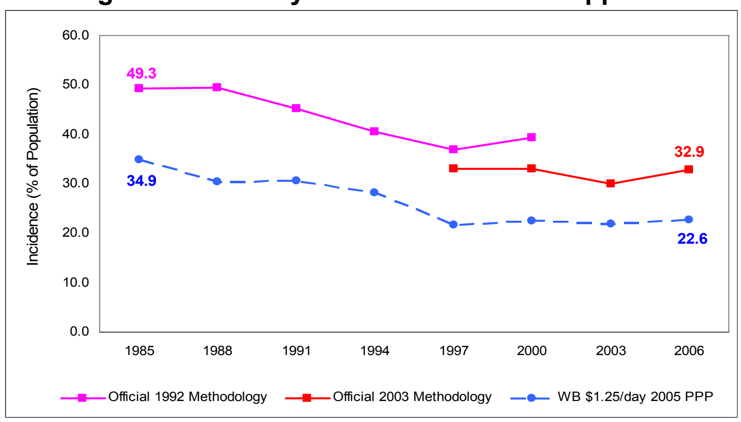
Second, internationally comparable estimates reveal lower poverty rates and counts than official national estimates. This is because the \$1.25-a-day poverty line is lower than the national poverty line. In local currency, the 2005 PPP poverty line is equivalent to P11,714 in 2006, which is well below the national poverty line of P15,057 (Table 5). Consequently, the number of poor people based on these two poverty lines is different. Besides the difference in the poverty lines used, it is also important to note that the \$1.25-a-day poverty estimates are not completely comparable with official poverty estimates for the Philippines because the two employ different measures of gauging poverty. Official poverty estimates use per capita income as the indicator of well-being while World Bank estimates use per capita consumption.

Table 5. Comparison of Poverty Estimates for the Philippines

Survey Year	$1.25-a-day in 2005 PPP Poverty Line			National Official Poverty Line		
	Annual Local Currency (Peso)	Poverty Incidence (%)	Number of Poor (million)	Annual Local Currency (Peso)	Poverty Incidence (%)	Number of Poor (million)
2003	9,666	21.99	18.0	12,309	30.0	23.8
2006	11,714	22.62	19.7	15,057	32.9	27.6

Third, the poverty trend based on the $1.25 benchmark shows that the Philippines made progress in the fight against poverty. This trend is similar to what the trend in official national estimates suggests. One limitation of poverty estimation in the Philippines is that estimates of poverty incidence are not comparable across time. Poverty estimation in the Philippines has undergone a major revision in 2003, and past estimates have not yet been revised to be comparable with recent numbers. Moreover, poverty lines used to derive official estimates are updated every time a new data for poverty estimation becomes available, and thus vary over time. It is thus difficult to assess the progress in poverty reduction in the Philippines over a long horizon using official numbers.

Figure 11. Poverty Reduction in the Philippines



Sources: Chen and Ravallion (2008); NSCB

A look at the past 20-year period using the 2005 PPP poverty, however, reveal that the proportion of the population living below the $1.25-a-day benchmark declined from 34.9 percent in 1985 to 22.6 percent in 2006. This means that poverty had been reduced by 35.2 percent over the past 20 years. Note that this indicates a similar reduction to what available official poverty estimates would suggest (33.3 percent reduction).

Fourth, despite a general declining trend in poverty, estimates using the $1.25 benchmark show that poverty increased in recent years, consistent with official estimates. Between 2003 and 2006, the Philippines' $1.25-a-day poverty increased to 22.6 percent from 22.0 percent. Meanwhile, official estimates show an even higher increase in poverty, from 30.0 percent to 32.9 percent. WB estimates an increase of 1.7 million in the number of poor people living below $1.25-a-day over 2003-2006. However by official accounts, an even greater number of Filipinos (3.8 million) succumbed into poverty between those years. Both measures suggest that in the last decade, no progress in poverty headcount has been made.

Lastly, while the $1.25-a-day poverty line provides a useful benchmark for comparing poverty across countries, it is important to note that national/official poverty lines are better suited for monitoring poverty trends at the country level. The $1.25-a-day international benchmark is derived as the average line of the world's 15 poorest countries to allow for international comparison. Maintaining this comparability across countries often constrains the ability to take into account country-specific circumstances in estimating poverty. For instance, in the case of the Philippines, poverty lines are estimated taking into account the consumption pattern of Filipinos at the household level, unlike the international poverty line that is based on an average of poverty lines of a group of countries. The $1.25-a-day international poverty line is also corrected over time using the national CPI, which does not take into account differences in prices in the 17 regions in the Philippines. In contrast, official poverty lines are updated using provincial CPIs. In part, this explains the difference in the number of Filipinos who fell into poverty between 2003 and 2006 using the official poverty line versus the $1.25 benchmark.

