

PHILIPPINES ECONOMIC UPDATE
**SAFEGUARDING STABILITY
INVESTING IN THE FILIPINO**

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PREFACE

The Philippines Economic Update summarizes key economic and social developments, important policy changes, and the evolution of external conditions over the past six months. It also presents findings from recent World Bank studies, situating them in the context of the country's long-term development trends and assessing their implications for the country's medium-term economic outlook. The update covers issues ranging from macroeconomic management and financial-market dynamics to the complex challenges of poverty reduction and social development. It is intended to serve the needs of a wide audience, including policymakers, business leaders, private firms and investors, and analysts and professionals engaged in the social and economic development of the Philippines.

The Philippines Economic Update is a biannual publication of the World Bank's Macroeconomics, Trade, and Investment Global Practice (MTI), prepared in partnership with the Poverty & Equity, Finance, Competitiveness & Innovation, and Social Protection & Labor Global Practices (GPs). Ndiame Diop (Practice Manager for the MTI GP) and Souleymane Coulibaly (Lead Economist and Program Leader) guided the preparation of this edition. The team consisted of Rong Qian (Senior Economist), Kevin Chua (Economist), Kevin Cruz (Research Analyst), Karen Lazaro (Consultant), and Ray Gomez (Consultant) from the MTI GP, Isaku Endo (Senior Financial Sector Specialist) from the Finance, Competitiveness and Innovation GP, Gabriel Demombynes (Program Leader), Xubei Luo (Senior Economist) and Sharon Faye Alariao Piza (Economist) from the Poverty & Equity GP, and Pablo Acosta (Senior Economist) and Arianna Zapanta (Consultant) from the Social Protection GP. The report was edited by Oscar Parlback (Consultant), and the graphic designer was Christopher Carlos (Consultant). Peer reviewers were Ralph Van Doorn (Senior Economist), Habib Rab (Program Leader), and Hnin Hnin Pyne (Program Coordinator). Logistics and publication support were provided by Reinaluz Ona (Program Assistant) and Adrienne Mendoza (Consultant). The Manila External Communications Team, consisting of David Llorito (Communications Officer), Clarissa David (Senior Communication Officer), Stephanie Margallo (Team Assistant) prepared the media release, dissemination plan, and web-based multimedia presentation.

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ABBREVIATIONS AND ACRONYMS

ARMM	Autonomous Region in Muslim Mindanao
ASR	Adult survival rate
BIR	Bureau of Internal Revenue
BPO	Business process outsourcing
BSP	Bangko Sentral ng Pilipinas
DHS	Demographic and health survey
EAP	East Asia and Pacific
EGRA	Early Grade Reading Assessment
EMDES	Emerging market and developing economies
FDI	Foreign direct investment
GAB	General Appropriations Bill
HCI	Human Capital Index
HCP	Human Capital Project
HHIC-PHIL	Hanjin Heavy Industries and Construction Philippines
IT	Information technology
LET	Licensure exam for teacher
NCR	National Capital Region
PDP	Philippine Development Plan
PIDS	Philippines Institute for Development Studies
PISA	Programme for International Student Assessment
PMI	Purchasing managers' index
PPAN	Philippine Plan of Action for Nutrition
PSA	Philippines Statistics Authority
RHU	Rural health unit
SHS	Senior high school
TIMSS	Trends in International Mathematics and Science Study
TRAIN	Tax Reform for Acceleration and Inclusion

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EXECUTIVE SUMMARY

Philippine economic growth moderated in 2018, as the country faced both external headwinds and high domestic inflation. Weak global trade led to slower export growth while import growth remained robust, resulting in net export being a drag on growth. Meanwhile, private consumption growth decelerated to its slowest pace since 2014, due to high domestic inflation and weaker consumer sentiment. Inflation only retreated toward the end of the year, as global fuel prices declined, rice supply increased, and in response to Bangko Sentral ng Pilipinas monetary policy tightening. The slowdown in private consumption and the net export drag combined caused a moderation in economic growth which slowed for the second consecutive year, from 6.7 percent, year-on-year, in 2017 to 6.2 percent in 2018—below the government’s 6.5-7.0 percent target range.

The overall economic growth slowdown occurred amid solid growth in private investment and public spending. Fixed capital formation accelerated from 9.5 percent, year-on-year, in 2017 to 14.0 percent in 2018, fueled by: i) continued investment in durable equipment as firms sought to improve their productive capacity; ii) a strong rebound in private construction activities; and iii) an acceleration in public investment growth as the government ramped up infrastructure spending. Public expenditure (in percent of GDP) reached its highest level since 1983, driven by a significant increase in infrastructure spending and a rise in personnel services expenditures mainly due to the implementation of the third tranche of the adjustment to the salary standardization law and an increase in the pay for the military and uniformed personnel.

The rapid increase in public spending mirrors good performance in revenue collection, even if the latter falls short of the ambitious target set by the Bureau of Internal Revenue (BIR) for 2018. Despite softer GDP growth, the tax ratio reached its highest level in more than two decades. Nominal tax revenue growth stood at 14 percent in 2018, leading to an overall government revenue growth of 15.2 percent (up from 12.6 percent in 2017). As a result, revenue-to-GDP increased to 16.4 percent, up from 15.6 percent in 2017, providing space for greater public spending. Nevertheless, expenditure

growth outpaced revenue growth, widening the fiscal deficit from 2.2 percent of GDP in 2017 to 3.2 percent of GDP in 2018—above the government’s deficit target of 3.0 percent. Still, the government’s overall fiscal position remains healthy as the national government debt, mainly denominated in peso, declined to 41.9 percent of GDP in 2018 from 42.1 percent in 2017.

On the external side, a weak and uncertain global market environment contributed to an overall balance of payments deterioration and a depreciation of the Philippine peso in 2018. Despite robust growth in services exports, the current-account deficit widened from 0.7 percent of GDP in 2017 to 2.4 percent of GDP in 2018, due to a widening of the merchandise trade deficit. Capital inflows, however, were notably higher with the financial account reaching a surplus of 2.4 percent of GDP in 2018 from 0.9 percent of GDP in 2017. The Philippine peso depreciated in nominal terms by 4.3 percent, year-on-year, in 2018, from a 5.8 percent depreciation in 2017.

While household income likely continued to increase in 2018, higher inflation may have slowed progress in poverty reduction. Data from the most recent annual poverty indicators survey suggest that the poverty rate declined in 2017, as household per capita income increased at a faster rate than inflation, and the income of the bottom 40 percent of the population grew at a faster rate than that of the average household. In addition, the continuing transition of employment to non-agricultural wage jobs suggests more sustainable sources of income for households. However, the impact of high inflation may have hampered poverty reduction efforts in 2018, as the poorest income quintile experienced higher inflation than the average household.

The economic growth outlook remains positive. The country’s economic growth is projected to reach 6.4 percent in 2019 and slightly edge up to 6.5 percent in 2020 and 2021, as inflation is expected to decline, and spending due to the upcoming midterm elections is likely to boost private consumption growth. Public investment growth is expected to be tempered in the first half of 2019 due to delays in approving the public

budget, and is projected to recover in the second half of 2019. Export growth will likely remain weak, as global economic and trade growth are projected to decelerate in the near term, due to persisting trade tensions. The further strengthening of the U.S. dollar, possible increases in U.S. interest rates, and geopolitical uncertainties continue to be the main external downside risks to the economic outlook.

However, domestic downside risks are intensifying with the delay in the approval of the 2019 budget and looming drought. The continuing delay in the approval of the 2019 budget is a significant downside risk as under a reenacted budget no new programs and projects can be implemented, which will negatively impact public investment, a key parameter of our projection in 2019 and over the medium term. Additional policy risks stem from uncertainty over the remaining tax reform programs. Indeed, as the government ramps up spending to implement its inclusive growth agenda, complementary reforms to enhance revenue generation are needed to ensure fiscal sustainability. Finally, the impact of the El Niño phenomenon on agriculture presents a risk to economic growth as it might affect production and food inflation.

Key short-term priorities to sustain the Philippines' rapid economic growth include prudently managing fiscal and current account balances and adopting policies to preserve consumer and business confidence. As the government continues to expand public investment to address the country's infrastructure gap, it is crucial to raise additional revenue to preserve fiscal sustainability, particularly as financing conditions may tighten globally. In addition, the trade deficit is estimated to remain wide, as export growth will likely stay weak while import growth is expected to accelerate. Given that global financing conditions may tighten, the government needs to closely monitor the performance of remittances, service exports, and foreign direct investment to prevent an external funding gap.

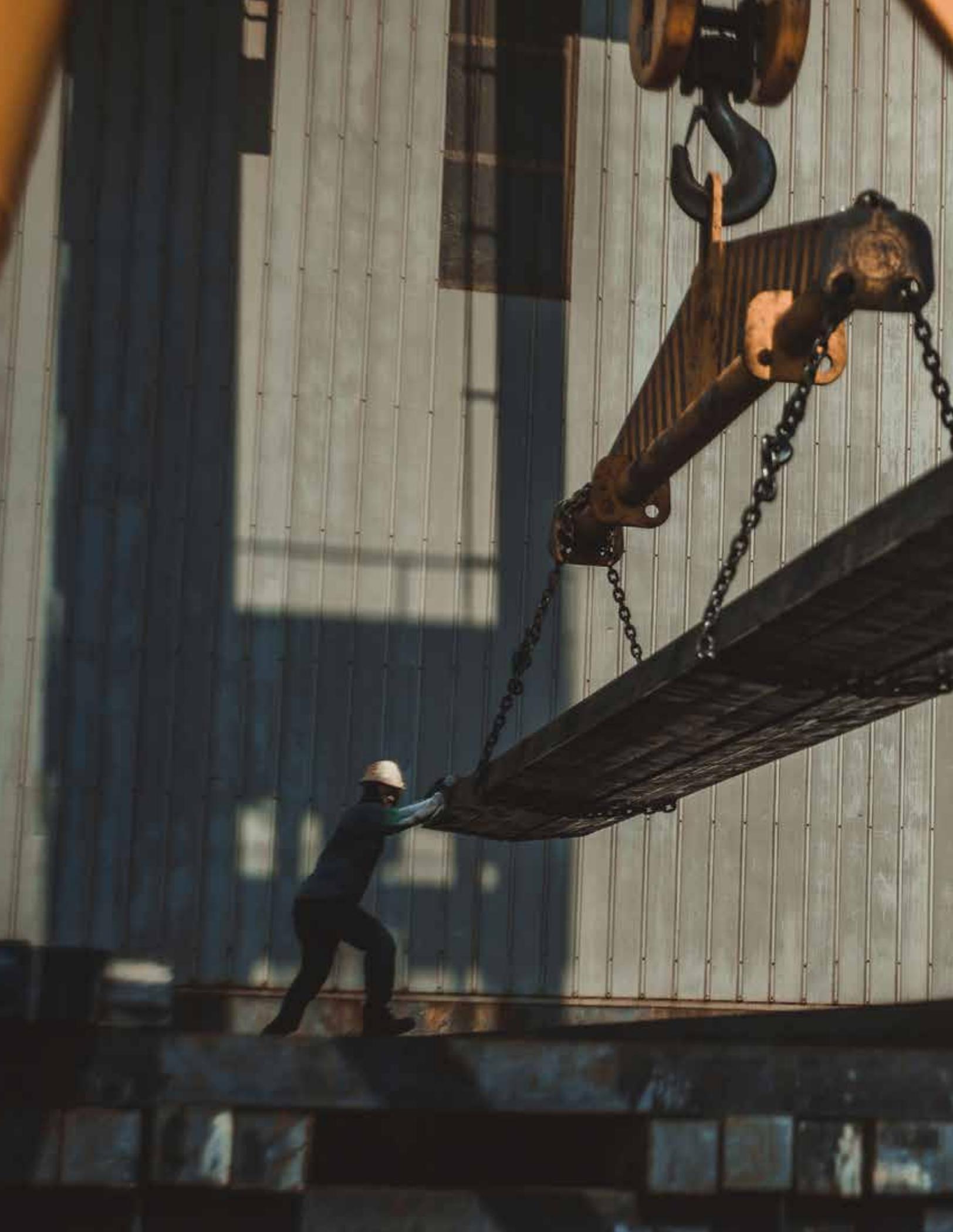
In the long term, in addition to sustained efforts to build human capital, initiatives to address structural constraints are needed to accelerate inclusive growth. Improved market competition, accelerated investment, and improved labor market conditions to boost both productivity and economic growth will be essential. This calls for urgent actions on a couple of policy initiatives including revisiting foreign participation in the domestic market, implementing reforms to improve

doing business, and reducing non-tariff barriers to boost trade. For instance, passing the Public Sector Act Amendment bill will entice foreign investments and bring competition to the transportation and telecommunications sectors that are key backbone services whose efficiency directly affects overall productivity.

Human capital formation remains a critical policy agenda for the Philippines given its critical role for long term economic growth. While labor productivity growth has been high since 2000, sustaining high productivity growth requires continuous investment in human capital in addition to ramping up physical investment. The recently released World Bank Human Capital Index is a helpful tool to deepen the understanding of human capital development, and helps the country identify area with most pressing needs for policy intervention.

Rapid technological advances are increasingly making human capital—knowledge, skills, and good health—essential to a country's economic success. The overall HCI of 0.55 for the Philippines is above the average for lower middle-income countries but substantially below the average of countries in East Asia and Pacific. This means that children born in the country today are expected to achieve only 55.0 percent of their potential income when they reach adulthood, compared to fully healthy children who receive a complete, high-quality education. Effective implementation of the government's human capital initiatives will make it possible for the Philippines and all Filipinos to achieve their full potential.

The Philippines' performance on the HCI points to three policy priorities to improve the country's human capital. The first is to improve the learning outcome of the entire education system. This orientation can motivate the implementation of the country's many education initiatives, including the Philippine Professional Standards for Teachers. The second priority is to tackle the high child stunting rate of 33 percent. The extreme level of stunting is a drag on the country's economic growth potential, and although the government has a Philippines' Plan of Action for Nutrition, and awareness about the issue is rising, government-wide recognition of how critical addressing this issue is to the country's future is missing. A third priority is leveraging expanded access to improve the quality of health care. The implementation of the Universal Health Coverage Law will provide this opportunity.



RECENT ECONOMIC AND POLICY DEVELOPMENTS

Economic growth moderated for the second consecutive year, from 6.7 percent, year-on-year, in 2017 to 6.2 percent in 2018—below the government’s 6.5-7.0 percent target range. The moderation in growth reflected both external headwinds and domestic challenges: export growth slowed due to weak global trade, and private consumption growth decelerated because of high domestic inflation. The growth slowdown was only partially offset by a strong rebound in investment spending, fueled by an acceleration in durable equipment investment growth and a dynamic construction sector. Inflation gradually retreated toward the end of 2018, as global fuel prices declined, rice supply increased, and in response to a cumulative 175 basis points increase in the Bangko Sentral ng Pilipinas policy rate to 4.75 percent in 2018. In line with other currencies in the region, the Philippine peso depreciated by 4.3 percent in 2018, owing to a fall in capital inflows and a larger current-account deficit. On the fiscal side, rapid expenditure growth outpaced strong revenue growth in 2018, resulting in a fiscal deficit of 3.2 percent—slightly above the government’s 3.0 percent budget deficit ceiling. Household income likely continued to increase during the year, especially for the bottom 40 percent of the population, although the impact of inflation may have slowed progress in poverty reduction.

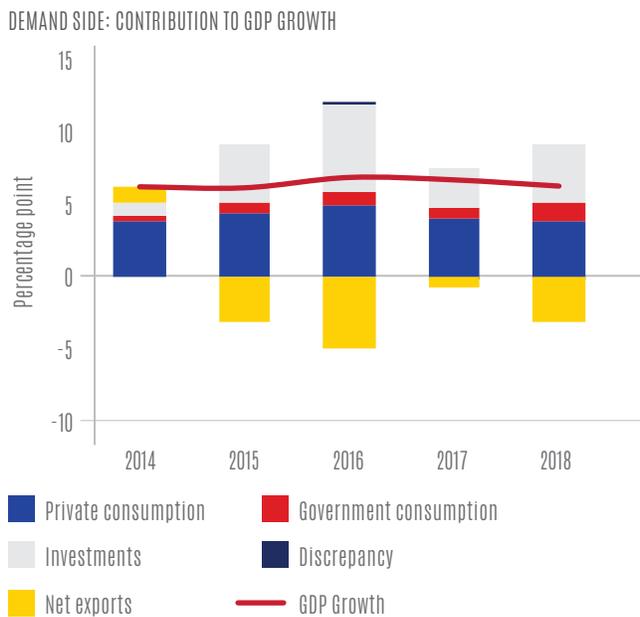
SOFT ECONOMIC GROWTH AMID RISING EXTERNAL AND DOMESTIC CHALLENGES

Philippine economic growth moderated to 6.2 percent, year-on-year, in 2018, driven by softer private consumption growth and weaker net export performance. While aggregate investment growth also accelerated—fueled by continued investment in durable equipment, an acceleration in public investment growth, and a strong rebound in private construction activities—it could only partially offset the deceleration in private consumption and net exports.

Philippine economic growth moderated in 2018 due to both external and domestic factors. The Philippine economy expanded by 6.2 percent, year-on-year, in 2018—down from 6.7 percent in 2017 and the lowest level since 2015. This was also below the government’s growth target range of 6.5-7.0 percent. The growth moderation in 2018 was partly driven by weak performance in the net exports sector, as import growth outpaced export growth for the year. The continued surge in import growth was primarily

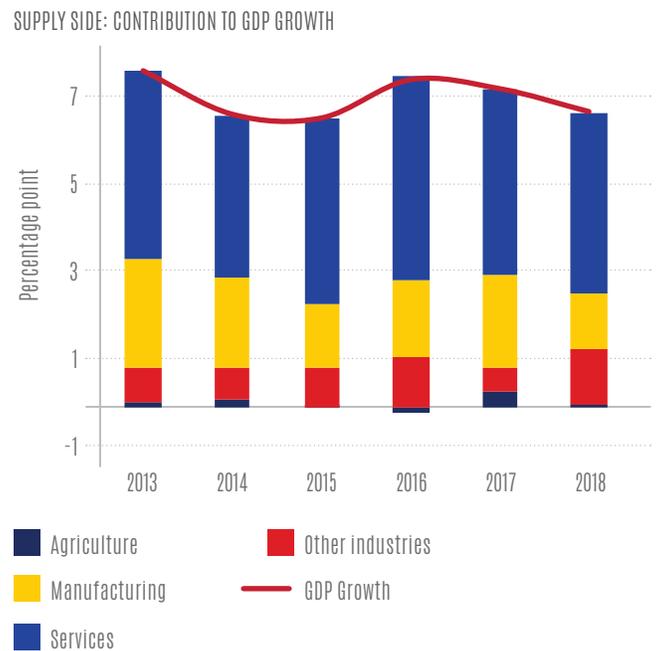
driven by robust public investment activity, while the deceleration in export growth was driven by global growth moderation, weakening global trade, and a slowdown in manufacturing activities (Box 1). In 2018, private consumption growth moderated to its slowest pace since 2014, tempered by high inflation and weaker consumer sentiment. Meanwhile, public consumption growth accelerated by double digits for the first time since 2012 due to the government’s expansionary fiscal policy stance.

Figure 1. Investment spending drove growth in 2018, as net export performance weakened...



Source: Philippine Statistics Authority (PSA)

Figure 2. ...while services remained the main engine of growth.



Note: Other industries are mining and quarrying, construction, and electricity, gas and water. Source: PSA

Investment growth was the principal driver of economic growth in 2018, bolstered by strong public investment spending (Figure 1). Fixed capital formation growth accelerated from 9.5 percent, year-on-year, in 2017 to 14.0 percent in 2018, as investments in durable equipment and the construction sector increased significantly. Investment growth in durable equipment, which account for nearly 60.0 percent of fixed capital formation, accelerated slightly from 10.7 percent, year-on-year, in 2017 to 13.4 percent in 2018.¹ Investments in the three broad durable equipment categories² all registered an acceleration in growth in 2018 compared to 2017, as relatively high capacity utilization rates led firms to focus on improving their productive capacity. In addition, investment growth in construction expanded by 15.1 percent, year-on-year, in 2018—more than double the growth of 5.9 percent registered in 2017.³ Robust construction growth was largely driven by an increase in public investment spending and a strong recovery in private construction activities.^{4, 5, 6}

Private consumption growth moderated for the second consecutive year in 2018 amid high inflation. Private consumption growth decelerated from 5.9 percent, year-on-year, in 2017 to 5.6 percent in 2018—the lowest level since 2014. The moderation in private consumption growth was primarily the result of rapidly rising inflation, which weakened consumer sentiment,⁷ and slower growth of remittances from overseas Filipinos.⁸ Nevertheless, consumption growth remained at a relatively healthy level, accounting for 68.5 percent of GDP in 2018, supported by a lower unemployment rate, continued expansion in credit, and an increase in disposable income due to personal income tax cuts under the Tax Reform for Acceleration and Inclusion (TRAIN), which benefitted over 60.0 percent of all wage earners. Meanwhile, public consumption benefitted from an expansionary fiscal policy,

increasing by 12.8 percent, year-on-year, in 2018, up from 7.0 percent in 2017, as personnel services (i.e., salaries and wages) and maintenance and operating expenditures increased substantially.

The country's net export performance weakened as import growth, despite decelerating since 2016, outperformed export growth in 2018. Philippine import growth slowed from 20.2 percent, year-on-year, in 2016 to 18.1 percent and 14.5 percent in 2017 and 2018, respectively. The continuous rise in imports was largely driven by robust import growth in capital investment goods and raw materials and intermediate goods—consistent with the government's focus on investment spending and the country's participation in global value chains (specifically electronics). Meanwhile, the Philippines' export growth softened, expanding by 11.5 percent, year-on-year, in 2018, down from 19.5 percent in 2017, as both merchandise and services export growth decelerated. A moderation in the growth of electronics exports, which accounted for nearly 60.0 percent of goods exports in 2018, drove the overall fall in exports, decelerating from 25.3 percent, year-on-year, in 2017 to 15.4 percent in 2018. Electronics exports fell partly because of the completion of the technology inventory restocking cycle, which led to a slowdown in global electronics output and exports (Figure 3). Moreover, exports of other major commodity groups fell substantially in the same year, partly as a result of a moderation in global growth and softening in global trade, manufacturing, and investment activities. Also, growth in services exports decelerated from 14.5 percent, year-on-year, in 2017 to 7.9 percent in 2018, which contributed to weaker overall export growth. In particular, the tourism sector grew by a mere 2.9 percent, year-on-year, in 2018, substantially lower than 35.5 percent in 2017, as the sector's performance was dampened by the closure of the island of Boracay for six months due to the government's rehabilitation efforts.⁹

¹ Investments in durable equipment contributed 2.2 percentage points to overall GDP growth in 2018, compared to 1.7 percentage points in 2017.

