

# 13 PHILIPPINES

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## RAPID GROWTH DESPITE DEBT FEARS

The year started with uncertainty as people had varying expectations on the outcome of the May presidential elections, which ultimately returned the Arroyo administration to office. In her first State of the Nation Address for her second term (her first by direct election rather than succession), the President pointed to the worsening fiscal and debt situation as the country's most urgent problem. This alarm was based on the steadily increasing share of debt to national output. By the end of 2004, the national government's debt was equivalent to 73.4% of GDP. As a whole, consolidated public sector debt was more than 130% of GDP.

The administration targets a balanced-budget by 2010. To meet this target, it proposes a number of measures to wipe out the deficit in its Medium-Term Fiscal Program. The eight-points of the agenda are:

- Adoption of gross income taxation
- Indexation of excise tax on tobacco and liquor
- Excise tax on petroleum products
- Rationalization of fiscal incentives
- General tax amnesty with submission of Statements of Liabilities
- Lateral attrition system
- Franchise tax on telecoms
- Review of the Value Added Tax (VAT) system

Of the eight measures, only three have been

approved by the legislature. The government was able to push Congress to pass the long-debated law raising "sin taxes," that is, excise tax on tobacco and alcohol. Although the original version of the bill proposed the indexation of the excise tax to inflation, the final version failed to do so. The increase in the "sin taxes" is expected to raise Peso15B in 2005. The "lateral attrition" bill was passed in January 2005. The law aims to provide incentives to revenue-collecting agencies and is expected to increase collection by Peso10B. The more important revision of the VAT, which is currently at 10% with exemptions on some goods and services, proved to be much more contentious. After much negotiation, a VAT bill was passed in May that removes exemptions now enjoyed by sectors such as power generation and oil companies starting in July; gives President Arroyo the power to raise the VAT rate next year to 12% from 10% if VAT collection exceeds 2.8% of GDP this year, or if the budget deficit exceeds 1.5% of 2005 GDP; and raises corporate income tax to 35% from 32% starting 2006 before cutting it to 30% in 2009. The VAT changes should raise Peso28-31B this year, and as much as Peso105B in 2006 if the president raises the rate.

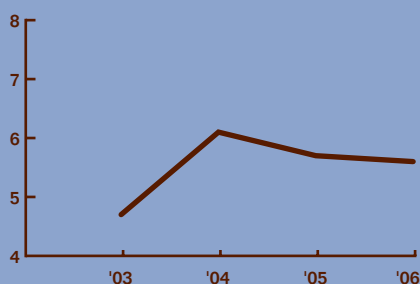
While 2004 was perceived as a difficult period, the Philippine economy proved its resiliency as it ended the four quarters with 6.1% growth in GDP notwithstanding the challenges that came from the fiscal deficit, oil price hikes, and natural disasters that severely affected several areas of the country late in the year. The

growth was the highest since 1988, when national output growth hit a high of 6.6%. The 16-year high GDP growth was fuelled by the growth of all three major sectors of the economy – agriculture, industry and services. Although the picture was clouded by fourth quarter growth, which slowed to 5.4%, the lowest for all quarters, the overall economic expansion came on the back of favorable weather conditions and in general, strong global economic growth.

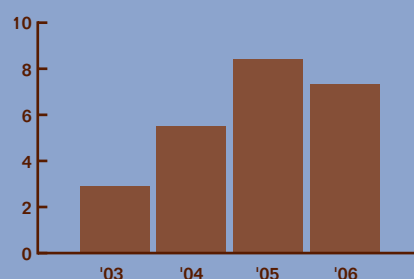
Services proved to be the strongest performer as they contributed 47% of total GDP. All of its sub-sectors posted positive growth, but the gain was led by trade, transportation, communications and storage (TCS) and private services. The telecommunications industry, contributing 51% to TCS growth, continues to expand as a result of the increasing spending on mobile communications services, both through phone subscriptions and Short Messaging Services. The industry and agriculture sectors contributed 2 and 1 percentage points to total GDP growth, respectively. Increasing from 3.8% in 2003 to 5.3% in 2004, the growth of the industry sector can be attributed to the strong performance of manufacturing and construction and, along with utilities, effectively offset the negative growth of the mining sector. On the other hand, agriculture, fishery and forestry (AFF) ended 2004 with a 4.9% growth, led by fishery, up by 1.1 percentage points from its 2003 performance.