Special Focus 2: Inflation and the Poor

Recent headline inflation in the Philippines has been the highest in a decade. The last time monthly inflation exceeded 10 percent for at least two consecutive months was in 1998 which saw two crises: the Asian Financial crisis and the El Nino crisis. Despite the twin crises, average headline inflation in 1998 remained below 10 percent. In contrast, inflation for 2008 is estimated to exceed 10 percent under prevailing assumptions. In between the two years, inflation fell below 5 percent in 4 out of 9 years and stayed within 5 and 8 percent in the other 5 years (Figure 12).

The inflation faced by the poor is even higher. People with low incomes tend to spend a higher fraction of their income on food than others. In the Philippines, households in the bottom income quintile spend 60 percent of their expenditure on food and 18 percent on rice alone. In contrast, those in the highest income quintile spend 33 and 4 percent, respectively, on food and rice. Given the much higher food prices in recent months compared to other items in the CPI basket, the poor Filipino has faced higher inflation than the average Filipino. In 2007, headline inflation was 2.8 percent but the inflation faced by the poor was estimated to be slightly higher at 3 percent. In 2008, with escalating food prices, year-to-date headline inflation reached 9.2 percent in September but the poor already have to cope with an estimated inflation of 10.5 percent.[19] By year end, the poor would have faced an estimated average inflation of 11.4 percent compared to 10 percent for the average Filipino (Figure 13).

Figure 12

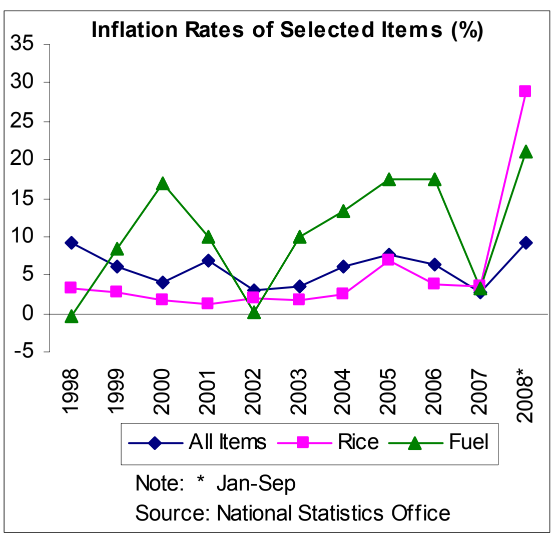
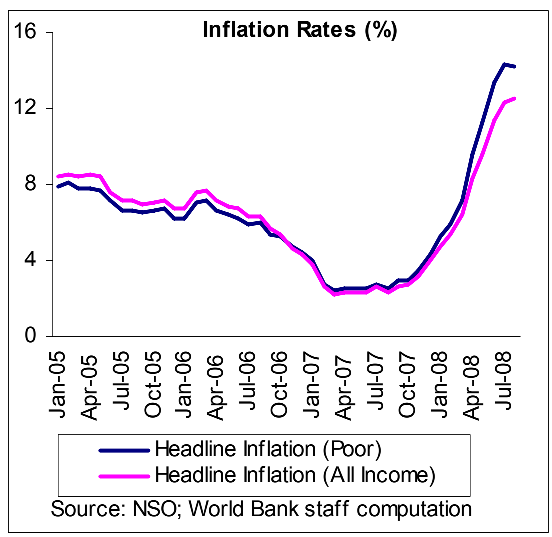


Figure 13



[19] The inflation faced by the poor is derived by reweighing the CPI of major commodity groups with weights that are representative of the expenditure patter of the lowest 30 percent of the population. A better method is to create a consumer basket for the poor so that the basket contains only the items the poor consume. This method is however costly and is not pursued in this exercise.

Rising inflation has caused the real income of households to decline and has likely brought more people closer or into poverty. As seen from the last household survey, prices increased faster than nominal income between 2003 and 2006 and contributed to the higher poverty headcount. In 2008, falling real incomes are again the trend and if not abated are likely to push more people into poverty. For instance, the hike in minimum wages in June 2008 in the National Capital Region has been much less than the emerging inflation rate, leading to a fall in the real income of people in the lower deciles.[20] However not all the poor are adversely affected by higher inflation. For instance, some of the poor residing in rural areas and deriving a significant amount of their income from agriculture are likely to be net producers of food, and thus less likely to be hurt by rising food prices. To understand the extent of higher prices on the poor, a direct impact analysis is undertaken. Box 3 describes the methodology while the succeeding paragraphs summarize the results.