² The three durable equipment categories are i) specialized machinery for particular industries; ii) general industrial machinery and equipment; and iii) transport equipment.

³ The construction sector's contribution to GDP increased by 1.5 percentage points in 2018, up from 0.6 percentage points in 2017.

⁴ Investments in private construction increased by 12.9 percent, year-on-year, in 2018, more than four times the 3.7 percent growth recorded in 2017. The sector contributed 0.9 percentage points to overall growth in 2018, up from 0.3 percentage points in 2017.

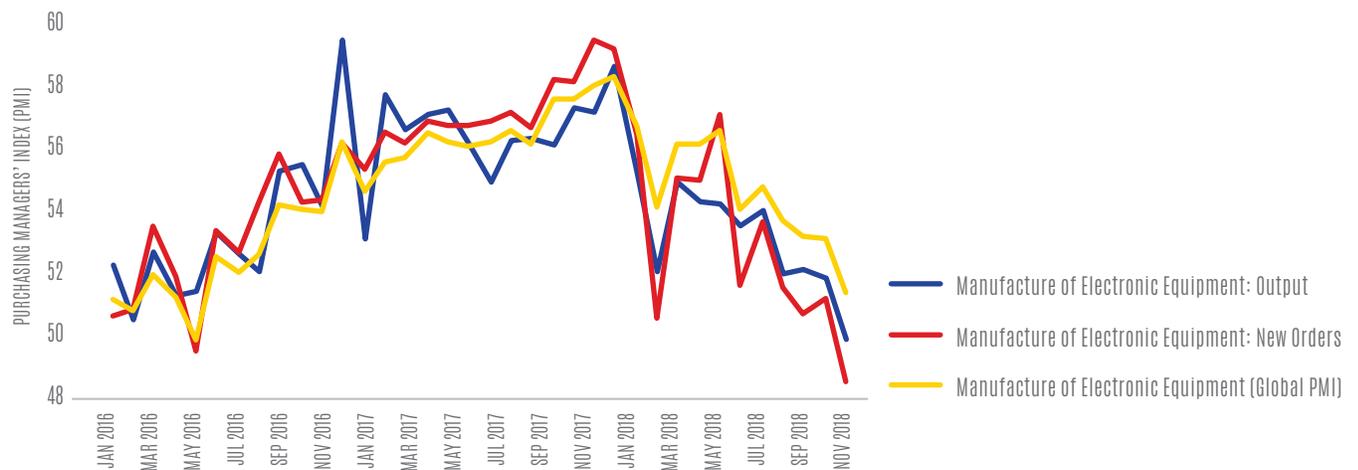
⁵ Investments in public construction expanded from 12.7 percent, year-on-year, in 2017 to 21.2 percent in 2018. The sector contributed 0.5 percentage points to overall growth in 2018, up from 0.3 percentage points in 2017.

⁶ Public investments expanded by 49.7 percent, year-on-year, in nominal terms in the first 11 months of 2018, substantially greater than the 15.3 percent growth registered in 2017.

⁷ As inflationary pressures continued to build up in 2018, consumer sentiments regarding the Philippine economy turned more pessimistic, with the consumer confidence index dropping to -22.5 percent in the fourth quarter of 2018. This was the lowest level of consumer confidence registered by the Bangko Sentral ng Pilipinas' Consumer Expectations Survey since the third quarter of 2014 (-26.3 percent).

⁸ In 2018, remittances grew by 3.0 percent, year-on-year, in nominal terms, down from 5.3 percent in 2017.

⁹ Although tourist arrivals increased by 7.7 percent, year-on-year, to reach 7.1 million in 2018, this was well below the Philippine government's 7.4 million target for the year. According to the Department of Tourism, Boracay island, which was closed for six months due to the government's rehabilitation efforts, sees an estimated 80,000 tourists per month.

Figure 3. Export of electronics equipment slowed globally in 2018.

Note: A value of 50+ signifies an expansion.
Source: Haver Analytics.

The services sector continued to drive economic growth in 2018, while the agriculture sector continued to underperform (Figure 2). Services expanded by 6.6 percent, year-on-year, in 2018, slightly down from 6.8 percent in 2017. Higher inflation and weaker consumer sentiment led to weaker growth in the wholesale and retail trade sector, from 7.3 percent, year-on-year, in 2017 to 5.9 percent in 2018. Meanwhile, the country's agriculture sector failed to sustain the progress achieved in 2017, growing by a mere 0.8 percent, year-on-year, in 2018, down from 4.0 percent in 2017. Production dropped in both the crops¹⁰ (from growing by 6.7 percent, year-on-year, in 2017 to contracting by 1.0 percent in 2018) and fisheries¹¹ (from contracting by 1.7 percent, year-on-year, in 2017 to contracting by 1.1 percent in 2018) sectors. The agriculture sector's continued poor performance was due to persistent challenges affecting the productivity of the sector, exacerbated by its vulnerability to severe weather conditions.¹² Specifically, the production decline in the crops sector was the result of a combination of inadequate irrigation services and severe weather conditions such as the occurrence of typhoons.

Manufacturing growth decelerated to its slowest pace in seven years in 2018, driving the slowdown in overall industry growth. The manufacturing

sector expanded by 4.9 percent, year-on-year, in 2018—lower than the 8.4 percent recorded in 2017 and the lowest level since 2011 (4.7 percent). Weaker manufacturing growth was largely driven by a contraction in the production of chemical manufactures, which accounted for 10.9 percent of total goods exports in 2018. Chemical manufactures contracted by 4.9 percent, year-on-year, in 2018, down from an expansion of 7.9 percent in 2017. The sector's weak performance was likely demand driven, as exports of chemical products contracted by 25.3 percent, year-on-year, in 2018—more than double the 12.7 percent contraction registered in 2017.^{13,14} In addition, softer growth in food manufactures (from 4.9 percent, year-on-year, in 2017 to 4.1 percent in 2018), which accounted for nearly half of all manufacturing output, contributed to a deceleration in manufacturing growth. The slowdown in food manufacturing was also affected by tepid growth in agricultural output and lower demand for food products due to high inflation in 2018. Yet, industry sector growth remained robust, decelerating slightly from 7.2 percent, year-on-year, in 2017 to 6.8 percent in 2018. Industry growth was driven by the construction sector, which grew by 15.9 percent, year-on-year, in 2018—three times the 5.3 percent growth recorded in 2017.

¹⁰ The crops sector accounted for 55.1 percent of total agricultural output in 2018.

¹¹ The fisheries sector accounted for 14.5 percent of total agricultural output in 2018.

¹² PSA, 2018. Performance of Philippine Agriculture (Q1-Q4 2018).

¹³ Based on value (FOB US\$). Source: PSA

¹⁴ The country's chemical manufactures primarily cater to regional value chains in the Asia-Pacific region, with Japan as the country's primary trading partner and China receiving an increasing share. By 2014, these two countries accounted for 58.0 percent of all chemical exports from the Philippines. Source: DTI, 2017. DTI Policy Briefs: The Philippines in Chemical Global Value Chain.

Table 1. Contribution to Growth, Expenditure Side (Percentage Points)

	2015	2016	2017	2018
Private Consumption	4.4	4.9	4.1	3.8
Government Consumption	0.8	0.9	0.7	1.4
Fixed Capital Formation	3.6	6.2	2.6	4.0
Construction	1.0	1.2	0.6	1.5
Durable Equipment	2.5	4.7	1.7	2.2
Exports	4.0	5.7	9.9	6.5
Merchandise Exports	2.5	4.1	8.4	5.6
Services Exports	1.5	1.5	1.6	0.9
Imports	-7.1	-10.6	-10.7	-9.5
Merchandise Imports	-5.4	-9.8	-9.4	-8.5
Services Imports	-1.7	-0.8	-1.3	-1.0
Gross Domestic Product	6.1	6.9	6.7	6.2

Source: PSA

Table 2. Contribution to Growth, Supply Side (Percentage Points)

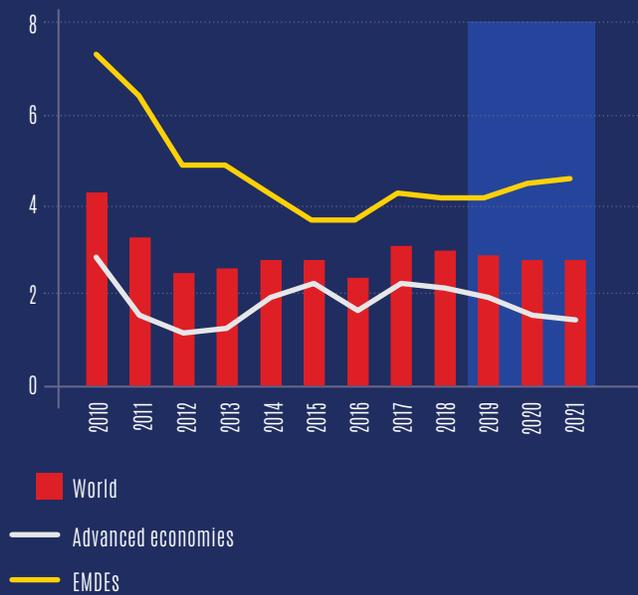
	2015	2016	2017	2018
Agriculture, Fishery, & Forestry	0.0	-0.1	0.3	0.1
Agriculture & Forestry	0.0	0.0	0.4	0.1
Fishery	0.0	-0.1	0.0	0.0
Industry	2.2	2.7	2.4	2.3
Mining & Quarrying	0.0	0.0	0.0	0.0
Manufacturing	1.3	1.6	1.9	1.1
Construction	0.7	0.7	0.3	1.0
Electricity, Gas, & Water	0.2	0.3	0.1	0.2
Services	3.9	4.3	3.9	3.8
Transport, Communication, & Storage	0.6	0.4	0.3	0.4
Trade	1.2	1.3	1.2	1.0
Finance	0.4	0.6	0.6	0.5
Real Estate, Renting and Business Activities	0.8	1.0	0.8	0.6
Government Services	0.1	0.3	0.3	0.6
Other Services	0.8	0.8	0.7	0.8
Gross Domestic Product	6.1	6.9	6.7	6.2

Source: PSA

Box 1. Recent Global Developments

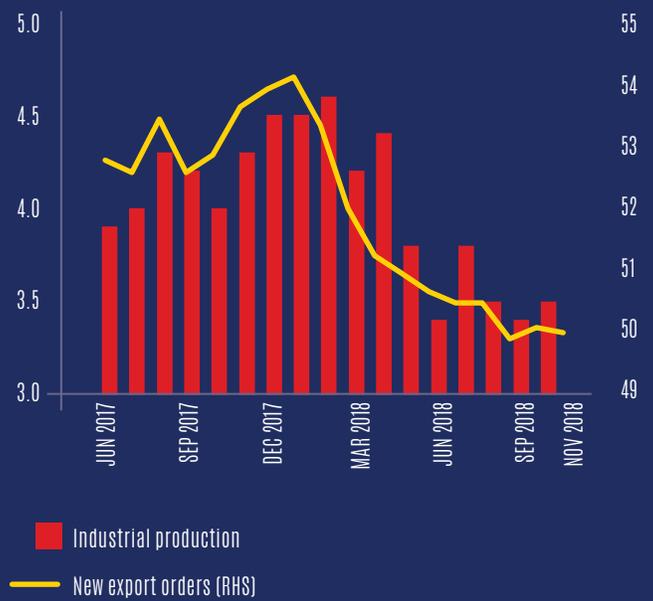
Global growth is moderating as the recovery in trade and manufacturing activities loses steam (Figure 4). Global growth slowed to a near three-year low of 2.2 percent (q/q seasonally adjusted annual rate) in the third quarter of 2018, and survey data suggest that the subdued momentum persisted in the fourth quarter, with the global manufacturing purchasing managers' index ending the year at a 27-month low (Figure 5). The weakness in global growth seems to have continued in 2019, with the global manufacturing PMI falling to 50.7 in January, its lowest in more than two years. Despite ongoing negotiations, trade tensions among major economies remain elevated. These tensions, combined with concerns about softening global growth prospects, have weighed on investor sentiment and contributed to a fall in global equity prices. Also, borrowing costs for EMDEs have increased, partly due to central banks in advanced economies continuing to withdraw policy accommodation in varying degrees. A strengthening U.S. dollar heightened financial market volatility, and rising risk premiums have intensified capital outflow and currency pressures in some large EMDEs, with some vulnerable countries experiencing substantial financial stress. Energy prices have fluctuated markedly, mainly due to supply factors, with sharp falls toward the end of 2018. Other commodity prices—particularly for metals—have also weakened, posing renewed headwinds for commodity exporters.

Figure 4. Global growth moderated in 2018...



Source: World Bank staff estimates

Figure 5. ...as global trade growth weakened and global manufacturing growth slowed.



Note: A value greater than 50 signifies an expansion in new export orders. Source: Haver Analytics.

Growth has moderated in most advanced economies, with the notable exception of the United States, where fiscal stimulus is boosting economic activity. U.S. growth reached an estimated 2.9 percent, year-on-year, in 2018, up from 2.2 percent in 2017, mostly reflecting stronger-than-expected domestic demand following a procyclical fiscal policy and an accommodative monetary policy that bolstered economic activity. By contrast, economic activity in the euro area has been weaker than previously expected, as economic growth slowed from 2.4 percent, year-on-year, in 2017 to an estimated 1.9 percent in 2018. In particular, exports in the euro zone softened, reflecting an earlier appreciation of the euro and lower external demand. While economic growth in advanced economies slowed to an estimated 2.2 percent, year-on-year, in 2018, it was still above potential and in line with previous forecasts. Japanese economic growth decelerated from 1.9 percent, year-on-year, in 2017 to an estimated 0.8 percent in 2018, reflecting a contraction in growth in the first and third quarters due to bad weather and natural disasters.

The economic recovery in EMDEs has stagnated. Economic growth in EMDEs decelerated slightly from 4.3 percent, year-on-year, in 2017 to an estimated 4.2 percent in 2018—0.3 percentage points lower than previously projected, as a number of countries with large current-account deficits experienced substantial financial market pressures and a slowdown in economic activity. Domestic demand across EMDEs has generally moderated, reflecting tighter domestic borrowing conditions, softer confidence, and policy tightening in some large economies to abate domestic price pressures and prevent capital outflows. A more challenging international environment was accompanied by renewed market attention to country-specific vulnerabilities and financial stress in some large economies with persistent macroeconomic fragilities, such as Argentina and Turkey. Economic growth moderated in about 40.0 percent of commodity importing EMDEs in 2018, with notable declines in countries facing currency and financial market pressures. Meanwhile, the recovery in many commodity exporting EMDEs stagnated in the same year, reflecting lower external demand, tighter borrowing conditions, volatile commodity prices, and various domestic headwinds.

Following a strong momentum in 2017, growth in global goods trade slowed markedly in the first half of 2018 and has only partially recovered. After reaching a six-year high of 5.4 percent, year-on-year, in 2017, global trade growth slowed to an estimated 3.8 percent in 2018—the sharpest deceleration since 2012. The slowdown was more pronounced than previously expected, which was reflected in the fall in export orders and global manufacturing activity. In particular, global capital goods production, which is highly trade-intensive, has slowed in Europe and developing Asia—two tightly interconnected global manufacturing hubs.¹⁵ The softening of global goods trade came against the backdrop of ongoing trade tensions between the United States and China. New tariffs introduced since the beginning of last year have affected about 12.0 percent of U.S. total goods imports, 6.5 percent of China's total goods imports, and about 2.5 percent of the global goods trade. The temporary pause in tariff hikes agreed by the United States and China during the G20 meeting in early December 2018 and the successful negotiations of the new United States-Mexico-Canada Agreement have somewhat tempered trade policy uncertainties. However, the possibility of escalating trade restrictions involving major economies remains elevated.¹⁶

¹⁵ Nearly one-third of European exports and more than half of German exports to developing Asia consist of machinery and vehicles, while capital goods and electronics account for one-third of exports from developing Asia to Europe. Source: Raschen and Rehbock (2016).

¹⁶ World Bank. 2019. Global Economic Prospects January 2019: Darkening Skies.

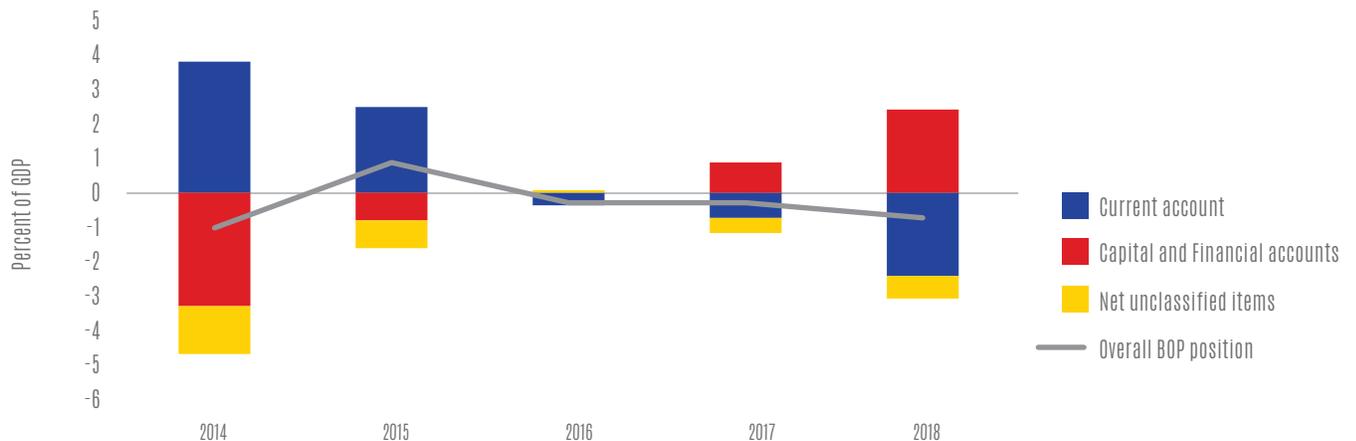
EXCHANGE RATE DYNAMICS AND THE EXTERNAL SECTOR: WEAK EXTERNAL ENVIRONMENT

A weak and uncertain external environment and subpar performance in net exports contributed to an overall balance of payments deterioration and a depreciation of the Philippine peso in 2018.

The current account deficit significantly widened in 2018, led by a large trade deficit (Figure 6). With imports growing faster than exports, the trade deficit ballooned from US\$40.2 billion (12.8 percent of GDP) in 2017 to US\$49.0 billion (14.8 percent of GDP) in 2018.¹⁷ The widening trade deficit was not offset by services exports, which expanded by 20.7 percent, year-on-year, in 2018, down from 23.4 percent in 2017. Services exports grew on the back of sustained revenues from telecommunication, computer, and technical services. The business process outsourcing (BPO) industry, in particular, expanded by about

4.0 percent and reached US\$23.8 billion in revenue as of June 2018, although it missed its revenue target under its five-year roadmap.¹⁸ Similarly, primary and secondary income¹⁹ receipts from abroad continued to grow but at a slower pace in 2018, mainly as a result of a growth deceleration in remittances from overseas Filipinos. Personal remittances grew by a mere 3.0 percent and reached US\$32.2 billion in 2018, down from 5.3 percent in the same period in 2017. As a result, the current account deficit further widened from US\$2.1 billion (0.7 percent of GDP) in 2017 to US\$7.9 billion (2.4 percent of GDP) in 2018.

Figure 6. The Philippines recorded a larger current account deficit in 2018.



Source: Bangko Sentral ng Pilipinas (BSP).

¹⁷ The surge in import growth was partly a result of the significant increase in capital goods imports in 2018, driven in part by the acceleration of the Philippine government's public investment program.

¹⁸ The Information Technology and Business Process Outsourcing Association of the Philippines remarked that it missed its revenue target under its five-year roadmap due to uncertainty amid plans to change the fiscal regime and the U.S. president's vow to attract jobs back to the United States. The cited 4.0 percent expansion measured growth over the past 18 months, ending in June 2018. The IT-BPM roadmap projected revenue to grow at 9.2 percent annually starting in 2017 to reach US\$38.9 billion by 2022. See <https://www.bworldonline.com/bpo-sector-blames-policy-challenges-for-missed-targets/>; and ITBPAP, "Accelerate PH Future Ready Roadmap 2022," 2017, available online: <http://itbpm-roadmap2022.ibpap.org>.

¹⁹ The primary income account shows the flows of labor, financial assets, and land and natural resources between resident and nonresident institutional units. It records receipts earnings of resident overseas Filipino workers and the profit of Philippine investments abroad. The secondary income account shows current transfers between residents and nonresidents. Transfers may be made in cash or in kind. Remittances of non-resident overseas Filipinos are recorded under the secondary income account together with current transfers such as gifts, grants, and donations. Source: BSP Balance of Payments and International Investment Position, and IMF, Balance of Payments and International Investment Position Manual, Sixth ed.



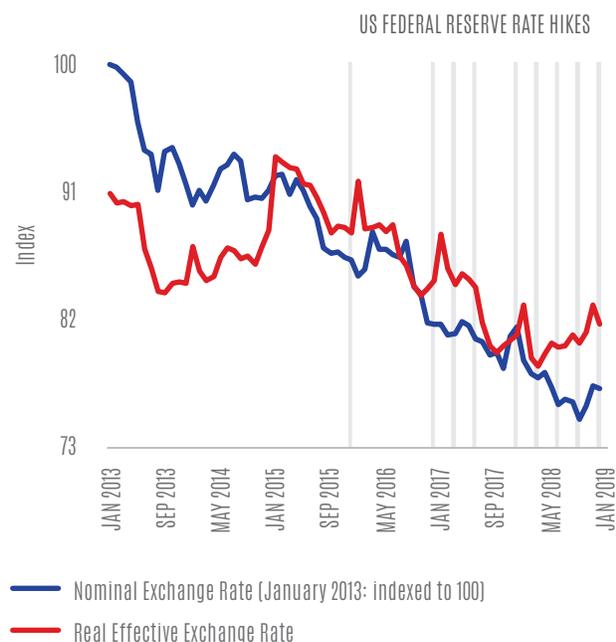
The country's balance of payments remained in deficit in 2018 despite increased capital inflows. Capital inflows were notably higher with the financial account reaching a surplus of US\$7.9 billion (2.4 percent of GDP) in 2018 from a US\$2.9 billion (0.9 percent of GDP) surplus in 2017. The higher surplus was led by the inflows of other investments²⁰, and the reduced outflows of portfolio investments. Other investments recorded net inflows of US\$2.9 billion (0.8 percent of GDP) in 2018, reversing the US\$1.8 billion (0.6 percent of GDP) outflows in 2017, while portfolio investments recorded net outflows of 0.3 percent of GDP in 2018, down from 0.8 percent of GDP in 2017. Meanwhile, foreign direct investment (FDI) contracted by 4.4 percent year-on-year to reach US\$9.8 billion (3.0 percent of GDP) last year from 23.9 percent expansion in 2017. Out of US\$9.8 billion in FDI, US\$6.7 billion represented debt instruments, while nearly half of the US\$2.3 billion that flowed to industries went to manufacturing.²¹ Despite the improvements in the financial account, the balance of payments deficit widened from US\$0.8 billion (0.3 percent of GDP) in 2017 to US\$2.3 billion (0.7 percent of GDP) in 2018 (Table 3).