On the demand side, consumer spending

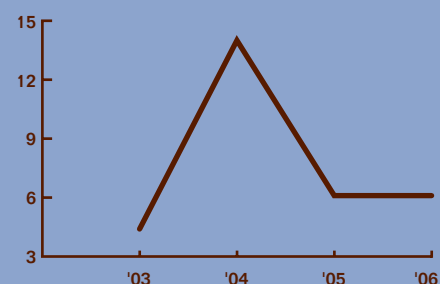
**GDP GROWTH (%)**



**CPI INFLATION (%)**



**EXPORT GROWTH (%)**





continued to drive the domestic economy, on the back of election-related activities last May, improved farm production and income, higher overseas worker remittances and sustained growth in the use of mobile phone services. Exports grew by 14% from 2003, while imports slowed to 6.3% growth from 10.2%.

## OUTLOOK FOR 2005

For this year, the budget deficit remains as the country's biggest challenge. The government has lowered its 2005 deficit target from Peso184.5B to Peso180B following the strong economic performance in 2004. Although the lower-than-expected deficit figures for 2004 can be taken as an indication of government efforts to address the deficit, more serious action and focus on reforms are required, especially in the face of the expected global economic slowdown this year.

Most economists foresee robust growth for 2005, but at a slower pace than in 2004. This can be partially attributed to an expected slowdown in consumption by Filipinos as a result of the imposition of higher taxes and successive oil price increases. The increased consumer spending last year was due partly to election-related activities and improved farm production and incomes. In the absence of heavy election spending and with the possible adverse impact of the El Niño (expected to hit the country this summer), personal consumption expenditure is likely to ease this year.

Nevertheless, it will remain one of the main drivers of the economy, as the remittances of the overseas Filipino workers have continued to rise by an annual average of 9% since 2000.

High interest rates are also expected to temper growth. The recent oil price increases may raise inflation more than expected, and this, together with an increase in volatility, is expected to

increase uncertainty premiums on borrowing. Moreover, this may also affect real interest rates. As the Fed continues to raise interest rates, market expectations will most likely force the Central Bank to raise its rates to prevent capital flight.

On a positive note, the rather modest economic and political expectations for 2005 have been offset by the strengthening of the local currency as investors continue to be encouraged by the progress on fiscal reforms. It is important to note, however, that the rally of the local currency is mainly due to an influx of "hot money" as reflected by the rise in the Philippine stock market. Moreover, the positive economic outlook for the year depends on the sustained growth momentum of 2004's industry winners. We forecast that the services sector will still remain a primary growth driver for 2005, as its usual winning sub-sectors – telecommunications, trade and finance – continue their bullish growth. Tourism is also expected to have bright prospects while overseas remittances will provide support for the property market, particularly low to medium-cost housing.

Industry, forecast to grow at a modest rate in 2005, will most likely be propelled by the resurgence in construction. The impact of the flow of foreign investments to the mining industry may only be felt by 2006. On the other hand, agriculture, expected to suffer from the impacts of El Niño, will most likely slow from its 4.9% growth rate of last year.

Business expectations for investment and trade remain positive, but the mood is not as upbeat as in 2004 due to limited public investment and lower exports. The end of the Multi Fibre Agreement and softer demand in the industrialized countries, particularly for

electronic products, has prompted the National Economic Development Authority to cut the projection for export growth this year from 10% to 8%, with electronics products still leading the way. Nevertheless, other trade developments such as the Early Harvest Program with China and the Japan-Philippines Economic Partnership Agreement will most likely boost the agricultural sector's export performance as they guarantee market access to Philippine products. Foreign investment inflows for 2005 will most likely enter through the IT, mining, infrastructure and energy sectors.

The year will call for careful and calculated economic and fiscal policies from the Arroyo administration as the country tries to weather a relatively unfavorable global economic climate and internal fiscal pressures. Recent ratings downgrades from three international agencies has sharply and painfully underlined the need for faster reforms. Although implemented fiscal policies have prevented the further expansion in Philippine bond spreads, it is still insufficient to earn an upgrade in the country's debt rating. In addition, the credit downgrades imply that borrowing for investments may be mostly sourced domestically.

Although fiscal problems still remain the priority of the administration, there is also an urgent need to improve the environment for private investment, should the government expect these inflows to push growth. A 2005 joint survey of the Asian Development Bank and the World Bank revealed investors' perception of weaknesses in the Philippines' investment climate in four primary areas: (1) weak macro-economic fundamentals; (2) corruption; (3) the lack of adequate infrastructure, especially in transportation and power sectors; and, (4) onerous business procedures and regulations.