Table 6. Simulated Effect of Inflation on Poverty

Change in	**No income-effect**		**With income-effect**	
	Actual price increase July 2007-08	10% price increase	Actual price increase July 2007-08	10% price increase
	Price Increase in ALL FOOD Items			
Poverty Incidence	5.7%	3.2%	3.6%	2.0%
Magnitude (millions)	4.8	2.7	3.0	1.7
	Price Increase in FUEL only			
Poverty Incidence	0.5%	0.4%	0.3%	0.3%
Magnitude (millions)	0.4	0.4	0.3	0.2
	Price Increase in ALL FOOD & FUEL			
Poverty Incidence	6.1%	3.6%	3.9%	2.3%
Magnitude (millions)	5.1	3.0	3.3	1.9

Note: Official poverty headcount in 2006 is 32.9% equivalent to 27.6 million poor people.

Overall, the poverty headcount is estimated to have increased in 2008 relative to 2006. With a 10 percent increase in the price of all food items, the poverty headcount is estimated to increase by 3.2 percentage points if all other factors are held constant. However, a more realistic estimate is to account for the income effect to households that generate income from the sale of food. Under this scenario, the increase in the poverty headcount is estimated at 2 percentage points. Both scenarios translate to an additional 2.7 and 1.7 million people living below the official poverty line in 2008. With the spike in food prices by 18.7 percent in July, the poverty headcount is estimated to increase by a

[20] In the absence of actual wage data, the change in minimum wage rate is used to proxy for wage increases. This is, however, imperfect since the minimum wage is normally not applied outside the formal sectors. Many firms in the formal sectors also do not comply with the minimum wage law.

higher 4.8 percentage points without the income effect and 3 percentage points with the income effect. In contrast, the increase in fuel price has a limited impact on poverty (Table 6).

High food prices affect urban dwellers and non-agricultural households more. Simulations indicate that higher food prices have a milder impact on households living in rural areas and deriving income mainly from agriculture. Using the July food inflation rate, rural poverty headcount is estimated to increase by 3.6 percentage points while poverty among agricultural households is estimated to increase by 1.4 percentage points. In contrast, with the same food inflation rate, poverty headcount among those living in the urban areas and non-agricultural households increase by 3.7 and 4.4 percentage points respectively (Table 7).

Table 7. Simulated Effect on Inflation Among Various Population Groups

Population Group	Official Poverty Incidence	Impact on Poverty of Actual Price Increases in All Food Items	Fuel Prices Only	Food& Fuel Combined
(1) By Agricultural Indicator				
Agricultural HH	65.4%	66.8%	66.1%	67.5%
Non-Agricultural HH	21.9%	26.3%	22.1%	26.4%
(2) By Urban/Rural Area				
Urban	19.5%	23.2%	19.7%	23.3%
Rural	45.9%	49.5%	46.3%	49.9%
ALL Philippines	32.9%	36.5%	33.2%	36.8%

Source: World Bank staff computation; raw data from the 2006 Family Income and Expenditure Survey

Higher inflation makes the poor even more vulnerable to shocks. The spending pattern of households sheds light on their vulnerability to shocks. Latest estimates from the Family Income and Expenditure Survey reveal that the poor spends 60 percent of their expenditure on food and only 1.4 percent on health and 1.7 percent on education. The large share of food to total expenditures makes the poor highly susceptible to falling deeper into poverty with sudden increases in food prices while the low shares in human capital expenditure makes them more at risk to shocks and less equipped to exit poverty.[21] Good health and education, however, provide security against future risks and help keep people out of chronic poverty.

In response to rising prices of basic commodities and falling human capital formation by the poor, the government has moved to provide more systematic social protection to the poor and vulnerable. Through the Department of Social Welfare and

[21] In fact, the average household spends only 2.9 percent of total expenditures for health and 4.4 percent for education.

Development, the government launched a conditional cash transfer program called *Pantawid Pamilyang Pilipino Program* or 4Ps based on successful experiences in Indonesia and Latin American countries. The program was launched in February 2008 in four pilot municipalities in the Philippines and aims to reach 320,000 beneficiary households by the end of 2008. Qualified households get an annual transfer of P9,000 for health and P3,000 per child up to three children, or a maximum of P15,000. The Food-for-School Program, a major transfer program which started in 2005, also received increased budget allocation in 2008.