Weakness in the Philippine peso persisted throughout 2018 amid heightened external uncertainty and weak net exports. The Philippine peso depreciated in nominal terms by 4.3 percent, year-on-year, in 2018, from a 5.8 percent depreciation in 2017 (Figure 7). It closed the year at Php/US\$52.72, compared to Php/US\$49.92 in 2017. In real terms, the peso weakened by 2.7 percent in 2018, compared to a depreciation of 4.5 percent in 2017. The foreign exchange market was generally volatile in 2018, affected by market uncertainties due to the U.S.-China trade dispute, contagion fear from the crisis in Turkey and Argentina, and the ongoing normalization of the U.S. Federal Reserve's monetary policy. Yet, domestic factors also played an important role in the depreciation of the peso, given the strong demand for U.S. dollars to cover imports of capital and intermediate goods. Import growth accelerated from 10.2 percent, year-on-year, in 2017 to 13.4 percent in 2018 (Figure 8). By contrast, exports contracted by 1.8 percent in 2018, a sharp reversal from the 9.5 percent expansion in 2017, impacted by weak external demand and competitiveness challenges.

²⁰ Other investment accounts include loans (trade and non-trade), holdings of currency and deposits, and other investments.

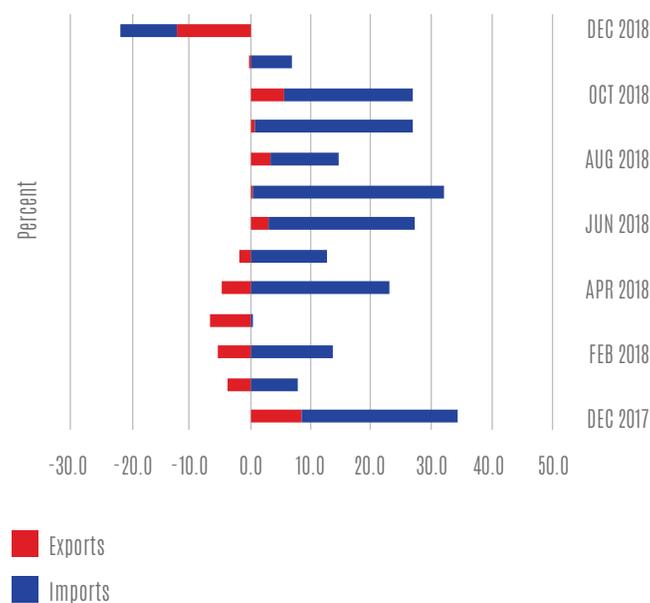
²¹ Of the US\$9.8 billion in FDI, US\$6.7 billion represented debt instruments, mostly in the form of intercompany borrowing and lending, US\$0.9 billion constituted retained earnings, and US\$2.3 billion represented equity other than reinvestment of earnings, which mostly went to the manufacturing (47.7 percent), finance (14.6 percent), and real estate (13.1 percent) sectors.

Figure 7. Both the real and nominal exchange rate depreciated further in 2018...



Source: BSP.

Figure 8. ...as imports grew faster than exports.



Source: PSA.

Table 3. Balance of Payments Position (2015 - 2018)

In percentage of GDP	2014	2015	2016	2017	2018
Current account	3.8	2.5	-0.4	-0.7	-2.4
Goods	-6.1	-8	-11.7	-12.8	-14.8
Exports	17.5	14.8	14	16.5	15.6
Imports	23.6	22.7	25.7	29.3	30.4
Services	1.6	1.9	2.3	2.8	3.2
Primary Income	0.3	0.6	0.8	1	1.2
Secondary Income	8	7.9	8.1	8.3	8.1
Capital and Financial accounts	-3.3	-0.8	0	0.9	2.4
Capital account	0	0	0	0	0
Financial account	3.4	0.8	0.1	-0.9	-2.4
Direct investment	0.4	0	-1.9	-2.2	-1.8
Net acquisition of financial assets	2.4	1.9	0.8	1.1	1.2
Net incurrence of liabilities ^{1/}	2	1.9	2.7	3.3	3
Portfolio investment	1	1.9	0.5	0.8	0.3
Financial derivatives	0	0	0	0	0
Other investments	2.1	-1.1	1.5	0.6	-0.8
Net unclassified items^{2/}	-1.4	-0.8	0.1	-0.5	-0.7
Overall BOP position	-1	0.9	-0.3	-0.3	-0.7
Memo:					
Basic Balance	3.4	2.5	1.5	1.5	-0.6
Gross international reserves (in billions USD)	79.5	80.7	80.7	81.6	79.2
Import coverage (in months)	9.9	9.9	8.8	7.7	7

1/Net incurrence of liabilities refers to net foreign direct investment to the Philippines.

2/The term "Net unclassified items" is a balancing figure. There are two methods of computing the BOP position: the first approach uses the change in net international reserves due to transactions, while the second approach computes the sum balances of the current account, capital account less financial account. The two measures do not necessarily tally. The BSP uses the first approach to determine the overall BOP position.

Note: Following the BSP presentation, the BOP balance = Current Account Balance + Capital Account Balance - Financial Account Balance + Net Unclassified Items.

MONETARY POLICY AND FINANCIAL MARKETS: TIGHTENING POLICY TO CURB INFLATION

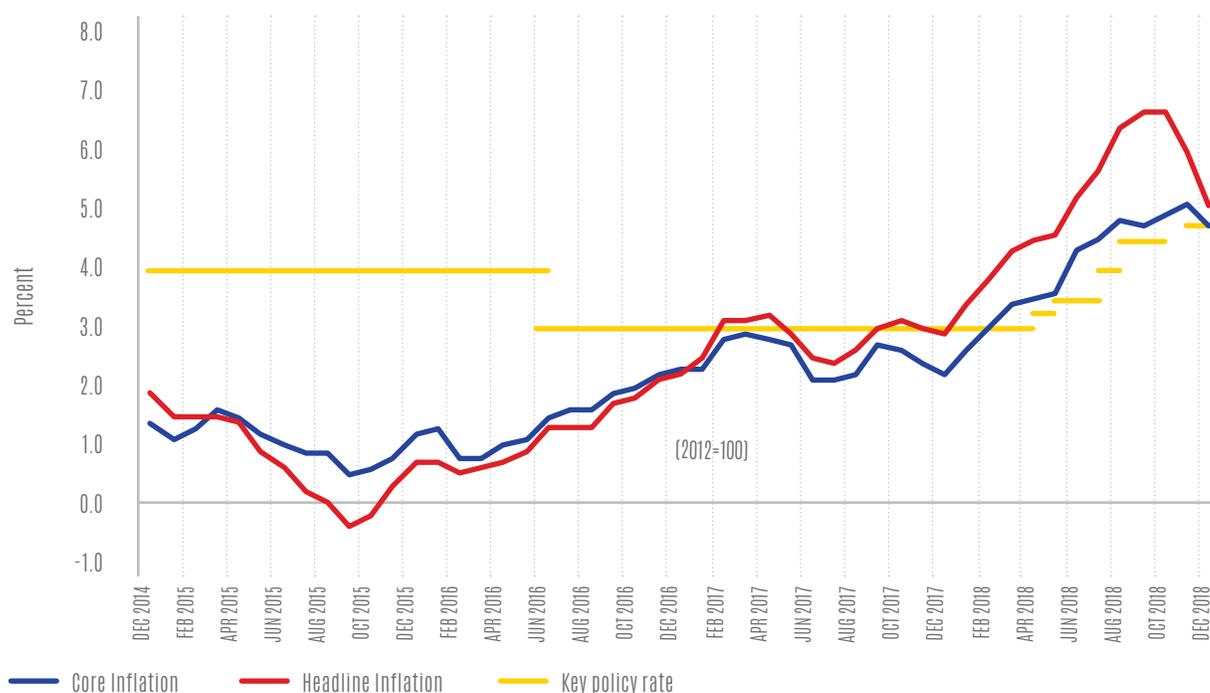
To manage rising inflation, the Bangko Sentral ng Pilipinas (BSP) tightened its monetary policy stance in 2018, resulting in higher interest rates that led to a moderation in the growth of credit and the money supply.

Inflation rose steadily throughout most of 2018, prompting the BSP to tighten its key policy rate. The headline inflation rate rose from 2.9 percent, year-on-year, in 2017 to 5.2 percent in 2018. It increased throughout most of 2018, peaking at 6.7 percent in the third quarter, before gradually decreasing in the last two months of the year. The main drivers of inflation were rising food, energy, and transport prices (Box 2). Food inflation increased primarily because of a tight domestic supply of key commodities such as fish, rice, meat, and vegetables, caused by the impact of typhoons and heavy rains as well as the mismanagement of rice imports. Moreover, the rise in energy and transport prices was due to a combination of rising global crude oil

prices, the increase in the excise tax on fuel, upward adjustments in electricity rates, and a weaker peso. Excluding the volatile energy and food items, the average core inflation rate reached 4.1 percent in 2018, up from 2.5 percent in 2017, suggesting underlying price pressures in the economy, which could be linked to the impact of fiscal expansion as well as the pass-through effect of a weaker peso. Both the headline and core inflation rates breached the upper end of the BSP's inflation target range of 2.0-4.0 percent in 2018. As a result, the BSP raised its key policy rates on a staggered basis by a cumulative 175 basis points, from 3.00 percent in the beginning of 2018 to 4.75 percent in November (Figure 9).

Figure 9. Inflation increased throughout most of 2018, before decreasing in the last two months.

YEAR-ON-YEAR INFLATION RATE (PERCENT)



Sources: PSA and BSP.

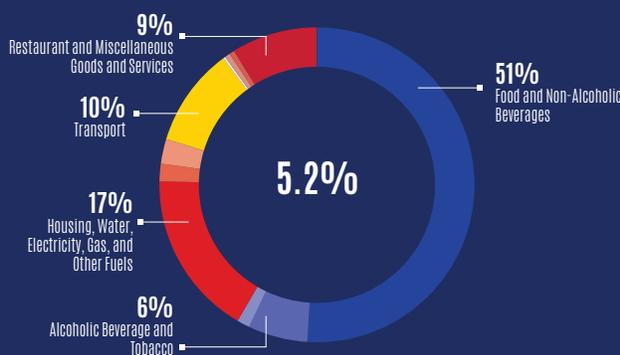
Box 2. Tracking the Basket Components of Inflation

Rising food prices were the main drivers of inflation in the Philippines in 2018. They contributed more than half of the headline inflation in the same year (Figure 10). The steady rise in food prices in the first half of 2018, followed by their sudden rise in the third quarter and decline in the last two months of 2018, closely paralleled the movement of the overall inflation rate. Throughout most of the year, rising fish, rice, and meat prices, which constituted about three-fifths of the food consumption basket, were the main drivers of food inflation. Heavy rains and typhoons severely disrupted food production and interrupted transport to key commercial hubs. Mismanagement and untimely importation contributed also to a tight rice supply. Moreover, a small supply of fish has been attributed to delayed fish stocking due to typhoons, the fishing ban in the Visayas, and the suspension of commercial fishing in the Davao Gulf from June to August.²² In the last two months of 2018, headline inflation eased as food inflation declined because of an improvement in supply conditions, the ongoing rice harvest season, and the arrival of rice imports.

The decline in housing and utilities and transport inflation toward the end of the year also helped to reduce price pressures. General housing, water, electricity, gas, and other fuel prices started to rise in the second quarter of 2018 (Figure 11). This was mainly attributed to upward adjustments in electricity rates due to higher power generation costs and an increase in water rates in the third quarter. Rising global oil prices as well as the implementation of the new excise tax on oil and fuel led to higher prices for domestic petroleum products, which exerted pressure on transport inflation. As a result of higher fuel prices, transport fares increased, such as for public utility jeepneys in July and for public utility buses in November, which contributed to higher transport inflation. As global oil prices started to decline in the last quarter of the year, energy prices started to ease, resulting in a series of rollbacks in household liquefied petroleum gas prices and a marked decline in gasoline and diesel prices.

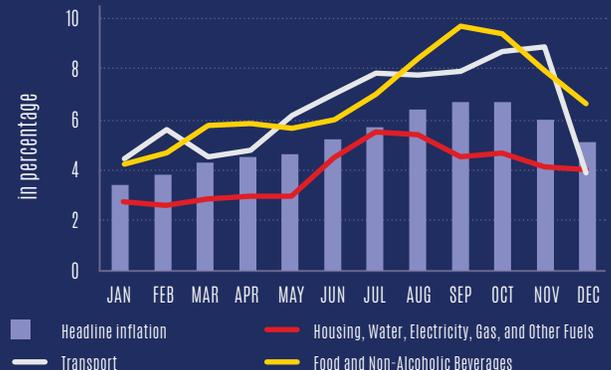
Year-end food and transport inflation rates were lower than their 2018 averages. The food and beverage inflation rate averaged 6.9 percent in 2018, reaching a peak of 9.7 percent in September. It fell to 6.7 percent at the end of December, signaling subsiding price pressures. Similarly, the transport inflation rate averaged 6.5 percent in the same year, reaching a high of 8.9 percent in October and November, before falling to 4.0 percent at the end of the year. Moreover, the average education inflation rate was lower in 2018 compared to 2017, which was mainly the result of the national government’s free tuition program for public tertiary education that became effective in 2018. Meanwhile, the inflation rates for the rest of the components of the consumption basket, including clothing and footwear, health, recreation and culture, and restaurants and miscellaneous goods and services, were markedly higher at the end of the year compared to their 2018 averages, suggesting continued underlying price pressure for these non-volatile items.

Figure 10. Rising food prices contributed to more than half of the total rise in inflation in 2018.



Source: PSA.

Figure 11. Rising food, housing and utilities, and transport prices were the main drivers of inflation in 2018.



Source: PSA.

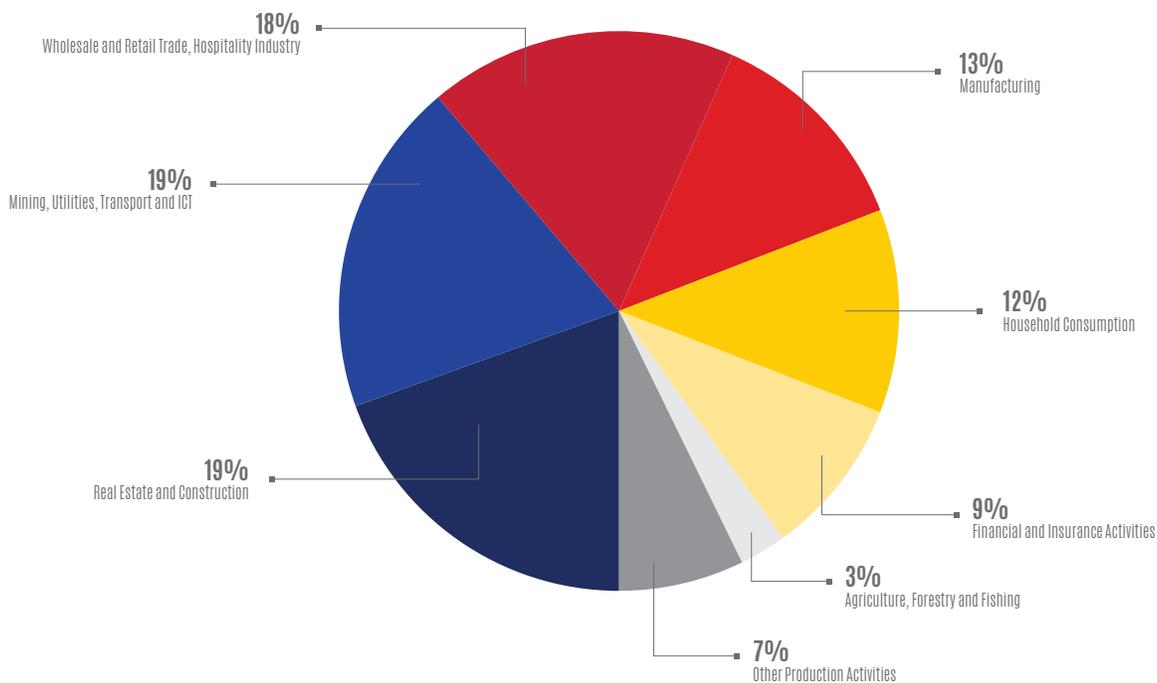
²² For more information, see the BSP’s Inflation Report. There is a general sense of declining overall fish stock as seen in the continuous contraction in the fishing sector since 2014.

Credit growth moderated in the second half of 2018, as the BSP adopted a tighter monetary policy stance. Domestic liquidity (M3) growth moderated from 13.0 percent, year-on-year, in 2017 to 10.0 percent in 2018. In December 2018, it grew by 9.2 percent, year-on-year, and totaled Php11.6 trillion pesos. Accordingly, the banking system's loan-to-deposit ratio increased from 75.6 percent in December 2017 to 79.0 percent in December 2018. Credit to firms grew by 15.0 percent, year-on-year, in December 2018, down from 17.2 percent in the same month of 2017, while the growth in household loans decelerated from 20.0 percent, year-on-year, in December 2017 to 8.5 percent in the same month of 2018. The sectoral composition of firms' loan portfolios remained broadly unchanged in 2018 (Figure 12). In December 2018, lending increased by 42.0 percent, year-on-year, in arts, entertainment, and recreation and by 34.0 percent in construction. Also, loans to finance household consumption grew by 10.1 percent, year-on-year, in the same month of 2018, among which

credit card and motorcycle loans increased by 20.0 percent and 23.0 percent, respectively. The credit-to-GDP ratio continued to rise at an average of 68.0 percent in 2018, slightly higher than the 64.5 percent registered in 2017.

The Philippines' financial system remains stable and resilient. The share of non-performing loans averaged 1.85 percent between November 2017 and November 2018, ranging from 1.90 percent to 1.73 percent. Philippine banks are well capitalized, with a total capital adequacy ratio of 15.36 in November 2018—an improvement from 14.66 in December 2017 and well above the 10.0 percent regulatory minimum. The banking sector maintained high profitability in 2018, with an average return on equity of 9.8 percent and an average return on assets of 1.2 percent. The share of interest income in total operating income in the 4th quarter of 2018 was 77.18 percent, compared to 75.73 percent in the same quarter of 2017.

Figure 12. Loan Portfolio of the Philippine Banking Sector (December 2018)



Source: BSP.



Box 3. The Resilience of the Philippines' Financial Sector

The Philippines' largest shipping firm filed for the largest corporate bankruptcy in the country's history in 2019, defaulting on US\$1.3 billion. On January 8, 2019, Hanjin Heavy Industries and Construction Philippines (HHIC-Phil) filed for bankruptcy in a regional trial court in Subic on a loan worth US\$1.3 billion. The court placed HHIC-Phil under corporate rehabilitation under the Financial Rehabilitation and Insolvency Act (Republic Act 10142). Five local banks—the Land Bank of the Philippines (Landbank), Rizal Commercial Banking Corporation (RCBC), Metropolitan Bank & Trust Company (Metrobank), Bank of the Philippine Islands (BPI), and Banco de Oro Unibank (BDO)—that were exposed to HHIC-Phil had losses totaled US\$412 million.²³ As a result, the Philippine stock market dropped by 81.14 points (-1.0 percent) and closed at 7,904.49 on the day of the bankruptcy. The index swiftly recovered in the following days as the market remained confident in the country's financial system.

The Philippines' financial system showed its resiliency due to strategic reforms implemented by the BSP. Over the past 20 years, the BSP has been implementing reforms that have resulted in higher capitalization ratios and stronger risk management systems to manage potential threats.²⁴ As a result, the banking system's capital adequacy ratio was 15.36 percent in December 2018, which was higher than the regulatory requirement of 10.0 percent. In addition, the banking system's non-performing loans remained at a low 1.77 percent in December 2018.

The BSP claims that the country's banking system is well-positioned to manage the effect of HHIC-Phil's default. According to its statement on the Hanjin bankruptcy, the BSP points to robust capitalization rates and sufficient liquidity buffers as evidence that the Philippine banking system can manage about US\$400 million in loan exposure to HHIC-Phil. The loan exposure represents only 0.24 percent of total bank loans and 2.49 percent of foreign currency loans from foreign currency deposit units. Moreover, an assumed write-off of loan exposures to HHIC-Phil will have a minimal impact on the industry's capital adequacy ratio, according to the results of the BSP's stress-test exercise.

²³ <https://www.philstar.com/business/2019/01/16/1885352/hanjin-philippines-shipbuilding-bankruptcy>.

²⁴ In 2014, the BSP issued Guidelines on Sound Credit Risk Management Practices; Amendments to the Manual of Regulations for Bank and Non-Bank Financial Institutions (BSP Circular 855 of 2014). The circular intends to fundamentally strengthen credit risk management practices of financial institutions and provides minimum set of operating standards that are consistent with BSP regulations and the Basel Core Principles for effective bank supervision.

THE SUCCESS OF FISCAL REFORMS

Despite softer GDP growth, public revenue reached its highest level in over two decades in 2018 due to recent tax policy and administration reforms. Nevertheless, the fiscal deficit breached the government's 3.0 percent of GDP target in 2018, as expenditure growth outpaced revenue growth.

The fiscal deficit exceeded its programmed target of 3.0 percent of GDP in 2018, as the government increased public spending in line with its expansionary fiscal policy stance (Figure 13). In 2018, the country's public expenditure effort²⁵ reached its highest level since 1983,²⁶ as the government continued to implement an expansionary fiscal policy for the third consecutive year. A significant increase in spending on infrastructure and personnel services was the primary driver of the overall acceleration in public spending. Meanwhile, revenue growth remained robust, as the tax ratio²⁷ reached its highest level in more than two decades, partly driven by tax policy and administration reforms introduced in the TRAIN law.²⁸ However, expenditure growth outpaced revenue growth in 2018, widening the fiscal deficit from 2.2 percent of GDP in 2017 to 3.2 percent of GDP in 2018—above the government's deficit target of 3.0 percent of GDP. The government continued to finance its deficit primarily through domestic borrowing (75.0 percent) in 2018 (Figure 14).²⁹

National government expenditure breached the programmed target and reached its highest level in 2018 due to a continued surge in infrastructure spending. Public expenditure growth accelerated from 10.8 percent, year-on-year, in nominal terms in 2017 (17.9 percent of GDP) to 20.7 percent in 2018 (19.6 percent of GDP), fueled primarily by a rise in infrastructure and personnel services expenditures (Figure 15). Public infrastructure outlays ramped up substantially, growing by 41.3 percent, year-on-year,

in nominal terms in 2018, up from 12.8 percent in 2017, as the government focused on implementing small-scale infrastructure projects.³⁰ As a result, public infrastructure outlays, which accounted for nearly one-fourth of total government spending in 2018, increased from 3.5 percent of GDP in 2017 to 4.6 percent of GDP in 2018. In addition, personnel services, which accounted for nearly one-third of public spending in the same year, expanded by 22.1 percent, year-on-year, in nominal terms in 2018 (up from 14.3 percent in 2017) and reached 5.7 percent of GDP in 2018 (up from 5.2 percent of GDP in 2017). The substantial increase in personnel services expenditures was the result of the implementation of the third tranche of the adjustment to the salary standardization law, the increase in pay for military and uniformed personnel, and the faster rate of filling vacant positions in various national government agencies.³¹

Moreover, despite softer GDP growth, public revenue reached its highest level in over two decades in 2018 in part due to the implementation of various tax reforms. In 2018, national government revenue increased by 15.2 percent, year-on-year, in nominal terms, up from 12.6 percent in 2017, and reached 16.4 percent of GDP, up from 15.6 percent of GDP in 2017. The robust growth in public revenue was driven by an acceleration in tax and non-tax revenue growth. Tax revenue growth accelerated from 13.6 percent, year-on-year, in nominal terms in 2017 to 14.0 percent in 2018, benefitting from a combination of strong economic growth³² and recent tax

²⁵ Defined as the ratio between public expenditure and GDP.

²⁶ Fiscal data published by the Philippine government are available beginning in 1983.

²⁷ Defined as the ratio between tax revenue and GDP.

²⁸ RA 10963 became effective on January 1, 2018.

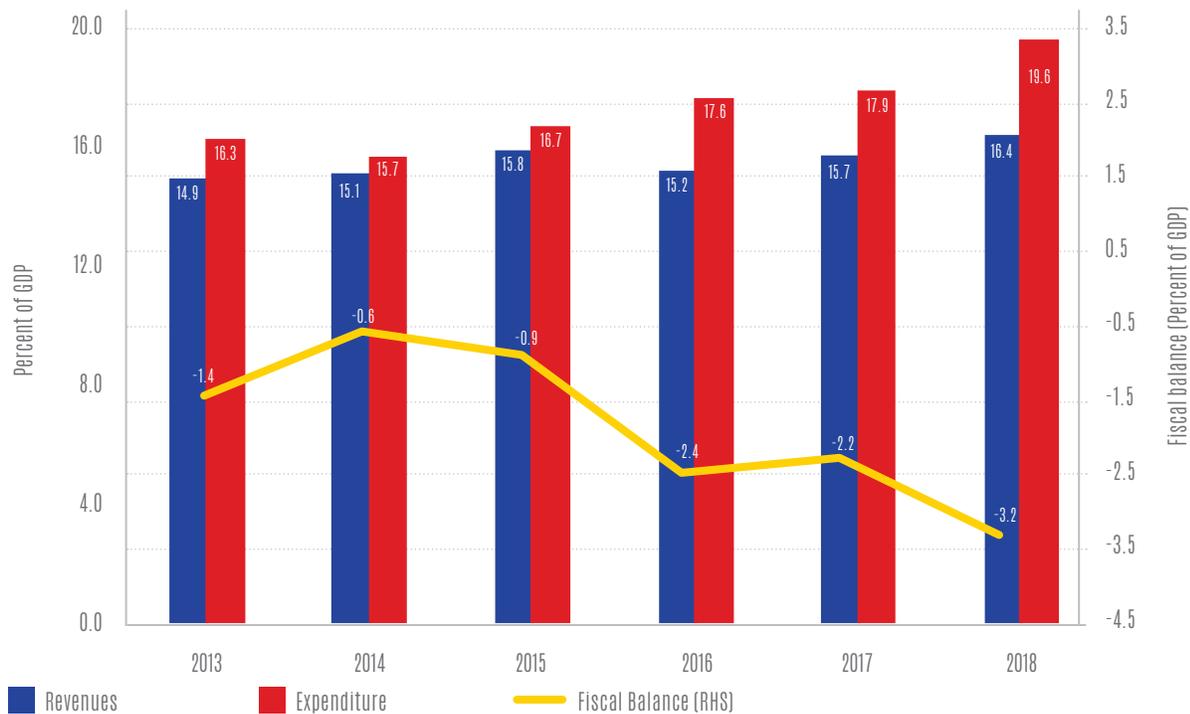
²⁹ The government increased its share of foreign financing from 19.0 percent of total financing in 2017 to 25.0 percent in 2018.

³⁰ Infrastructure outlays were directed toward implementing various road infrastructure, flood control, and dike and river basin repair projects as well as repairing and rehabilitating school and medical (under the Department of Health's Health Facilities Enhancement Program) facilities. In addition, other capital outlays were directed to the purchase of military equipment under the Armed Forces of the Philippines' modernization program and the procurement of machinery, aircraft, and aircraft equipment under the Department of Transportation.

³¹ Source: http://www.dbm.gov.ph/wp-content/uploads/DBCC/2018/NG_Disbursements-November-2018_Full-Report_for-posting.pdf.

³² Nominal GDP expanded by 10.2 percent year-on-year in 2018, higher than the 9.2 percent in 2017.

Figure 13. National Government Fiscal Balance, 2013-18



Source: Bureau of the Treasury (BTr).

policy and administration reforms. As a result, the Philippines' tax ratio increased from 14.2 percent of GDP in 2017 to 14.7 percent of GDP in 2018—the highest level since 1997 (15.3 percent of GDP). However, despite strong growth in tax collections, the government failed to meet its revenue target for the year, as the Bureau of Internal Revenue (BIR) fell short of meeting its Php2.044 trillion collection target for 2018 by Php82 billion, or 0.5 percent of GDP. The BIR missed its collection target largely due to a shortfall in income tax, value-added tax, and excise tax collections.³³ Meanwhile, non-tax revenue increased by 27.8 percent year-on-year in 2018 (3.2 percent in 2017), reaching 1.7 percent of GDP in 2018 compared to 1.4 percent of GDP in 2017. The substantial increase in non-tax revenue was fueled by the significant increase in Bureau of Treasury income³⁴ and the proceeds from the privatization of the Coco Levy fund.³⁵

Despite the wider fiscal deficit, the Philippine government's overall fiscal position remains healthy. The country's debt management has resulted in favorable debt metrics. The national government's debt-to-GDP ratio fell from 42.1 percent of GDP in 2017 to 41.9 percent of GDP in 2018 (Figure 17). The debt portfolio is predominantly composed of long term borrowings at 80.7 percent and short- to medium-term at 19.3 percent in 2018. Two-third of the debt is peso-denominated and a third is foreign currency denominated. In an effort to reduce the risk exposure to exchange rate volatilities, the government pursued a debt mix of 65-35 in 2018, in favor of domestic borrowings. The average costs of borrowings, both external and domestic, have generally been declining since 2014. In September 2018, the average interest rates of external borrowings reached 4.3 percent, cheaper than the average interest rates for domestic borrowings at 5.3 percent.³⁶

³³ The BIR missed its collection targets for the income tax by 4.0 percent (Php42.5 billion, or 0.2 percent of GDP), value-added tax by 17.8 percent (Php77.6 billion, or 0.4 percent of GDP), and excise tax by 12.7 percent (Php42.2 billion, or 0.2 percent of GDP). The shortfall was partly offset by the Php80.2 billion (0.5 percent of GDP) in tax collections from other percentage taxes (the BIR defines other percentage taxes as taxes imposed on individuals or businesses who sell or lease goods, properties, or services and whose gross annual sales or receipts do not exceed Php1,919,500, and are not VAT registered) and other taxes in excess of the BIR's programmed targets.

³⁴ Total income generated by the BTr expanded by 14.0 percent year-on-year in 2018 as a result of higher dividends from national government's shares of stocks, and the national government's share from Philippine Amusement and Gaming Corp. (PAGCOR) income.

³⁵ Proceeds from privatization reached Php15.7 billion in 2018, a more than 15-fold increase compared to the Php0.8 billion in privatization revenues in 2017. This was in large part due to the one-off transfer of the Php13.5 billion worth of bond proceeds from the Coconut Industry Investment Fund to the Special Account in the General Fund for the Coco Levies.

³⁶ S&P Global Ratings raised the Philippines' outlook to 'positive' in April 2018, while maintaining a BBB rating. While both Fitch Ratings and Moody's Investor Service maintained a 'stable' outlook for the Philippines in 2018.

INFLATION AFFECTED POOR HOUSEHOLDS

Labor demand remains strong, driven primarily by public construction projects. The demand for labor increased in the second half of 2018, and the unemployment rate reached 5.1 percent in October 2018, equivalent to 2.2 million Filipinos, bringing the full-year average unemployment rate for 2018 to 5.3 percent—its lowest level in over a decade (Figure 18). Throughout 2018, labor demand was driven by the services and industry sectors, which created 610,000 and 475,000 jobs, respectively. The biggest job-generating sectors were construction, with 328,000 additional jobs, public administration and defense, with 152,000 additional jobs, and manufacturing, with 144,000 additional jobs (Figure 19). The large contribution of the construction sector to total employment generation mirrored its robust growth, fueled by the rapid expansion of public construction activities, although the private sector still accounts for a majority of investments in the Philippines.³⁷

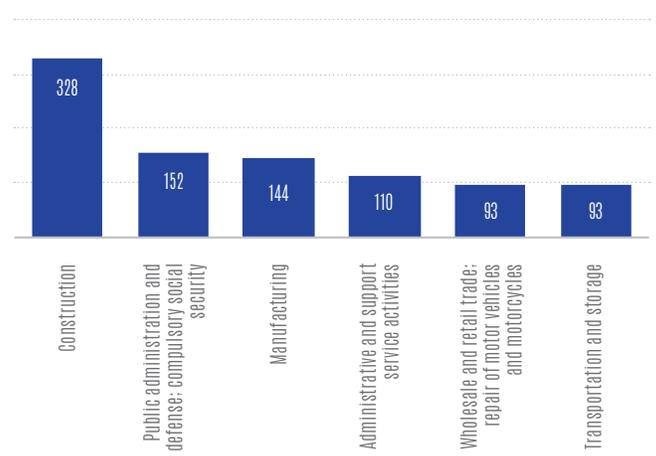
However, net job creation was below the government’s target partly due to persistent job losses in the agriculture sector. Total net-job creation reached 826,000 in 2018, below the annual target of 900,000. The lower-than-expected job creation was partly due to the 259,000 job losses recorded in the agriculture sector (job losses started accelerating in the second quarter). The destructive typhoons that hit the country in 2018 partly explain the loss in agricultural jobs, as they adversely affected agricultural output.³⁸ Nearly all of the Philippines’ regions either improved or retained their unemployment rates compared to 2017, except for Central Visayas, Bicol, and the Autonomous Region in Muslim Mindanao (ARMM), all of which experienced a rise in unemployment. In October 2018, Ilocos recorded the country’s highest unemployment rate of 6.7 percent, followed by major urbanized regions such as the National Capital Region (NCR) and central Luzon, both of which recorded an unemployment rate of 6.0 percent.

Figure 18. Unemployment and Underemployment Rates



Source: Labor Force Survey (various rounds), PSA.

Figure 19. Number of New Jobs by Sector (in ‘000)



Source: Labor Force Survey (2017 and 2018), PSA.

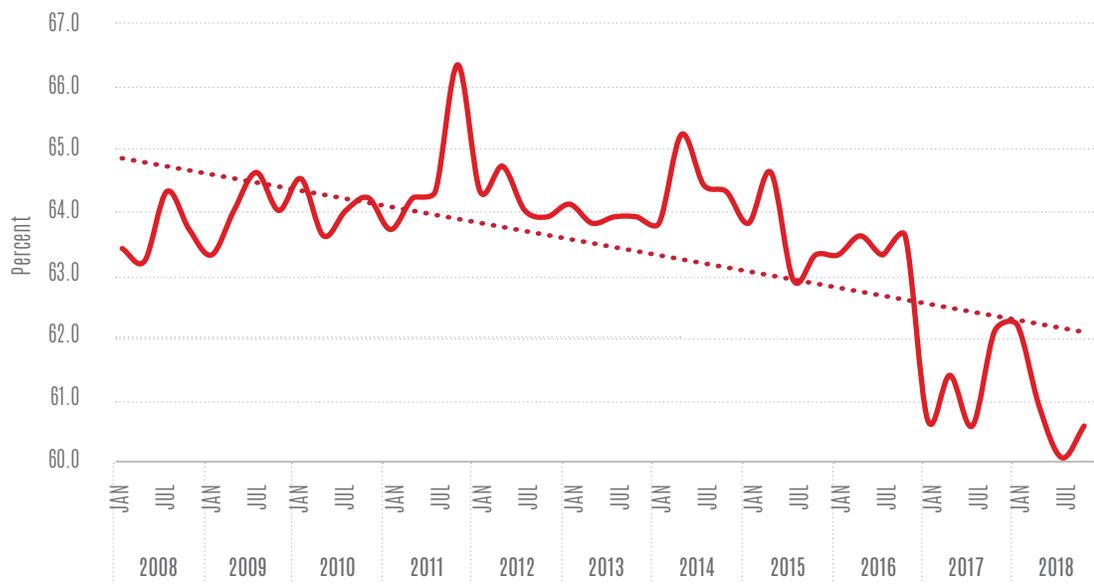
³⁷ Based on national income accounts, the construction sector grew by 15.9 percent, year-on-year, in 2018, up from 5.3 percent recorded in 2017. Moreover, the public construction sector grew by 21.2 percent, year-on-year, in 2018, while the private construction sector, which accounts for 73.0 percent of total investments, grew by 12.9 percent in the same year.

³⁸ Based on the Philippine Atmospheric, Geophysical and Astronomical Services Administration (PAG-ASA) data, 21 tropical cyclones hit the Philippines in 2018, 8 of which were classified as typhoons. The damage from typhoon “Ompong,” which arrived in the Philippines in the second half of 2018, totaled an estimated Php26.7 billion worth of agricultural losses, according to the National Disaster Risk Reduction and Management Council.

Underemployment improved in the second half of 2018 but remains high in most regions. The underemployment rate, or the proportion of employed persons who desired additional hours of work or additional jobs, averaged 15.3 percent in the latter half of 2018—equivalent to 6.3 million Filipinos. It fell to 13.3 percent in October 2018, the lowest level since 2008, with underemployment in the services sector falling from 47.9 percent in October 2017 to 43.2 percent in October 2018. The total share of self-employed and unpaid family workers also declined, from 33.9 percent in October 2017 to 32.2 in October 2018, implying that the share of vulnerable work fell at the end of 2018. Nevertheless, the full-year underemployment rate marginally increased from 16.2 percent in 2017 to 16.4 percent in 2018, mostly due to the high underemployment rates recorded in the first three quarters (average of 17.4 percent in January-July 2018). In addition, only 6 out of 16 regions, outside the NCR, observed year-on-year improvements in underemployment in 2018, highlighting the need to expand access of quality jobs nationwide.

The supply of labor continued to decline in the Philippines in 2018. The labor force participation rate, representing the workforce engaged in work or available for work, fell in the second half of 2018 and averaged a record-low of 61.0 percent in 2018 (Figure 20). The labor force participation rate declined despite the graduation of the first cohort of senior high school (SHS) students in the second quarter.³⁹ The labor force participation rate for the portion of the population aged 15-24 fell from 41.1 percent in October 2017 to 37.2 percent in the same month of 2018. The passage of the Universal Access to Quality Tertiary Education Act, which provided free tuition in 112 state universities and colleges and 78 local universities and colleges starting in the 2018/19 academic year, may have incentivized graduates to continue their studies.⁴⁰ Evidence from the Philippines Institute for Development Studies (PIDS) suggests that three out of four SHS students plan to proceed to higher education, including technical-vocational-livelihood education.⁴¹ More women opting out of the workforce also contributed to the overall decline in the labor force participation rate. The participation rate among women declined from 47.8 percent in October 2017 to 46.4 percent in October 2018.

Figure 20. Labor Force Participation Rate



Source: Labor Force Survey (various rounds), PSA.

³⁹ An estimated 1.2 million SHS students graduated in 2018, according to the Department of Education.

⁴⁰ Republic Act 10931 also provides free tuition in state-run technical-vocational institutions, establishes tertiary education subsidies and student loan programs, and strengthens the unified student financial assistance system for tertiary education.

⁴¹ See Ortiz, M., Lagarto, M., Ortiz, D., Orbeta, A., & Potestad, M. (2018). "Senior High School and the Labor Market: Perspectives of Grade 12 Students and Human Resource Officers," Discussion Papers DP 2018-49 (Revised), Philippine Institute for Development Studies.

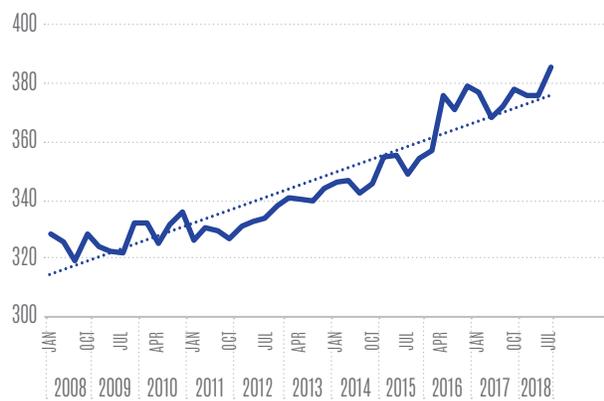
Real wage growth accelerated in 2018, boosting household income. The real daily wage increased in the second half of 2018 after stagnating in the second half of 2017. In July 2018, the daily wage averaged Php385 (at 2012 prices), a 3.5 percent increase from the same period in 2017 of Php372 (Figure 21). This was likely an effect of the regional wage hikes enforced in 2018. Meanwhile, the movement of workers from agricultural employment to non-agricultural wage jobs has continued in recent years, changing the structure of household incomes. Based on the annual poverty indicators survey, the share of wages in household income has increased over time, accounting for about half of total household income in 2017 (from about 44.0 percent in 2007). This has been especially evident among households in the bottom income quintile, where the share of wages in total income increased from 32.0 percent in 2007 to 44.0 percent in 2017.

The increase in inflation in 2018 especially affected poor households. Consumer prices soared between the first and third quarters of 2018, resulting in an average inflation rate of 5.2 percent, year-on-year, in 2018, up from an average of 2.9 percent in 2017. However, the average inflation rate for households in the poorest income quintile increased from 2.7

percent, year-on-year, in 2017—below the national average—to 6.2 percent in 2018—above the national average. As a result, when the headline inflation rate peaked at 6.7 percent in September 2018, the poorest households effectively experienced an inflation rate of 8.4 percent (Figure 22).

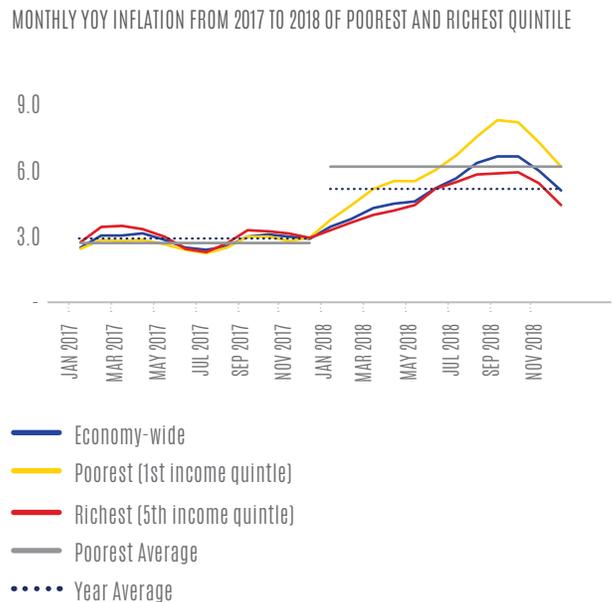
While household incomes likely continued to grow in 2018, higher inflation may have slowed progress in poverty reduction. Data from the most recent annual poverty indicators survey suggest that the poverty rate declined in 2017, as household per capita income increased at a faster rate than inflation, and the income of the bottom 40 percent of the population grew at a faster rate than the income of the average household. Furthermore, the continuing transition of employment to non-agricultural wage jobs suggests more sustainable sources of income for households. It is likely that household incomes, especially for the bottom 40 percent, continued to increase in 2018. However, the impact of inflation may have hampered poverty reduction efforts. The opinion survey from the Social Weather Stations showed a much lower percentage of Filipinos (37 percent) saying their lives improved in December 2018 compared to the same period in 2017 (41 percent).

Figure 21. Average Daily Real Wage (Measured in Constant 2012 Php)



Source: Staff estimates using Labor Force Survey (various rounds), PSA.

Figure 22. Rising inflation especially affected poor households.



Source: PSA and WB Staff Calculations.

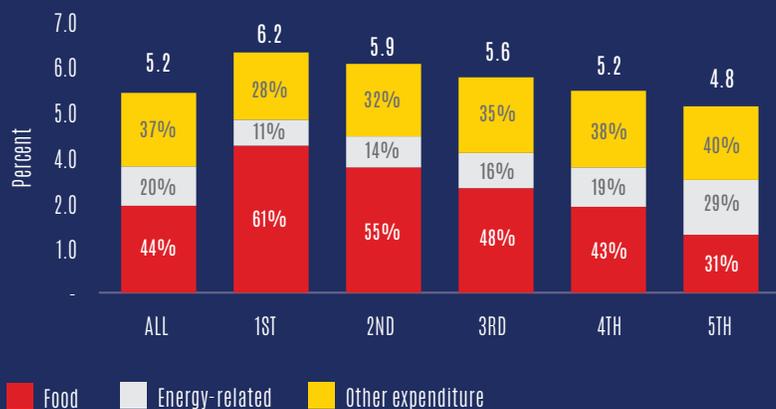
Box 4. The Impact of High Inflation



High food prices contributed to the surge in inflation experienced by poor households in 2018 (Figure 23). An analysis of 2018 average inflation rates by per capita income quintile reveals that food inflation, which averaged 6.6 percent per month in 2018, up from 3.2 percent in 2017, constituted two-thirds of the average inflation rate of 6.2 percent that households in the poorest income quintile experienced in 2018. By contrast, less than one-third of the 4.7 percent effective average inflation rate faced by the richest income quintile was affected by food inflation in the same year. Rice, fish, and vegetables, which constitute a larger share of the consumption baskets of poorer than richer households, experienced a monthly average inflation rate of 5.7, 12.0 and 10.5 percent, respectively, in 2018, up from 0.96, 7.5, and 4.4 percent, respectively, in 2017. Together, their price increases constituted 47 percent of the effective inflation experienced by poor households in 2018.

Figure 23. The increase in food prices contributed to higher inflation faced by the poor.