There is scope, however, to improve targeting to minimize leakage and maximize the impact of transfers on poverty reduction. Government efforts to protect the poor through social protection schemes had been compromised by design weaknesses, mis-targeting, and significant leakage to the non-poor. Leakage of the Food-for-School program and the NFA subsidized rice, for instance, were estimated at about 40 percent. The government is now trying to improve targeting of these schemes. An effort to build a unified/national household targeting model is also underway to ensure that programs are received by their intended beneficiaries. It is hoped that the proxy means test that is used to select household beneficiaries of the 4Ps can be used as a starting point towards improving the delivery of welfare programs to the poor. With the availability of more disaggregated poverty data such as the updated small area estimates (SAEs) generated by the National Statistical Coordination Board, national and local governments should be able to improve targeting by using SAEs as primary filters (i.e. determining the poorest 200 municipalities) and then proceeding to conduct local censuses in identified poor municipalities to identify poor households. Box 4 gives an overview and update of SAEs.

Box 3. Simulating the Impact of Inflation on Poverty

A direct impact analysis is applied to simulate the effect of inflation on poverty using the 2006 Family Income and Expenditure Survey (FIES). The FIES contains household level data on family income sources, such as income from agricultural activities and transportation, as well as detailed expenditure items, including spending on all food items, rice, and fuel.

The simulation exercise assumes that income and spending patterns of households in 2008 are as they were in 2006 (as recorded in the FIES). It is further assumed that there is no substitution between goods, which implies that (1) households do not switch more expensive commodities with less expensive ones, and (2) the composition of the menu for the poverty line remains unchanged. This is admittedly a strong assumption and so is used in assessing the impact of shocks or reforms only in the short-term, before economic agents are able to make adjustments and behavioral changes. In the face of limited data, this assumption could be useful to give an idea of the *upper bound* of the impact of inflation on poverty.

Price data disaggregated by region is used to capture the spatial heterogeneity in inflation and commodity type. The exercise simulates the effect of a 10 percent price increase as well as the actual price change between July 2007 and July 2008.

To simulate the impact of inflation on poverty, suppose that the poverty line is initially given by z. If the price of all goods increased by x, then the amount of money one needs to maintain the consumption at the poverty line is $z(1+x)$. Now, suppose instead that only the price of food increased by x. Then, under the assumption of no substitution, the amount of money one needs after the increase in the food price will be $zs(1+x)+z(1-s)$, where s is the share of food expenditure to total expenditure in the poverty line. In a similar manner, the poverty line after the increase in the prices of some other goods, such as fuel, can be computed.

To account for the possible "income effect" from higher prices, again, the substitution between production processes is ignored so that the output remains unaffected by higher prices. Under this assumption, the new income level after the food price increase can be calculated. Suppose the initial income level is given by y, then if the price of food increased by x, the income one receives after the inflation is $yt(1+x)+y(1-t)$, where t is the share of income from selling food. Capturing the income effect is a challenge because the exact share of income from selling food, t, is not known from the FIES. As proxy, the share of the following variables to total income in the FIES is used to approximate the income effect: income from agricultural activities (farming, fishing, and poultry-raising), income from crop farming and gardening, and income from transportation.

Box 4. Small Area Estimates of Poverty

In September 2008, the National Statistical Coordination Board released to the public small area estimates (SAEs) of poverty for 2003, which are updates of the 2000 SAEs released in 2005. The SAEs cover all 1,700 provinces, cities, and municipalities in the country and is a direct response to the clamor of policymakers in the last decade for more disaggregated statistics to aid both national and local governments in planning and budgeting.

Small area estimates are important complements to official poverty estimates. Currently, official statistics on poverty are reliable only at the national and regional levels given limitations in the sample size of the household survey. However, regional statistics have very little policy use since regions do not have government administrations. While provincial estimates are produced unofficially, estimates for about one-half of provinces have high standard errors, making these estimates unreliable.

On the other hand, SAEs are statistically more reliable since they benefit from a much larger dataset that arises from merging the Family Income and Expenditure Survey (FIES) and Labor Force Survey (LFS) with the Census of Population and Housing (CPH) and other administrative data. From the survey dataset, income is estimated using variables that are common to the surveys and the CPH and that are highly correlated with poverty, such as housing characteristics, education, and family size.

SAEs have many policy uses and are important inputs in targeting the poor. For instance, the government's conditional cash transfer program can be better targeted with the aid of SAEs. Moreover, the selection of LGUs for community-driven development type funding can also be improved upon by using SAEs. Finally, provincial governments can better allocate scarce resources for social services to the province's poorer municipalities.