CONTRIBUTION OF FOOD AND ENERGY INFLATION TO INFLATION BY PER CAPITA INCOME QUINTILE (AVERAGE)



While higher food inflation severely affected poorer households, the direct impact of higher energy prices in 2018 especially affected richer households. An increase in the price of energy-related expenditure items, including electricity, liquefied petroleum gas, solid fuels, fuel and lubricants for operation of personal transport, and transport services (railway, road, sea, and air), contributed more to the effective inflation experienced by richer households. The direct impact of higher energy prices on poor households in 2018 was only minimal due to the low share of energy-related items in their total expenditure. The inflation experienced by richer households was largely driven by higher prices of energy-related commodity items.



OUTLOOK AND RISKS

The Philippines' growth outlook remains strong, with the economy projected to grow at 6.4 percent in 2019 and 6.5 percent in both 2020 and 2021. Private consumption growth is expected to accelerate in 2019 as inflation declines and election activities provide an added boost. Investment spending may initially be tempered, impacted by delays in approving the public budget and the pre-election spending ban on new public construction projects, but is expected to recover toward the second half of 2019. Export growth is likely to remain weak, as global growth and trade activities are projected to moderate in the medium term. The government is expected to continue its expansionary fiscal policy agenda, while the BSP may take a pause in its tightening stance as inflationary pressure diminishes. The positive growth outlook, together with the delivery of public transfer programs, will contribute to poverty reduction. Nonetheless, the economic outlook is subject to downside risks, including the further strengthening of the U.S. dollar, possible increases in U.S. interest rates, continuous trade tensions and geopolitical uncertainties, and the impact of the El Niño phenomenon on agriculture. Prudent management of fiscal and current-account balances and policies to preserve consumer and business confidence are key short-term priorities, while fostering inclusive growth remains an important long-term policy objective.

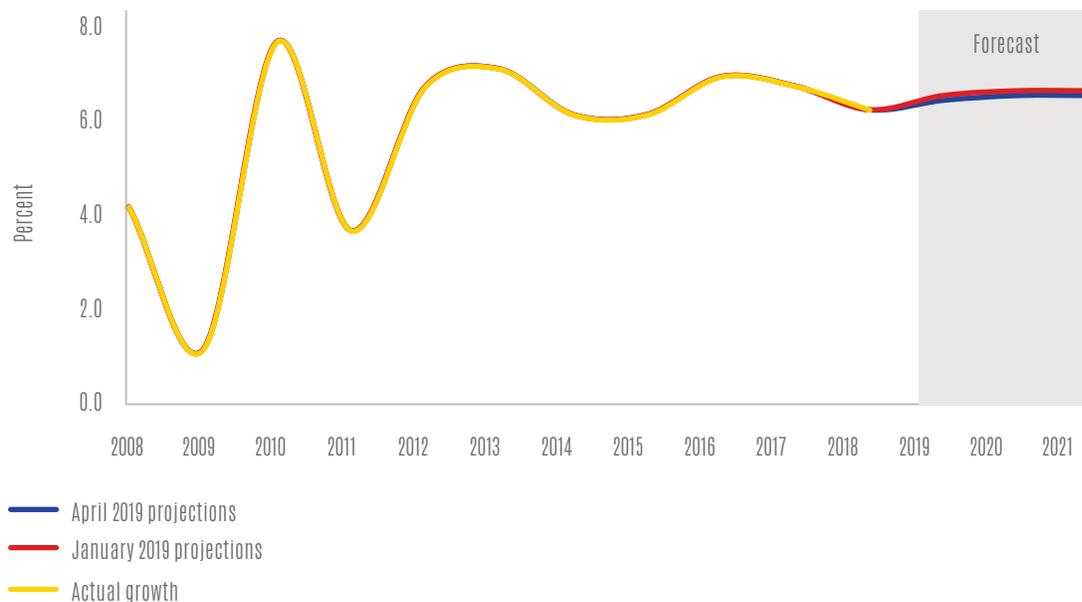
GROWTH OUTLOOK REMAINS POSITIVE

Economic growth in the medium term will be anchored in robust domestic demand, an expected decline in inflation, and an added boost from election activities. Export growth prospects, however, remain bleak due to the weak external environment. Capital formation growth may be tempered, impacted by the delay in approving the government budget.

The Philippine medium-term growth trajectory remains strong, with growth expected to gradually accelerate in 2019-21. The World Bank baseline forecast projects real GDP growth at 6.4 percent in 2019 and 6.5 percent in both 2020 and 2021 (Figure 24). These estimates are lower than the projected 6.5 percent growth in 2019 and 6.6 percent in 2020, reflected in the January edition of the Global Economic Prospects. The country's growth outlook remains strong, and economic growth is expected to recover in 2019, driven by higher private consumption growth amid a projected decline in inflation and an added boost from election⁴² activities. Inflation is

expected to decline in 2019 in line with projected lower global crude oil prices. The roll out of policy measures such as the liberalization of the rice sector could also contribute to lower food prices. Capital formation growth is expected to temper in the first half of 2019 due to delays in approving the public budget and the implementation of a 45-day pre-election spending ban on new public construction projects, and it is expected to recover towards the end of 2019. Net export growth will likely remain subdued, given the weak external environment and an expected increase in imports.

Figure 24. Real GDP is expected to grow above 6.0 percent in 2019-21



Source: PSA, World Bank staff calculations.

⁴² The Philippine midterm elections will be held on May 13, 2019 covering municipal, city, provincial-level positions, as well as all seats in the House of Representatives, and 12 seats in the Senate of the Philippines.

The growth forecast assumes a pause in the BSP's tightening monetary policy stance, mimicking the US Fed and as domestic inflationary pressure is expected to diminish in 2019. Inflation peaked in the third quarter of 2018, before falling in the last two months of the year. Inflation is expected to continue to decline, as global crude oil prices are projected to fall from an estimated US\$68.3 per barrel in 2018 to US\$67.0 per barrel in 2019-20. The decline in crude oil prices is likely to temper the inflationary impact of the second round of the excise tax on petroleum products, which officially took effect on January 1, 2019.⁴³ Meanwhile, rice supply management is expected to improve and lead to lower rice prices upon the implementation of the liberalization of the rice sector, which will open the country to unrestricted rice importation subject to a minimum of 35 percent tariff. Additionally, an administrative order adopted in the third quarter of 2018 streamlined the importation of fish, vegetables, meat, and other food products to supplement the domestic food supply. Finally, inflation expectation will likely adjust to lower levels in relation to falling inflation, further supporting the declining price trend in 2019.

Household consumption growth is anticipated to rebound as inflation declines and pre-election spending starts. The Philippine economy has historically been consumption-driven, with households contributing more than two-thirds of aggregate expenditures. Annual private consumption growth declined from 5.9 percent in 2017 to 5.6 percent in 2018 due to high inflation, but it is expected to recover to 6.0 percent in 2019-2020 due to declining inflation and an improving labor market⁴⁴ (Table 4). Moreover, remittance inflows are expected to remain steady as new employment opportunities for Filipinos become available in countries like Japan, Germany, and Poland, which is expected to contribute to an acceleration in consumption growth.⁴⁵ Finally, consumption will be supported by pre-election activities and the continued implementation of infrastructure projects, which will increase public spending and generate job opportunities.

Table 4. Economic Indicators for Baseline Projections

	2016	2017	2018	2019f	2020f	2021f
Real GDP growth, at constant market prices	6.9	6.7	6.2	6.4	6.5	6.5
Private Consumption	7.1	5.9	5.6	6.0	6.0	6.0
Government Consumption	9.0	7.0	12.8	10.8	10.0	9.7
Gross Fixed Capital Investment	26.1	9.5	14.0	11.4	16.5	17.0
Exports, Goods and Services	11.6	19.5	11.5	12.4	13.0	13.8
Imports, Goods and Services	20.2	18.1	14.5	14.0	16.4	17.0
Inflation (period average)	1.3	2.9	5.2	3.5	3.3	3.0
National government balance (% of GDP)	-2.4	-2.2	-3.2	-2.8	-2.8	-2.8
Current account balance	-0.4	-0.7	-2.4	-2.3	-2.5	-2.5

⁴³ The TRAIN law imposed a Php2.50 per liter excise tax on diesel and increased the levy on gasoline to Php7.00 per liter on January 1, 2018. Fuel excise taxes increased by Php2.00 per liter in January 2019.

⁴⁴ The unemployment rate continues to improve in the Philippines, falling to 5.3 percent in 2018—its lowest level in over a decade and well below the ten-year average of 6.9 percent.

⁴⁵ The Philippines Overseas Employment Administration reported demand for Filipino health workers in Germany, Saudi Arabia, and the United Arab Emirates. Japan has announced that it will welcome over half a million foreign workers in 2019-25 to help fill its labor shortage in the nursing, shipbuilding, construction, and hospitality industries.



The growth forecast also assumes further ramping up of public spending. The Philippine government remains committed to accelerating investments in both public infrastructure and human capital development, reflected in its Php3.76 trillion budget for 2019. While public spending will be tempered in the first half of 2019 impacted by the delay in approving the budget, growth outlook assumes that public spending will accelerate in the second half of 2019. This rests on the assumption that the 2019 budget will be approved before end of the 17th Congress. Programmed disbursements are expected to increase by 13.7 percent, year-on-year, in nominal terms to Php3.83 trillion (19.7 percent of GDP) in 2019, driven by a significant rise in recurrent and infrastructure spending⁴⁶ Recurrent spending will be driven by a rise in personnel services expenditures, as the government implements the fourth and last tranche of the salary standardization law adjustment and creates new public-sector jobs. Meanwhile, public infrastructure spending is expected to increase gradually to reach 6.4 percent of GDP in 2021, as the government continues its rollout of the “Build, Build, Build” program.

However, project delivery constraints will likely lower the country’s fiscal deficit targets. The government’s current fiscal deficit target is 3.2 percent of GDP for 2019 and 3.0 percent of GDP for 2020-21. The World Bank projects a slightly lower deficit over the projection period, as a number of constraints, stemming from longstanding implementation bottlenecks and capacity limitations, may hinder progress in program implementation by line agencies.⁴⁷ A slightly narrower deficit for 2019 also factors in the delay in approving the 2019 national government budget, which is likely to delay new capital outlays in the first half of 2019 (Box 5). Although public infrastructure spending continued to improve throughout 2018, infrastructure outlays were largely driven by small public works projects, as the implementation of the public “Build, Build, Build” infrastructure program was slower than expected.⁴⁸ The timely implementation of the government’s infrastructure investment program remains vital to accelerate investment growth in the Philippines.

⁴⁶ National government disbursements are expected to increase by 12.6 percent, year-on-year, in 2020 to Php4.314 trillion (20.1 percent of GDP) and by 11.3 percent to Php4.803 trillion (20.3 percent of GDP) in 2021.

⁴⁷ The government needs to tackle issues related to weak program and project design, procurement difficulties, and limited absorptive capacity.

⁴⁸ Infrastructure outlays are typically front-loaded during an election year to comply with election rules on disbursement of public funds and the implementation of public works projects.

Box 5. Implementation of Flagship Infrastructure Projects under the “Build, Build, Build” Program

Implementation of the “Build, Build, Build” program has been slower than expected. While 46 projects started implementation activities between 2016 and 2018,⁴⁹ only 11 have reached the construction phase,⁵⁰ out of which only two projects, valued at Php1.2 billion, were completed in 2018⁵¹ (Table 5). Under the government’s program, there are a total of 37 approved projects worth Php1.56 trillion, 29 projects under review worth Php0.60 trillion, and nine projects that do not require the NEDA Board’s approval worth Php11.4 billion, according to the latest status update released by NEDA in January 2019.⁵²

Table 5. Implementation of Flagship Infrastructure Projects under the “Build, Build, Build” Program

Target start of implementation	NEDA Board-Approved		Under Review by NEDA Board		Does Not Require NEDA Board’s Approval		Total		Started Construction Phase as of January 31, 2019	
	Number of projects	Project cost (Php billion)	Number of projects	Project cost (Php billion)	Number of projects	Project cost (Php billion)	Number of projects	Project cost (Php billion)	Number of projects	Project cost (Php billion)
2014					1	1.0	1	1.0	1	1
2016	1	5.4					1	5.4	1	5.4
2017	2	4.7			1	0.2	3	4.9	2	2.1
2018	11	969.4	10	230.7	4	9.0	25	1209.1	7	31.7
2019	13	554.3	10	232.1			23	786.3	-	-
2020	4	10.5	5	55.5	1	1.2	10	67.2	-	-
2021	6	20.0	1	10.5			7	30.5	-	-
TBD			3	71.6	2	TBD	5	71.6	-	-
Total	37	1564.4	29	600.4	9	11.4	75	2176.2	11	40.2

Source: NEDA.

Close to a quarter (Php909.7 billion) of the 2019 public budget (Php3.757 trillion) is dedicated to flagship infrastructure projects.⁵³ This represents 4.8 percent⁵⁴ of nominal GDP and is projected to create 1.1 million jobs.⁵⁵ About 60.0 percent of the budget for flagship projects is allocated to projects under the Department of Public Works and Highways for road construction, rehabilitation and improvement, flood and drainage systems management, asset preservation, and river ferry stations, along with big ticket projects in Luzon, Visayas, and Mindanao.⁵⁶ Meanwhile, the Department of Transportation has been allotted 8.3 percent, or Php76.1 billion, for its railway, airport, and sea transportation projects. The remaining 2019 funds will benefit other projects focused on assistance to municipalities and state universities’ internet connection as well as the national broadband plan.

However, the delayed passage of the 2019 national budget, along with the 45-day public spending ban prior to elections in May 2019, risks further delaying the implementation of infrastructure projects. Specifically, a lack of access to funding may aggravate delays due to existing implementation constraints, such as restrictive procurement laws, right-of-way issues, contractors’ lagging schedule, and late fund disbursements.^{57,58} To minimize the impact of limited government spending on first quarter economic growth, the government has requested the Commission on Elections to exempt vital infrastructure projects worth at least Php500 billion⁵⁹ under the “Build, Build, Build” program from the election-related spending ban that will run from March 29th to May 12th.^{60, 61}

⁴⁹ Implementation includes budgeting, financing, Detailed Engineering Design, and procurement stages, aside from the construction phase.

⁵⁰ The following 9 projects are still under construction as of January 31, 2019: Clark International Airport Expansion (Php9.36 billion), Clark Green City Commercial Center (Php0.85 billion), Clark Green City Government Center (Php1.78 billion), Clark Green City Mixed-Income Housing (Php3.33 billion), Bonifacio Global City to Ortigas Center Road Link (Php1.90 billion), Estrella-Pantaleon Bridge (Php1.37 billion), Chico River Pump Irrigation (Php4.34), Panguil Bay Bridge (Php7.38 billion), and Binondo-Intramuros Bridge (Php4.61 billion). In addition to BBB projects, other big-ticket infrastructure projects such as the South Integrated Transport System (Taguig) (Php5.2 billion) and LRT Line 1 Cavite Extension and O&M (Php64.9 billion) have also begun pre-construction activities in 2018 and early 2019, respectively.

⁵¹ Pulangi 4 Selective Dredging Phase 3 Project in Region 10 (Northern Mindanao Region) worth Php0.24 billion (funded through GAA) and the project focused on improving the remaining sections along Pasig River from Delpan Bridge to Napindan Channel in the NCR worth Php1 billion (funded by a loan from Japan).

⁵² National Economic and Development Authority <http://www.neda.gov.ph/infrastructure-flagship-projects/>, „Public-Private Partnership (PPP) Center, Retrieved from <https://ppp.gov.ph/project-database/>

⁵³ The Php909.7 billion budget for the flagship infrastructure projects refer to both ongoing projects and projects that have yet to be implemented.

⁵⁴ Given World Bank’s projected real GDP growth rate for 2019 at 6.3 percent and projected inflation in 2019 at 3.5 percent.

⁵⁵ Musico, Jelly, “P909.7-B allotted for ‘Build, Build, Build’ program in 2019”, Retrieved from <http://www.pna.gov.ph/articles/1042562>

⁵⁶ Cervantes, Filane Mikee, “Solon backs infra exemption from poll ban”, Retrieved from <http://www.pna.gov.ph/articles/1060614>

⁵⁷ Torres, Sherrie Ann, “Foreign firms eyed amid ‘shortage’ of contractors for infra projects,” Retrieved from <http://news.abs-cbn.com/business/07/19/18/foreign-firms-eyed-amid-shortage-of-contractors-for-infra-projects>

⁵⁸ Velasco, Ed, “NEDA: Build, Build, Build projects done by ‘22”, Retrieved from <https://www.manilatimes.net/neda-build-build-build-projects-done-by-22/422368/>

⁵⁹ Nicolas, Bernadette D, “Spending ban exemption to cover P500-billion projects”, Retrieved from <http://governance.neda.gov.ph/spending-ban-exemption-to-cover-p500-billion-projects/>

⁶⁰ Cervantes, Filane Mikee, “Solon backs infra exemption from poll ban”, Retrieved from <http://www.pna.gov.ph/articles/1060614>

⁶¹ Cu, Rea, “Comelec seen to grant exemption of vital infrastructure from spending ban,” Retrieved from <https://businessmirror.com.ph/2019/01/30/comelec-seen-to-grant-exemption-of-vital-infrastructure-from-spending-ban/>



The global economic environment remains challenging, limiting the Philippines' export growth prospects. Global growth is projected to moderate from 3.0 percent, year-on-year, in 2018 to 2.9 percent and 2.8 percent in 2019 and 2020-21, respectively, amid elevated trade tensions, a slowdown in international investments, and tightening financing conditions (Box 6). Close to 70.0 percent of advanced economies are expected to register weaker growth in 2019 compared to 2018, while growth projections were downgraded in more than 40.0 percent of EMDEs. The growth deceleration will soften the demand for Philippines exports, as exports to high-income economies account for roughly 70.0 percent of the country's export market. The growth of the Philippines' main goods exports—electronics and electronics components—have already started to slow, growing by a mere 2.8 percent, year-on-year, in 2018, down from 24.2 percent in 2017.⁶² Meanwhile, import growth is expected to outpace export growth in 2019, driven by an increase in domestic economic activities, anchored in the capital requirements of public infrastructure projects. As a result, net exports are likely to remain a drag on economic growth, while current-account pressures may continue.

Growth in the services and industry sectors will be supported by strong domestic demand, while a weak recovery is anticipated for the agriculture sector. A growing middle class and a steady flow of remittances from overseas Filipinos are expected to fuel the demand for real estate and financial services. Also, the upcoming general elections in May are expected to provide an added boost to transport and communication and government services, helping to accelerate growth in the services sector from 6.6 percent, year-on-year, in 2018 to 6.9 percent in 2019. However, growth in the industry sector is expected to slightly decelerate from 6.8 percent, year-on-year, in 2018 to 6.7 percent in 2019, as manufacturing activities are expected to be impacted by the slowdown in global trade. While growth in the agriculture sector is likely to recover partly due to the low base in 2018, it will be limited due to unresolved productivity challenges and vulnerability to weather disturbances, such as the potential impact of El Niño in 2019.⁶³

⁶² In FOB Value in US Dollars.

⁶³ <https://pubfiles.pagasa.dost.gov.ph/climps/climateforum/climateoutlook.pdf>

Box 6. The Global Economic Outlook



Global growth is expected to gradually slow in the coming years, from an estimated 3.0 percent in 2018 to 2.9 percent and 2.8 percent in 2019 and 2020-21, respectively (Figure 25). Economic growth in advanced economies is expected to slow as monetary policy is normalized and capacity constraints become increasingly binding. Meanwhile, growth in EMDEs is likely to weaken, reflecting weaker-than-expected growth in commodity exporters along with growth deceleration in commodity importers. Growth also continues to be affected by trade tensions between the United States and China.⁶⁴ While the temporary pause in tariff hikes agreed by the two countries in early December 2018 tempered trade policy uncertainties, the possibility of escalating trade restrictions remains elevated. This uncertainty is likely to weigh on firms' investment and export decisions. Combined with an increasing prevalence of temporary trade barriers, such as anti-dumping and countervailing duties and safeguards, recent protectionist measures have disproportionately affected trade in parts and components, with negative repercussions for international value chains and trade growth (Figure 26).

The growth deceleration may be more severe if downside risks to the global outlook materialize. These downside risks include an escalation of trade tensions, a sharper-than-expected tightening of global financing conditions, and heightened political uncertainty. For example, escalating trade tensions can cut about 5.0 percent of global trade flows if all tariffs under consideration were implemented. While a number of countries stand to benefit from trade diversion in the short run, trade protectionism would stifle investment and disrupt global value chains, contributing to higher prices and lower productivity. Further tightening of global financing conditions could exert further downward pressure on economic activities in EMDEs, including in countries with large current-account deficits financed by portfolio and bank investment flows. Debt levels have risen in some EMDEs over the last few years, including in many low-income countries, reducing the fiscal space to respond to shocks and heightening the exposure to shifts in market sentiment and rising borrowing costs.

Given the substantial risks and weaker growth prospects, EMDEs are faced with the challenge of ensuring sustained improvements in living standards while promoting productivity growth. This will require investments in both human capital and skills development to raise productivity and take full advantage of technological change. In the current environment of limited fiscal resources, it is vital that the government ensures the effective allocation of public resources and increases the efficiency of the public sector. Moreover, many EMDEs could do more to liberalize their trade regimes and further integrate their economies into global value chains, which would foster job creation, export diversification, and a more efficient allocation of resources. Policies that address these areas would also address the challenges associated with informality, reinforcing the basis for future productivity growth.

⁶⁴ The trade dispute led to the introduction of new tariffs that affected about 12.0 percent of U.S. goods, 6.5 percent of China's goods imports, and 2.5 percent of global goods trade in 2018.

Figure 25. Global growth is expected to slow in the coming years...

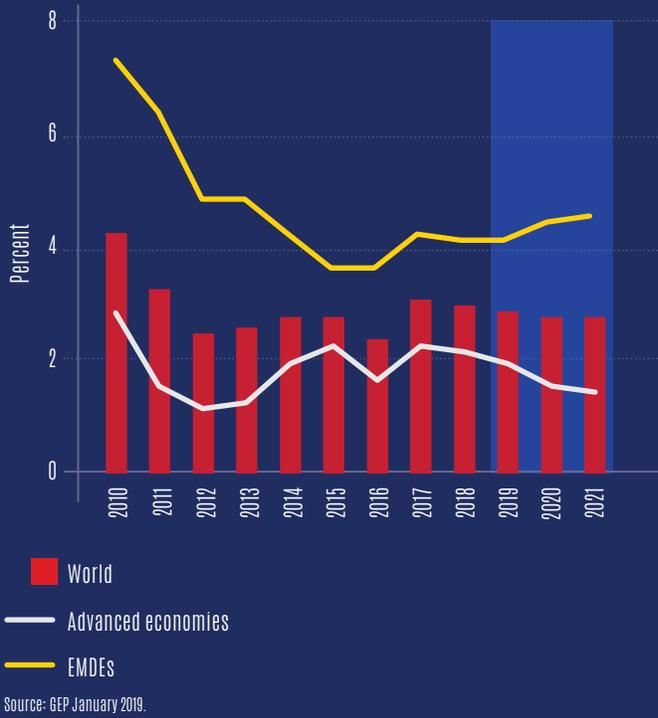


Figure 26. ...along with a slowdown in global trade.

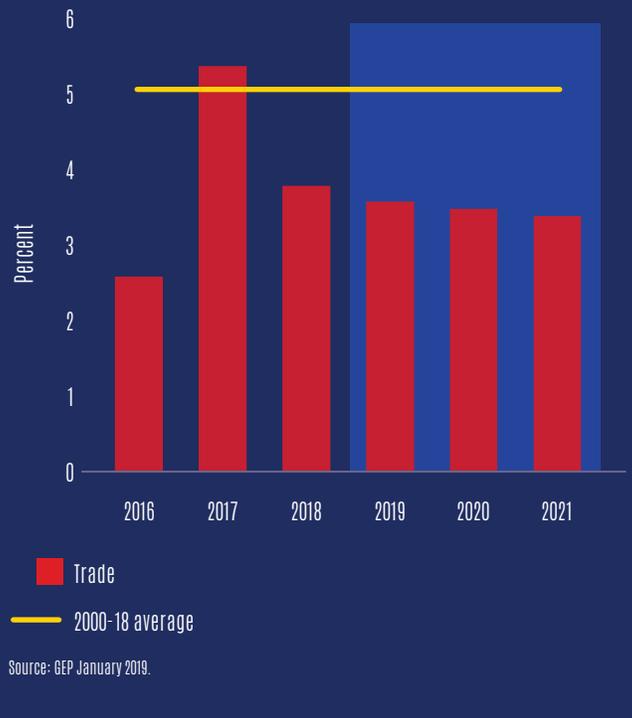


Table 6. Real GDP Growth, 2016-21

	2016	2017	2018e	2019f	2020f	2021f
World	2.4	3.1	3.0	2.9	2.8	2.8
Advanced economies	1.7	2.3	2.2	2.0	1.6	1.5
Emerging market and developing Economies	3.7	4.3	4.2	4.2	4.5	4.6
Developing East Asia & Pacific	6.3	6.6	6.3	6.0	6.0	5.8
Philippines	6.9	6.7	6.2	6.4	6.5	6.5

Note: Developing East Asia & Pacific includes Cambodia, China, Fiji, Indonesia, Lao PDR, Malaysia, Mongolia, Myanmar, Papua New Guinea, Philippines, Solomon Islands, Thailand, Timor-Leste, and Vietnam.
Source: World Bank Global Economic Prospects, January 2019; World Bank Global Monthly, January 2019.

POVERTY REDUCTION AND SHARED PROSPERITY PROGRESS

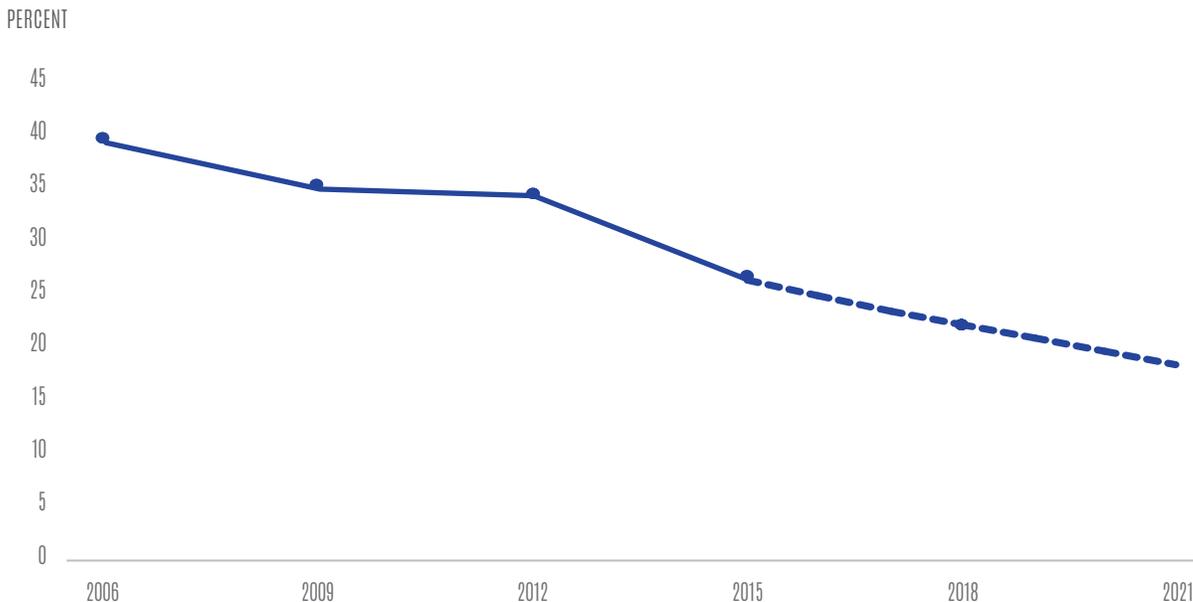
The positive growth outlook is expected to further contribute to poverty reduction efforts, supported by the improvement in non-agriculture wages and the delivery of public programs such as the *Pantawid Pamilyang Pilipino Program*.

Filipino households are likely to continue reaping the gains from high economic growth. Non-agriculture wages are expected to continue to spur growth in household incomes, particularly for lower income groups. Cash transfers from the government, including from programs that were started in 2018, have been particularly helpful to mitigate the impact of high inflation. For example, the Unconditional Cash Transfer Program was rolled out to the government's *Pantawid Pamilyang Pilipino Program* beneficiaries and senior citizens in 2018, with Php2,400 in annual benefits to mitigate the impact of higher excise taxes. According to administrative data, about 7 million beneficiaries

have received the cash grant to date. The program will continue in 2019, with benefits increasing to Php3,600.

Poverty reduction is also expected to continue based on the current economic growth outlook. An acceleration in economic growth will contribute to poverty reduction through job creation, higher wages, and a continuation of social programs. Medium-term poverty projections based on the middle-income poverty line of US\$3.20/day show the poverty rate declining from 26.0 percent in 2015⁶⁵ to 20.7 percent in 2019, 19.6 percent in 2020, and 18.5 percent in 2021 (Figure 27).

Figure 27. Actual and Projected Poverty Rates in the Philippines, 2006-2021.



Source: PSA, World Bank staff calculations.

⁶⁵ Actual estimates are slightly different from previous publications due to updates in the Consumer Price Index.

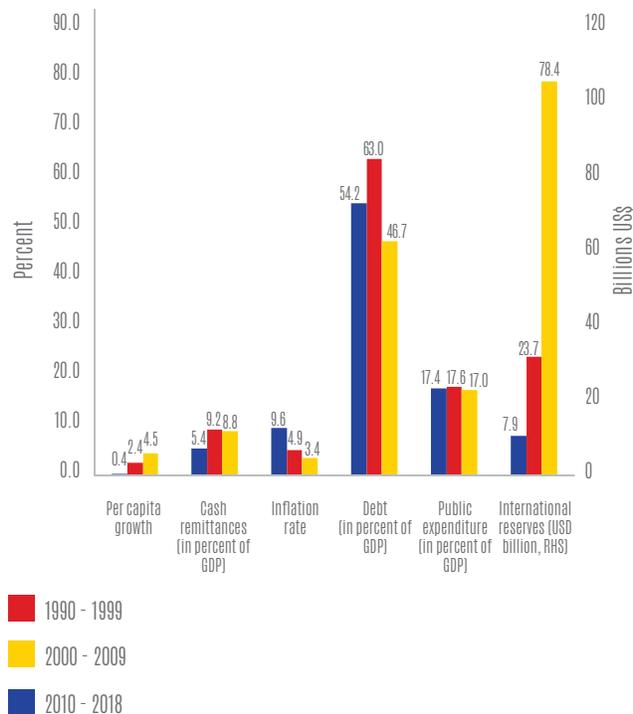
SOME RISKS AND POLICY CHALLENGES REMAIN

The economic outlook is subject to downside external and domestic risks. Prudent management of fiscal and current-account balances and policies to preserve consumer and business confidence are key short-term priorities, while fostering inclusive growth remains an important long-term policy objective and challenge.

Downside risks to the Philippines' economic growth outlook have increased. Key external risks emanate from heightened uncertainty generated by the U.S.-China trade dispute, the ongoing policy normalization in advanced economies, and tightening global financial conditions. Domestic risks have increased with the delay in the approbation of the 2019 budget, negatively impacting the implementation of public infrastructure projects. Uncertainty over the passage of the remaining packages of the government's tax reform program,⁶⁶

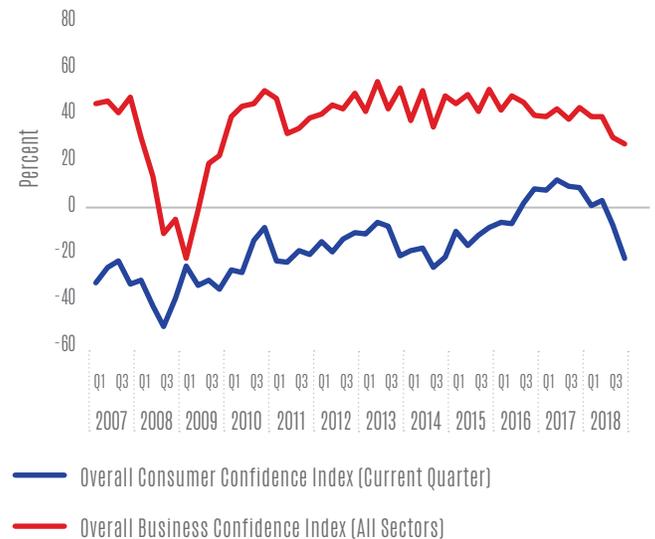
and the potential impact of El Niño phenomenon on agriculture production and food prices are additional domestic risks that might affect the growth outlook. In the medium to long term, the government's expansionary fiscal policy could lead to fiscal sustainability challenges if not accompanied by revenue increases. Nonetheless, there are strong macroeconomic fundamentals in place to protect the country against shocks such as large foreign reserves, an accommodative monetary policy, and the flexible exchange rate regime. (Figure 28).⁶⁷

Figure 28. While the Philippines' macroeconomic fundamentals are strong, challenges remain.



Source: PSA, World Bank staff calculations.

Figure 29. Consumer and business confidence worsened in 2018.



⁶⁶ A number of tax reform packages have passed in the House of Representatives but are still being deliberated in the Senate. Should Congress fail to pass the tax reform packages before the end of the 17th Congress of the Philippines, these will need to be refiled once the 18th Congress resumes in June 2019.

⁶⁷ For example, the growth of cash remittances decelerated from an average of 9.2 percent in 2000-09 to 8.8 percent in 2010-18, and remittances grew by a mere 3.1 percent in the first 11 months of 2018. The import cover of international reserves has fallen from 8.8 months in December 2016 to 7.7 months and 7.0 months in December 2017 and December 2018, respectively.

External uncertainty remains high, posing a challenge to the Philippine economy. Heightened global uncertainty is rooted in the potential escalation of trade tensions between the U.S. and China and the ongoing policy normalization in advanced economies, which can undermine investor confidence and trade activities in the region. In the past, episodes of market uncertainty have led to volatility in the country's capital and foreign exchange markets, induced by foreign capital outflows as investors looked for safer investment outlets. Sudden capital outflow puts pressure on the Philippine peso and may undermine consumer and business confidence. Moreover, the policy normalization by the U.S. Federal Reserve can lead to tighter financing conditions, raising borrowing costs at a time when foreign funds are partly used to finance the government's infrastructure investment program. The external environment is, therefore, not expected to be accommodative to domestic growth, warranting prudent policy actions.

The current-account deficit has to be carefully managed to prevent gaps in external funding. The current-account deficit is expected to further widen, as goods export growth remains weak while import growth accelerates, driven by the government's focus on increasing infrastructure investment spending. Unlike in the past, services exports and inflow of remittances are unlikely to offset the trade deficit, as growth in remittances and the IT-BPO industry has started to soften after years of double-digit growth. In the context of possible further tightening of global financing conditions, the government needs to manage the current-account deficit to prevent it from widening too much too fast. In a way to address the sagging export competitiveness, it can help exports industries connect to the global value chain, improve domestic linkages not only between services and other sectors but also among industrial subsectors, attract more investments, and support the IT-BPO industry move up the value chain.⁶⁸ Nevertheless, healthy foreign reserves, large inflows of FDI, a flexible exchange rate regime, and low public debt levels will help public authorities address emerging external funding challenges.

Domestic risks include further delay in the approval of the 2019 budget while the passage of additional comprehensive tax reforms is needed to ensure fiscal health. An important downward risk to baseline growth outlook is the delay in the 2019 budget approval process, and the reenactment of the 2018 budget (Box 7). Under a reenacted budget, no new programs and projects will receive funding, as budget allocations are based on the appropriations made in the previous year's budget. As a result, the limited public spending may negatively impact the Philippines' growth prospects for 2019. Meanwhile, as the government ramps up spending to implement its inclusive growth agenda, complementary reforms to enhance revenue generation are needed to ensure fiscal sustainability. In particular, additional tax policy measures, which were expected to pass in 2018, have yet to be adopted by the Congress of the Philippines.⁶⁹ These measures were included in the national government's medium-term fiscal program and the budget preparation process for 2019. The passing of these revenue measures will help to ensure that the government is able to limit deficit increases while continuing its ambitious program to increase public spending in infrastructure and human capital.

Prudent management of fiscal balance and improvement in public investment management are needed as the government ramps up its public investment program. As financing conditions continue to tighten globally, the government must continue to exercise prudent fiscal management to maintain long-term debt sustainability. In addition to raise new revenue to meet spending needs, the government may benefit from diversifying sources of project financing to include overseas development assistance, general appropriations funding, and public-private partnerships. Beyond financing, public investment management needs to be improved to help maximize the efficiency of infrastructure investment in the medium-term, particularly in project appraisal, multi-year budgeting, portfolio management and oversight, and procurement.⁷⁰

⁶⁸ See Philippines Economic Update October 2016 for a box on Moving up the value chain: from BPO to KPO; and Philippines Economic Update April 2017 for a chapter on trade competitiveness and global value chains in the Philippines.

⁶⁹ For example, tax reform Package 1B, which includes reforms to estate tax amnesty, a general tax amnesty, adjustments to the motor vehicle user tax, and a relaxation of bank secrecy and automatic exchange of information, was expected to generate Php37.2 billion (0.2 percent of GDP) in additional revenues in 2019 under the government's 2019 medium-term fiscal program. Moreover, Package 2+, which includes an adjustment to excise taxes on alcohol and tobacco as well as mining revenue, is expected to generate an additional Php62.7 billion in 2020 (0.3 percent of GDP) and Php78.9 billion in 2021 (0.3 percent of GDP).

⁷⁰ Source: International Monetary Fund. The Philippines: Public Investment Management Assessment, 2018.



Box 7. The Delayed Passage of the 2019 National Government Budget

For the first time since 2010, the government operated under a reenacted budget in the first quarter of 2019,⁷¹ as the Congress was unable to pass the proposed 2019 budget in 2018. The 2019 public budget was ratified by Congress on February 8, 2019 but is still pending approval, as an impasse between both houses of Congress has caused further uncertainty on the timing of the passage of the 2019 budget. The ratified budget would significantly increase allocations to a number of key agencies. In particular, the Department of Public Works and Highways would receive an additional Php32.9 billion, while the Department of Health would receive an additional Php21.5 billion. The ratified version of the budget also reverts the 2019 budget back to an obligation-based budget, as Congress rejected the implementation of a cash-based budgeting system.

To soften the limitations created by the reenacted budget, the Department of Budget and Management issued guidelines (DBM Circular 2019-01) on the release of public funds. These stated that government agencies were authorized to obligate 2019 budget funds in the first quarter of 2019 but only up to 25.0 percent of their corresponding 2018 budget allocations. This applied to personnel services, maintenance and operating expenditures for regular programs, and existing capital outlays under a multi-year obligation authority.

The implementation of the reenacted budget meant delays in the government's disbursement program. Under a reenacted budget, no new programs and projects under the proposed budget will receive funding, as budget allocations will continue to be based on the appropriations made in the previous year's enacted budget. For example, under the reenacted budget, no new capital outlays will be implemented in the first quarter of 2019, which is a crucial period during an election year when the government typically frontloads the implementation of infrastructure projects. According to the Department of Budget Management, the delayed passage of the 2019 national budget is estimated to lower programmed disbursements by Php43.7 billion in the first quarter of 2019.

Sources: Department of Budget and Management; and Cepeda, M. 2019. "Bicam approves 2019 budget but rejects cash-based budget system." Retrieved from <https://www.rappler.com/nation/223033-bicam-approval-2019-budget-remove-cash-based-budgeting-system>. Accessed on 2019. "Bicam approves 2019 budget but rejects cash-based budget system." Retrieved from <https://www.rappler.com/nation/223033-bicam-approval-2019-budget-remove-cash-based-budgeting-system>.

⁷¹ Under the 1987 Constitution, if the Philippine government is unable to pass the General Appropriations Bill (GAB) by the end of the year, the government will operate under the previous year's budget until the government passes the GAB.

Preserving business confidence not only requires policy clarity and commitment but also consensus among government agencies on the nature and timing of reforms. Business sentiment in the Philippines worsened in 2018, with the BSP's business confidence index falling from 43.3 in the fourth quarter of 2017 to 27.2 in the fourth quarter of 2018—its lowest level since the first quarter of 2010 (Figure 29). Uncertainty in the external environment and persistent high inflation are reasons for a more pessimistic expectation. A lack of clarity into the timeframe of the government's planned policy reforms, including the remaining tax reform packages, creates uncertainty among investors who may be temporarily withholding investments until the scope of reforms becomes clear. Moreover, uncertainty is heightened by difficulties in reaching a consensus between the executive and legislative branches as witnessed for instance, in the delayed approval of the public budget, which casts doubt over the timely delivery of public investment projects. Therefore, while the government has established policy clarity and demonstrated a commitment to reforms, it needs to effectively convene and build consensus among government agencies on the opportunity, nature, and timing of reforms to lower governance risks and temper market uncertainties.

An intensified El Niño in 2019 may weaken agriculture output and result in food supply constraints if mitigating measures are not put in place. Past El Niño events in the Philippines have resulted in production losses in the agriculture-fisheries sector due to dry farmlands, stunted growth of livestock, and lower fish catch. In 2015-16, an El Niño episode resulted in about Pph15.4 billion worth of damage and production losses (0.11 percent of GDP) from lost crops such as corn, cassava, banana and rubber.⁷² It directly affected 413,456 farming households which needed government support to recommence farming activities for the next cropping season. Production loss might cause higher food inflation as it was seen during the 1997-98 El Niño when food inflation reached 8.3 percent. According to the Philippine Atmospheric, Geophysical, and Astronomical Services Administration (PAGASA), some effects of a drought are already prevailing in the country and warns a 65 percent chance of

El Niño in September to November 2019. Mitigation measures, such as targeted cash transfer to farmers and ample and timely importation of rice, vegetables, and other food products, would be key in preventing inflationary risk and welfare loss by the farmers.

The Hanjin corporate default—the largest in Philippine history—is unlikely to threaten the country's financial stability. According to the BSP, the country's healthy capital buffers and the low share of non-performing loans in the total loan portfolio make the country's banking system well-positioned to withstand the corporate loan default of US\$412.0 million from five local banks affected by the default of HHIC-Phil. The loan exposure represents only 0.2 percent of total loans in the banking system and 2.5 percent of foreign currency loans in foreign currency deposit units. However, credit rating agencies, including Moody's Investor and Fitch Ratings, warn that the Hanjin default poses risks to local banks, as it will reduce profits and raise credit costs.⁷³

The government is faced with the challenge of effectively and sustainably implementing its inclusive growth agenda in the long term. This requires a commitment to structural reforms that improve market competition, encourage investments, and improve labor market conditions. Policies that support market competition and investments are critical to boosting both productivity and economic growth as it has been identified as the key steps toward achieving inclusive growth.⁷⁴ Key policy initiatives include revisiting foreign participation limits in the domestic market and implementing reforms to improve doing business in the country which will lead to higher competition, improve consumer choices, improve quality of products and services, and lower prices. Labor market initiatives include reducing labor market rigidities, implementing training and job-search programs, and measures to support workers affected by the sectoral shifts of employment, which will boost productivity growth while ensuring workers' welfare. Moreover, to accelerate inclusive growth, sustained investments are needed in human capital development, especially in health and education, and in sectors that create quality jobs.

⁷² El Niño in the Philippines, Food and Agriculture Organization of the United Nations, September 2015, Available online: www.fao.org/3/a-i4947e.pdf.

⁷³ <https://www.rappler.com/business/221037-moodys-hanjin-crisis-threatens-banks-credit-ratings>; and <https://www.philstar.com/business/2019/01/15/1885318/fitch-unit-hanjin-bankruptcy-unlikely-threaten-philippines-financial-stability>.

⁷⁴ World Bank (2018)



THE PROMISE OF HUMAN CAPITAL

Human capital is a critical driver of both economic growth and inclusion. The prospects for continuing economic growth in the Philippines will depend on expanding its high-skill services sector, which will require boosting human capital. The Human Capital Index (HCI) is a useful starting point for considering the country's human capital challenges. The HCI score of 0.55 for the Philippines indicates that due to shortcomings in human capital, a Filipino child born today will on average achieve only 55 percent of his or her potential lifetime earnings. Access to education and health care has improved in recent years due to reforms and increased public spending, but the Philippines continues to spend less on human capital investments than many other countries in the region. Key policy priorities to improve the country's human capital including making learning the central objective of the education system, leveraging expanded access to improve the quality of health care, and reducing the high level of child stunting.

THE PHILIPPINES CAN ACHIEVE ITS FULL POTENTIAL BY BOOSTING HUMAN CAPITAL

Advances in human capital—knowledge, skills, and good health—have driven economic growth and lifted millions of people out of poverty. The extraordinarily rapid ascent of the East Asian miracle economies was due in large part to their efforts to improve human capital. With rapid technological change, the wealth of nations has become closely tied to their level of human capital development. Investments in human capital serve a dual purpose: they accelerate future economic growth and increase opportunities for all Filipinos.

The risk that the Philippines may be left behind by technological change is high. Technology has made possible the tremendous expansion of the BPO sector in the Philippines, which has grown to constitute 7.8 percent of GDP in 2017. This success has generated hundreds of thousands of new jobs for those with basic skills. But many of those same jobs could be eliminated in just a few years as call center operators are replaced by automated computer systems with voice simulation and artificial intelligence. To maintain its success the BPO industry will have to upgrade into higher-skilled services. Likewise, across manufacturing and agriculture, processes are becoming increasingly technology and skill-intensive. Investments in human capital can ensure that the Filipinos are ready for the economy of tomorrow.

The World Bank launched the Human Capital Project (HCP) in 2018 in an effort to accelerate investments in human capital across the globe. The Philippine government was an “early adopter” of the Human Capital Project and is working with the World Bank to improve and implement the human capital initiatives of the Philippine Development Plan (PDP). The PDP recognizes the challenge posed by technological change and states the government must undertake “investment in human capital so that Filipinos are equipped to learn and adapt to new technology and the changing profile of society.”

This is especially important for realizing people’s aspirations for a prosperous and predominantly middle-class society by 2040.

The Human Capital Index developed as part of the HCP constitutes a useful starting point for understanding the challenges faced by the Philippines in an increasingly technology-intensive global economy. It quantifies the level of human capital that a child can expect to attain by age 18. The HCI consists of three components:

1. Survival: the proportion of children that survive from birth to school age;
2. Schooling: the number of “learning-adjusted” years of schooling a child born today is expected to complete; and
3. Health: a combination of the child stunting rate and the adult survival rate.

The index is designed to capture the impact of human capital on future productivity, earnings, and economic growth. The HCI uses an underlying theoretical framework that is based on the economic returns from good health and schooling. Figure 30 presents a conceptual version of the HCI.

The different components of human capital development are closely interrelated. For example, a child’s survival is determined by a country’s general health conditions. Also, a student’s nutrition is a key driver of success in school, as malnourished children risk limited cognitive development, which can lead to learning difficulties and early school dropout.

The overall HCI for the Philippines is above the average for lower middle-income countries but substantially below the average of countries in East Asia and Pacific (EAP). Globally, the Philippines ranked 84th out of 157 countries included in the HCI, with a score of 0.55. The HCI can be interpreted in two ways. One interpretation is that the country’s

Figure 30. The Human Capital Index shows the impact of current investments in children on future productivity.



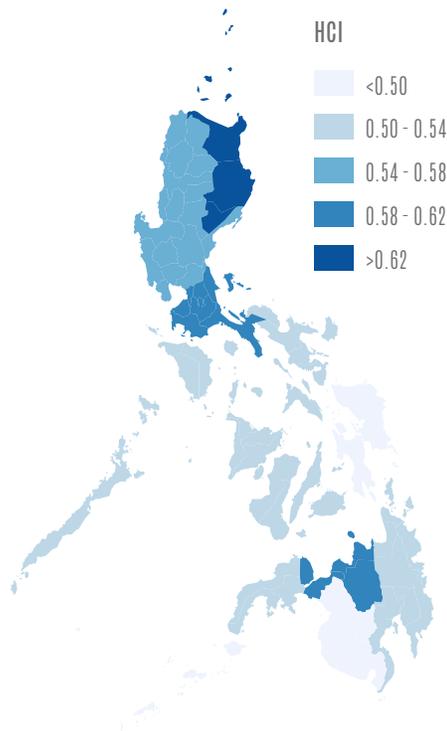
Source: World Bank

future GDP will reach 55 percent of what it could be, if the Philippines' of human capital were at the level of top performers like Singapore. An alternative interpretation is that an average Filipino child, in the absence of renewed efforts on human capital, will reach 55 percent of potential, in terms of productivity and lifetime income.

There are wide disparities in human capital in the Philippines. Region II (Cagayan Valley) has the highest average HCI score, while Bangsamoro

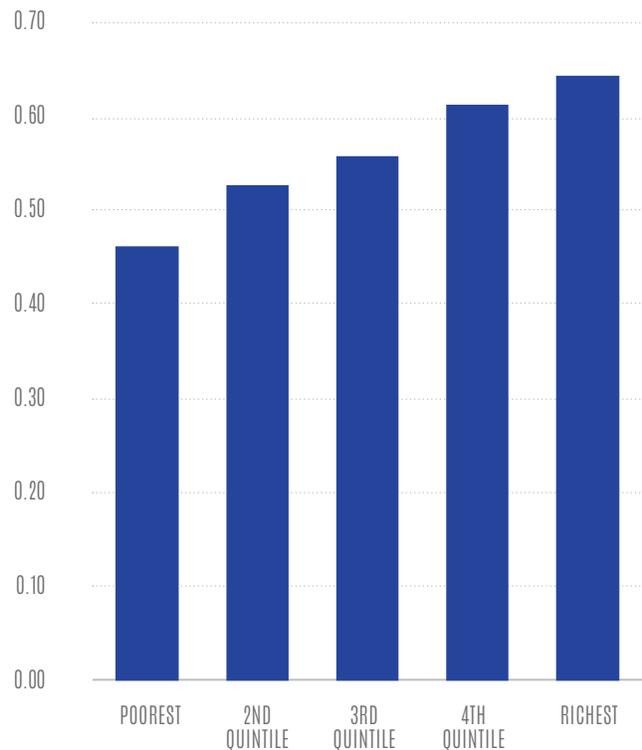
Autonomous Region of Muslim Mindanao (BARMM) has the lowest average score (Figure 31). As a result of limited human capital opportunities, children in BARMM, Eastern Visayas, and Soccsksargen will reach less than half of their potential future earnings when they reach adulthood. There is also a marked difference in the HCI between rich and poor households (Figure 32). Children who grow up in the wealthiest one-fifth of families accumulate 40 percent more human capital than those in the poorest one-fifth of households.

Figure 31. Human Capital Index by Region, 2017.



Source: World Bank staff analysis.

Figure 32. Human Capital Index by Socioeconomic Status, 2017.



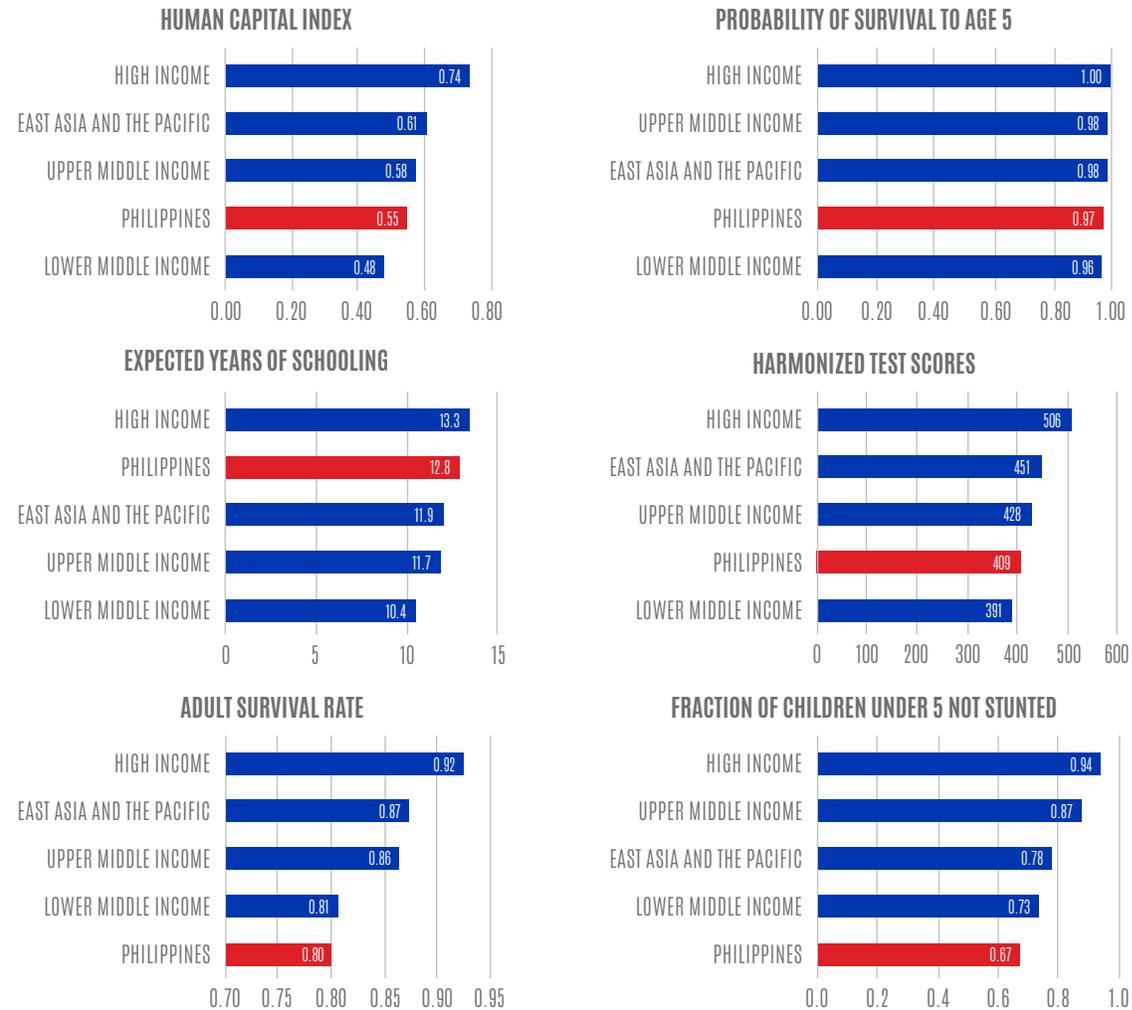
Source: World Bank staff analysis.

Philippine women fare better than men in all aspects of the HCI. Girls are slightly more likely to survive to the age of five and are less likely to be stunted than boys. They also stay in school longer and perform better on standardized tests, on average. As in most countries, Philippine women are also more likely than men to survive to the age of 60. As a result, the Philippines' overall HCI for women is 0.58, compared to 0.52 for men.

Human capital can be accumulated in early childhood, later childhood, and adulthood. In early

childhood—up to the age of five—the primary considerations are child survival and nutrition. In later childhood, human capital is acquired through education. Finally, adults maintain their human capital through good health. The remainder of this section examines human capital in the Philippines in these three life phases in light of the HCI and its subcomponents. Figure 33 shows a comparison of the values of the HCI and its subcomponents for the Philippines to the averages of the East Asia and the Pacific region and to other countries by income group.

Figure 33. The Human Capital Index and Its Subcomponents



Source: World Bank

NUTRITION IS THE WEAKEST LINK OF HUMAN CAPITAL FOR THE PHILIPPINES

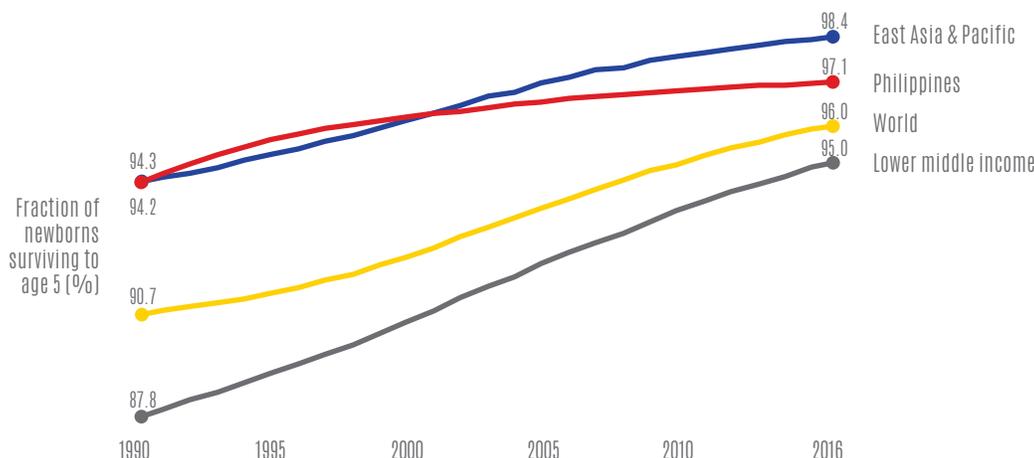
The most critical period for human capital development encompasses the early years of life. During the first 1,000 days, between conception and a child's second birthday, the foundation for optimum health, growth, and neurodevelopment is established. The HCI includes two separate components that capture a child's experience during this period: i) the child survival rate—the fraction of children who survive to the age of five—and ii) the fraction of children under the age of five who are not stunted.

The Philippines performs well in terms of child survival. Ninety-seven percent of Philippine children live to see their fifth birthday. This rate is slightly above the average of lower middle-income countries (95.0 percent) and has improved over time, from 94.3 percent in 1990 to 97.1 percent in 2016 (Figure 34). There are, however, disparities by wealth and geography. Children in the poorest 20 percent of households are nearly four times more likely to die before the age of five than children in the wealthiest 20 percent of families. The child survival rate is the lowest in Bangsamoro Autonomous Region of Muslim Mindanao (BARMM), where 5.5 percent of children die before reaching the age of five.

The levels of child malnutrition in the Philippines are shockingly high.⁷⁵ One in three children under the age of five is stunted—the principal marker of malnutrition—and stunting rates have been stagnant over a decade. Malnutrition is particularly severe among children in poor households. Half of children in the poorest income quintile are stunted, and one in five are severely stunted. These data points demonstrate one facet of intergenerational poverty: children who grow up in poor households are often inadequately nourished and more likely to suffer from limited cognitive and physical development, increasing the likelihood that they will suffer from poverty in adulthood.

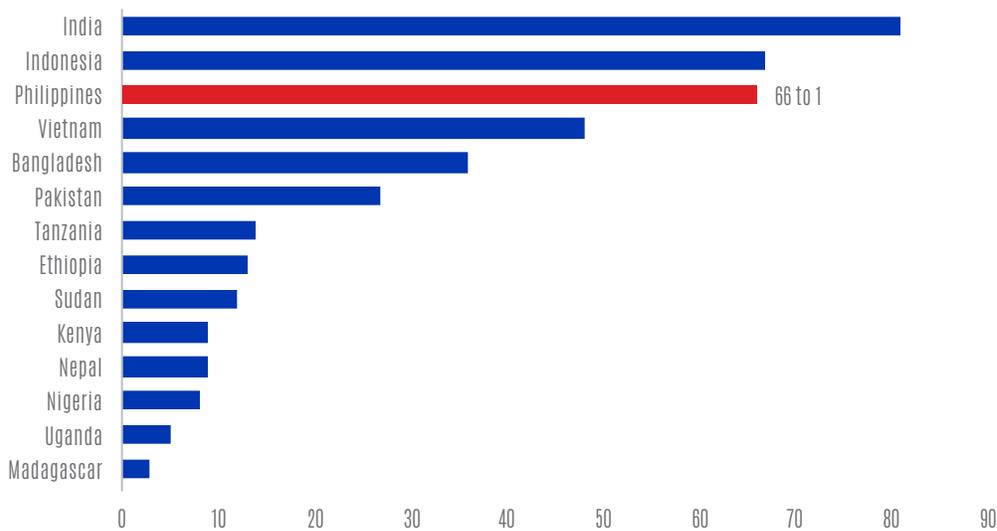
The Philippines has long-standing efforts to address the country's high malnutrition rates, however, the rate of stunting remains high. For example, the National Nutrition Council, the principal agency responsible for nutrition planning and policy, was created in 1974. The Philippines Development Plan highlights nutrition as a priority, and the 2017–2022 Philippine Plan of Action for Nutrition (PPAN) recommends a multisectoral combination of both nutrition-specific and nutrition-sensitive initiatives. However, the rate of stunting remains

Figure 34. Between 1990 and 2016, the probability a Filipino child survives to the age of five improved from 94 to 97 percent.



Source: World Development Indicators

⁷⁵ The term "malnutrition" refers to a deviation from optimal nutrition status and includes both overnutrition and undernutrition. Overnutrition represents an oversupply of nutrients relative to the body's physiological needs. Undernutrition refers to a state of nutritional deficiency and presents the most serious risks to health and development when experienced by women during pre-pregnancy/pregnancy/lactation, and infant and young children. There are a variety of measure of undernutrition. The discussion here focuses on one measure: child stunting, defined as low height-for-age in children under five years of age. Stunting results from chronic undernutrition and indicates a failure of a child to attain the height expected among healthy children.

Figure 35. Rates of Return on Investments to Reduce Stunting by Country

Source: Galasso and Wagstaff (2016).

stubbornly high. The initiatives outlined in the PPAN are in line with the recommendations based on global evidence, but implementation—which relies largely on effective action by health workers and policymakers at the local level—is uneven. The potential rate of return on investments to boost nutrition is extraordinarily high in the Philippines, as the estimated benefit is Php66 for every Php1 invested—the third highest rate of return across all countries surveyed (Figure 35).

Costs of Malnutrition

Evidence from countries around the world shows the high long-term costs of child malnutrition.⁷⁶ Childhood stunting is associated with adverse outcomes throughout life. Malnourishment and the diseases that cause stunting impede the development of young brains, resulting in impaired cognitive and socioemotional skills, which can lead to lower levels of schooling and less income when reaching adulthood. Additionally, children who are stunted are more likely to face health problems later in life, resulting in higher healthcare costs.

A study tracking children born in Cebu has estimated the long-term impact of malnutrition in the Philippines. Children who were not stunted in their early years performed significantly better in school.⁷⁷ They started school at a younger age, learned more during each year of schooling, were less likely to repeat grades, and stayed in school longer.⁷⁸ Children who were better nourished also had a higher IQ at the age of eight.⁷⁹ These effects endured into adulthood: those who were not stunted at a young age were more likely to hold formal sector wage jobs in their early 20s.⁸⁰ One recent study, which attempted to aggregate the costs of undernutrition in the Philippines, estimated that undernutrition costs the society 2.8 percent of GDP in terms of lower skills and productivity and 0.05-1.6 percent of GDP in additional healthcare costs.⁸¹ A separate study, using a different methodology, estimated the total economic burden of undernutrition in the Philippines at US\$4.5 billion per year—equivalent to 1.5 percent of GDP.⁸²

⁷⁶ Galasso and Wagstaff (2016) provides one recent survey of this evidence.

⁷⁷ Glewwe et al (2001)

⁷⁸ Daniels and Adair (2004) and Daniels and Adair (2005)

⁷⁹ Mendez et al (1999)

⁸⁰ Carba et al (2009)

⁸¹ Save the Children (2016)

⁸² UNICEF (2017)

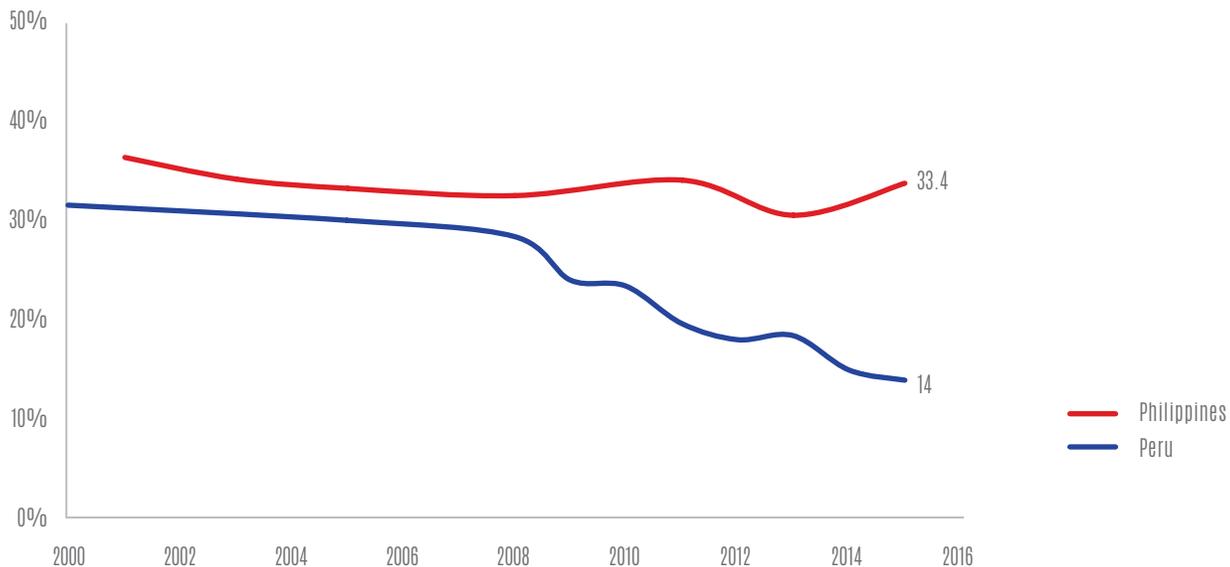
Drivers of Malnutrition

Malnutrition is driven by a complex mix of factors. A number of studies have examined the potential drivers of the high levels of stunting in the Philippines.⁸³ Factors include lack of breastfeeding, child nutrient deficiencies and low quality of diet, lack of access to clean water and sanitation, and high levels of adolescent pregnancy.

Poor health and nutrition of mothers before and during pregnancy is a key cause of child stunting. In 2015, one in four pregnant women in the Philippines were categorized as “nutritionally-at-risk,” and a substantial number of mothers were anemic or had iodine deficiencies. International research shows that a child with low weight at birth (less than 2.5 kg) is at very high risk of being stunted, and 14.5 percent of Filipino children had low birth weights.⁸⁴ Low birth weight is principally a consequence of the mother’s health and nutrition before and during pregnancy.

The view that stunting is principally due to genes is not supported by science. If genetic factors were the main cause of stunting, rates of stunting would be fairly constant over time. In reality, many countries—including China, Vietnam, Brazil, and Iran—have achieved rapid drops in stunting. One particularly relevant point of comparison for the Philippines is Peru. Up until 2008, Peru had a level of stunting similar to that of the Philippines (Figure 36). A common view in Peru at that time was that stunting was largely driven by genetic factors. Unlike the Philippines, Peru experienced a large drop over the following years, cutting the stunting rate in half. Factors in Peru’s successful fight against stunting include economic growth paired with strong and sustained leadership, effective use of communications tools to change behaviors, and multisectoral efforts including a conditional cash transfer program optimized for nutrition and a targeted financing mechanism. Spending focused on key interventions including vaccinations to reduce childhood infections, monitoring the growth of infants and young children, and promotion of feeding and hygiene practices at home.⁸⁵

Figure 36. Stunting Trends in the Philippines and Peru



Source: World Development Indicators and Food and Nutrition Research Institute (2016).

⁸³ Recent studies that discuss possible factors include Food and Nutrition Research Institute (2016) and Herrin (2016). Danaei et al (2016) estimates the importance of various drivers by comparing international evidence with national data.

⁸⁴ Source: Demographic and Health Survey (DHS) 2017. This figure is among the 84 percent of births for which a weight is reported by the DHS. Weight is reported for only 70 percent of children in the poorest wealth quintile. The actual percentage of children with low birth weight is likely higher.

⁸⁵ Marini and Rokx (2017)

LIMITED QUALITY OF EDUCATION GENERATES A LEARNING GAP

The HCI highlights that learning is not the same as schooling. Traditionally, education outcomes have been measured by how many years of schooling a child receives. But it is clear that what matters is not only how long a child is in a classroom but how much she learns while she is there. To reflect this point, the HCI combines two measures. The first is the number of years of schooling a child is expected to complete by her 18th birthday. The second is a measure of learning based on international student achievement tests. These two measures are combined to calculate “learning-adjusted years of schooling.” The adjustment reflects how far short a country falls in terms of learning relative to the best performing education systems.

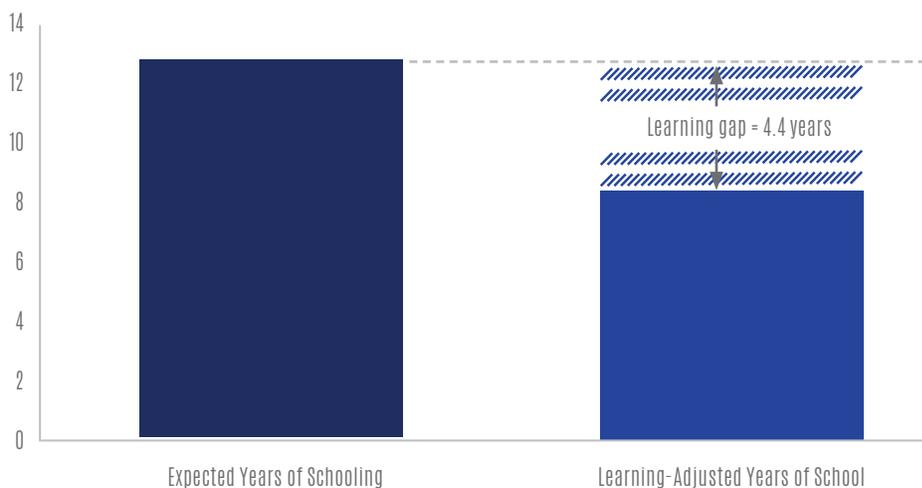
The Philippines compares quite favorably to regional peers in terms of the number of years of schooling a child today can be expected to complete. The expected years of schooling for a Filipino was 12.8 in 2017, significantly above the average of 11.9 years for EAP and 10.4 years for lower middle-income countries. The high level of expected schooling in the Philippines reflects major government efforts to increase access to education in recent years.

However, limited learning creates a gap between years of schooling and learning-adjusted years. Adjusting for how much children learn, 12.8 years of schooling in the Philippines is equivalent to just 8.4 years in the highest performing education systems, such as that of Singapore, resulting in a “learning gap” of 4.4 years (Figure 37). The Philippines’ learning gap is an indication that its education system is failing to provide full educational opportunities for its children.

There are also large disparities in educational opportunities between regions and socioeconomic groups in the Philippines. On average, a child born today in Cagayan Valley will complete nearly three additional learning-adjusted years of schooling than a child born in the BARMM.

The Philippines has implemented a series of reforms that have increased access to education and reduced drop-out rates. First, it has implemented a K-12 Basic Education Program, made kindergarten universal and mandatory, and added two additional years of senior high school to what was previously a 10-year education curriculum. The first cohort of senior high

Figure 37. Limited Learning Creates a “Learning Gap” between Expected Years of Schooling and Learning-Adjusted Years.



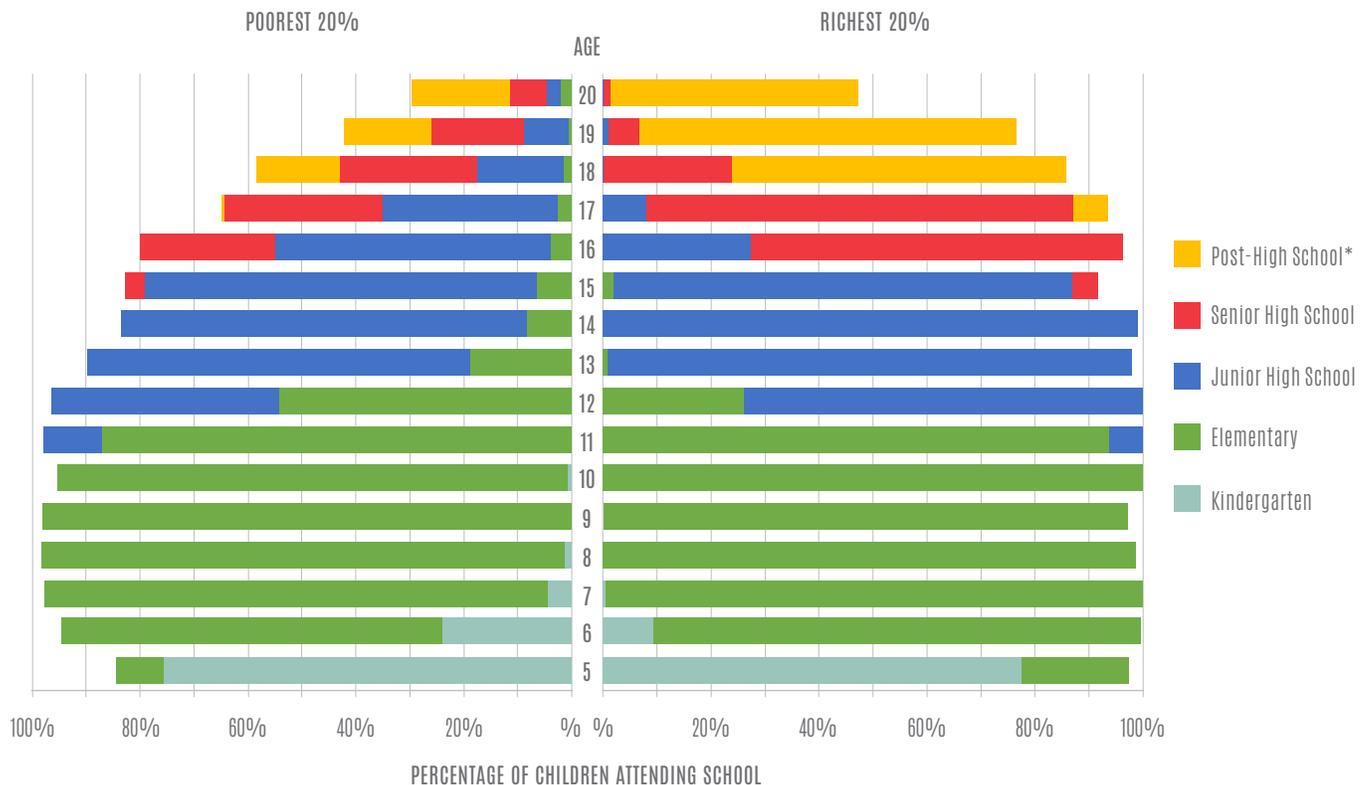
school students under the new program graduated in 2018. Second, the 2017 Universal Access to Quality Tertiary Education Act provides free tuition for all Filipino students enrolled in state or local universities or colleges. The Free Tuition Law also establishes a tertiary education subsidy to further support poor students by subsidizing their schooling if they enroll in private higher education institutions. Finally, the government expanded its conditional cash-transfer program *Pantawid Pamilyang Pilipino* to cover about 4.4 million identified households. The program helped raise enrollment rates to near universal levels for elementary-age children in beneficiary households and led to an increase in high school enrollment.

These efforts have greatly expanded enrollment rates. Nearly all Filipino children up to the age of 17 in the richest 20 percent of households were enrolled in school in 2017 (Figure 38). Even among students in the poorest income quintile, enrollment is close to universal for children up to age 12 and exceeds 80 percent for children up to age 16. A large number of children from the poorest households attended

senior high school in 2017-18—the first year in which the second year of senior high school existed. While there has been no full evaluation of the impact of the K-12 expansion, initial evidence suggests that it raised the enrollment rates substantially, particularly for poorer students.

Educational enrolment, completion, and attainment rates are low in conflict-affected areas. In 2014-15, the average achievement test score for grade six students in BARMM was 60 percent, and it was 41 percent for fourth year high school students, compared to the national averages of 69 percent and 50 percent, respectively. Repeated cycles of armed violence have damaged many education and health facilities. The region also suffers from low levels of public spending and poor service delivery, and regional authorities find it difficult to attract qualified teachers since many areas are remote and insecure. A 2015 study found that school closures were prevalent in ARMM, and absence rates are high for both teachers (31 percent) and students (29 percent).⁸⁶

Figure 38. School Enrollment Rates by Age for the Poorest 20% and Richest 20%



Source: Staff estimates using 2017 APIS
*includes technical-vocational education and training, college and post college

⁸⁶ Making Education Spending Count for the Children of Autonomous Muslim Region of Mindanao: Public Expenditure and Institutional Review for ARMM Basic Education (2015).

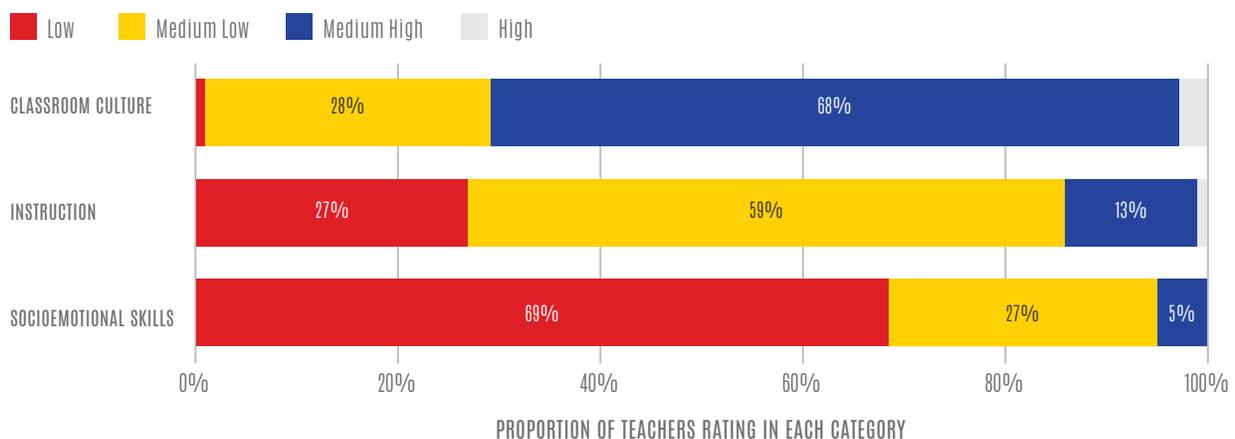
The principal challenge for the Philippine education system is to ensure that children learn. The Trends in International Mathematics and Science Study (TIMSS) and the Programme for International Student Assessment (PISA) are two major international standardized tests. The Philippines last participated in TIMSS in 2003 and joined PISA for the first time in 2018. The 2003 TIMSS was administered separately for students in grade four and grade eight. Among the 25 countries for which a fourth-grade test was administered, the Philippines ranked 23rd in both mathematics and science. Among the 45 participating countries in the eighth-grade test, the Philippines ranked 42nd in mathematics and 41st in science.⁸⁷ Available data suggest that school quality remains a key concern for educational outcomes in the Philippines. While it is likely that school quality has improved somewhat since the 2003 TIMSS was administered, results from national achievement tests suggest that quality improvements have been modest.

The 2018 PISA offers a critical opportunity to identify areas where the education system is succeeding and where more effort is needed to boost learning. Results from the exam will be publicly available in December 2019. The results will provide an updated assessment of the relative performance of the Philippine system to other countries. Additionally, a detailed analysis of the rich PISA data can identify the key constraints to learning and help prioritize efforts.

Teacher knowledge and skills are a core constraint to improving learning outcomes. Unlike in many other countries, Philippine teachers have low absenteeism rates. However, they have on average insufficient knowledge of the subjects they teach and are poorly prepared in terms of pedagogical techniques. In tests administered to teachers in the subject areas they teach, a majority of teachers in both grade six and ten answered less than half of the questions correctly, with the one exception of sixth-grade teachers in English who demonstrated relatively strong performance.⁸⁸ A recent study of teacher methods based on classroom observations in Mindanao found that most teachers scored “high” or “medium high” in terms of creating a supportive classroom culture. However, a majority were categorized as “low” or “medium low” in terms of quality of instruction, and most rated in the bottom category in fostering socioemotional skills (Figure 39).⁸⁹

Despite increased demand for socioemotional skills in the job market, school curricula devote little attention to developing these skills. Socioemotional skills are important for acquiring other technical and cognitive skills, including an ability to focus on tasks, articulate arguments, communicate effectively, learn to listen, work with others, and mature emotionally. Furthermore, these types of skills are often linked to an ability to observe professional etiquette in the workplace and follow work-specific rules and guidelines. Socioemotional skills are rewarded in the job market, especially for women and youth.⁹⁰

Figure 39. Results from the TEACH Classroom Observation Study



Source: World Bank (forthcoming)

⁸⁷ Because of the lack of a more recent TIMSS or PISA score, the HCI for the Philippines made use of a separate exam, namely the 2013 Early Grade Reading Assessment (EGRA) administered to a nationally representative sample of children in Grade 3. The EGRA score was transformed into a “TIMSS-equivalent” value using a statistical technique that exploits the correlation between EGRA and TIMSS scores in countries where both tests were administered. Details can be found in Patrinos and Angrist (2018).

⁸⁸ World Bank, 2016.

⁸⁹ World Bank, 2019.

⁹⁰ Acosta et al (2017)

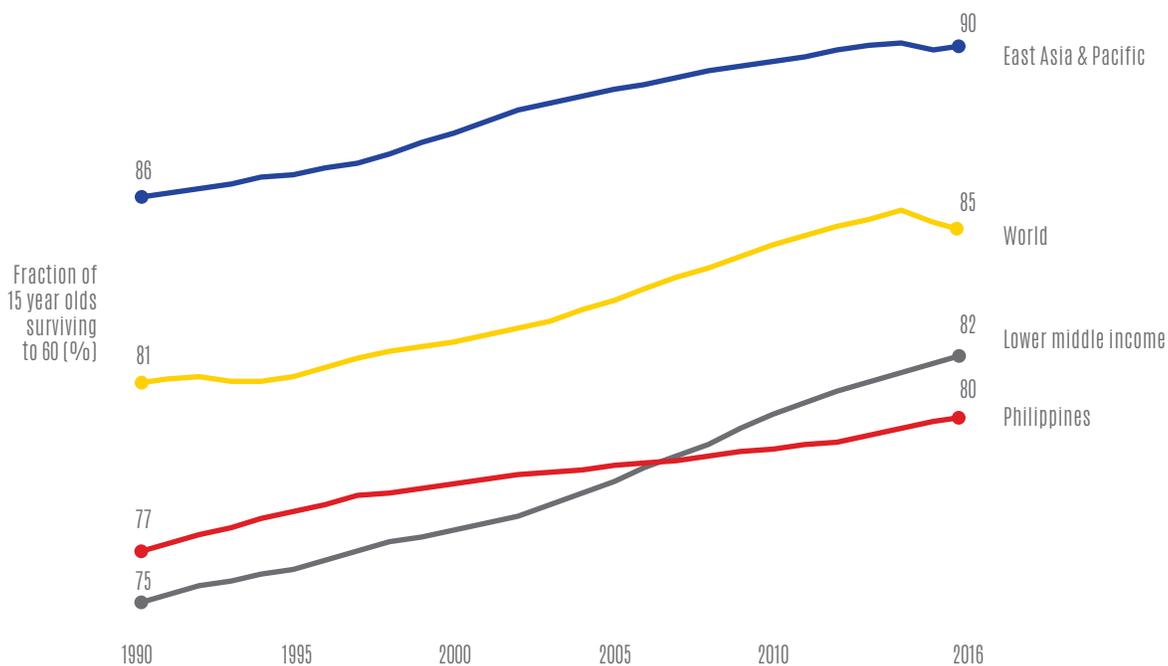
OUT-OF-POCKET HEALTH EXPENDITURE AND QUALITY OF CARE REMAIN CHALLENGES

In addition to child survival and malnutrition rates, the HCI includes the adult survival rate (ASR) as a proxy for overall health conditions. The Philippines' ASR—the percentage of the population alive at the age of 15 that survives to the age of 60—was 80 percent in 2017—below the average of 81 percent for lower middle-income countries and substantially below the average of 87 percent for EAP countries. The ASR in the Philippines is much higher for women (87 percent) than men (74 percent). At current age-specific mortality rates, three in four Filipino men will survive from the age of 15 to the age of 60. This relatively low survival rate likely reflects weak overall health services for much of the population.

Access to healthcare in the Philippines has improved in recent years, particularly among poor households.

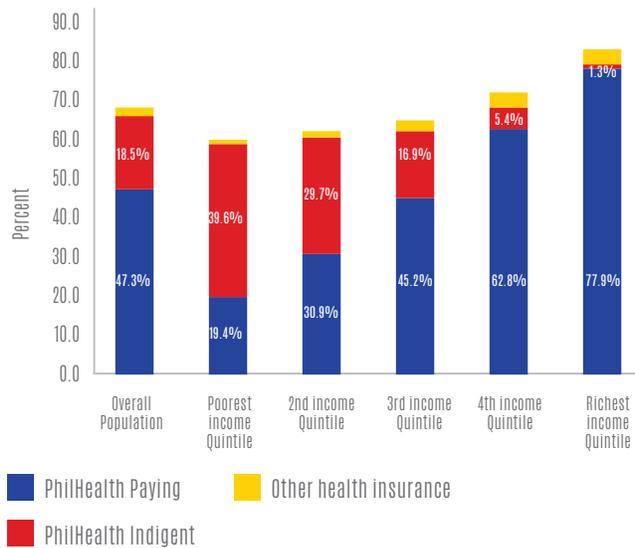
The country expanded its health insurance scheme—the Philippine Health Insurance Corporation (PhilHealth)—with higher taxes on cigarettes and alcohol beginning in 2013. This reform increased coverage and widened the benefits package to include outpatient services. As a result, the portion of the population with some health insurance coverage rose dramatically, from 38 percent in 2008 to 66 percent in 2017 (Figure 41). While PhilHealth is supposed to provide universal coverage for the poor, many poor households report not having health insurance. The reasons for this include a lack of knowledge and exclusion errors and other inefficiencies in the rollout and implementation of the program.⁹¹ The recently approved Universal Health Coverage Law represents a renewed effort by policymakers to expand equitable and affordable access to healthcare.

Figure 40. Four out of five Filipino 15-year-olds will survive to the age of 60



Source: World Development Indicators

⁹¹ Brederkamp et al, 2016.

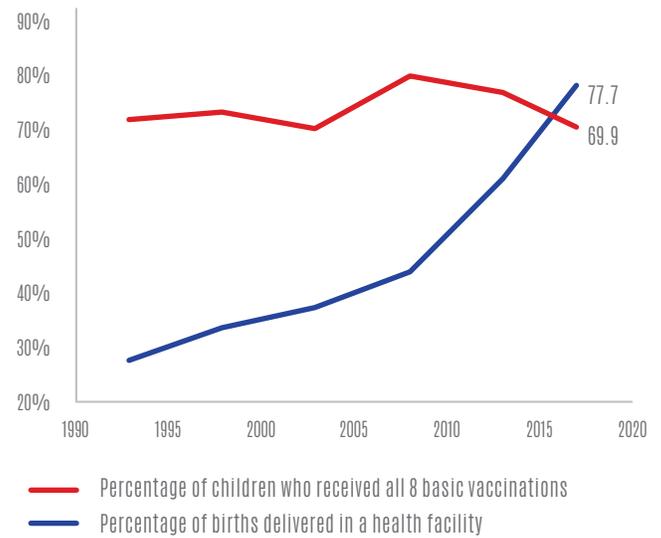
Figure 41. Health Insurance Coverage, 2017

Source: 2017 Demographic and Health Survey

The impoverishing impact of out-of-pocket health expenditures remains high, pushing vulnerable and poor households deeper into poverty. The share of the population that fell into poverty because of health spending has doubled over the past decade. Despite the national health insurance program, households' out-of-pocket health expenditures totaled 54 percent of total health expenditures in 2016.

Philippine households also face a triple burden of disease. First, non-communicable diseases contribute increasingly to mortality and morbidity in the Philippines, and the country's health system needs to improve its ability to manage chronic diseases. Second, communicable, maternal, neonatal, and nutritional diseases remain a challenge for the health system. Finally, increasing levels of urbanization have forced the government to focus on diseases associated with highly urbanized communities.

Leveraging expanded access to improve the quality of service delivery is a core challenge. The number of Filipino children born in health facilities more than doubled in the last two decades, from 28.3 percent in 1993 to 77.7 percent in 2017, mainly as a result of the massive expansion of health insurance coverage (Figure 42). However, vaccination rates—a

Figure 42. Birth Trends in Facilities and Vaccination Rates

Source: Demographic and Health Survey data

rough proxy for the overall functioning of the health system—fell in the same period. The portion of young children who had received all eight basic vaccinations initially increased from 71.5 percent in 1993 to 79.5 percent in 2008, before falling to 69.9 percent in 2017. Alarmingly, only 9.0 percent of children had received their basic vaccinations in ARMM in 2017. While the country's low vaccination rate is a concern in itself, it also illustrates weaknesses in overall health service delivery.

Rural health units (RHUs) in poor areas perform worse than their wealthier counterparts in terms of service readiness. RHUs in the wealthiest 40 percent of municipalities have better quality infrastructure, more basic equipment, and higher diagnostic capacity than units in municipalities in the poorest quintile. In particular, RHUs in BARMM lack key inputs to effectively deliver services, including essential medicines.⁹² Policymakers need to improve access to health units and the quality of care, especially in poor rural areas. Concurrently, the broader health sector requires reform to increase efficiency and sustainability of health financing, and the integration of service delivery to provide continuity of patient-centered care. Implementation of the ambitious new Universal Health Coverage Law provides an opportunity for the government to address these various challenges.

⁹² Morimoto, T. et al., Supply-Side Readiness of Primary Health Care in the Philippines, 2017 and Morimoto, T. et al. "Supply-Side Readiness of Primary Health Care in ARMM" (forthcoming) A forthcoming study conducted in ARMM in 2017 that compared the same indicators as the earlier national survey show that ARMM scored lowest among the regions in seven out of eight tracer conditions.



Box 8. Tools for Boosting Human Capital: The *Pantawid Pamilyang Pilipino Program*

The national conditional cash-transfer program *Pantawid Pamilyang Pilipino* has played a key role in increasing human capital of children and reducing the extent and incidence of poverty in the Philippines. The cash-transfer program expanded rapidly in 2007–15, increasing its coverage from 6,000 households in 2007 to 4.4 million in 2015, and has become the primary government social assistance program for the poor. It extends cash grants to 77 percent of the country's poor households and contributes both to reducing poverty and building human capital. Its budget accounted for 0.5 percent of GDP in 2018.

The *Pantawid Pamilyang Pilipino Program* has raised school enrollment rates for older children, encouraged early childhood education, and increased the health-seeking behavior of beneficiaries. Studies show that gross enrollment rates for high school students from beneficiary households is 6 percent higher than those for students from non-beneficiary households, and the program has contributed to reducing severe stunting among beneficiary children by up to 10 percentage points.

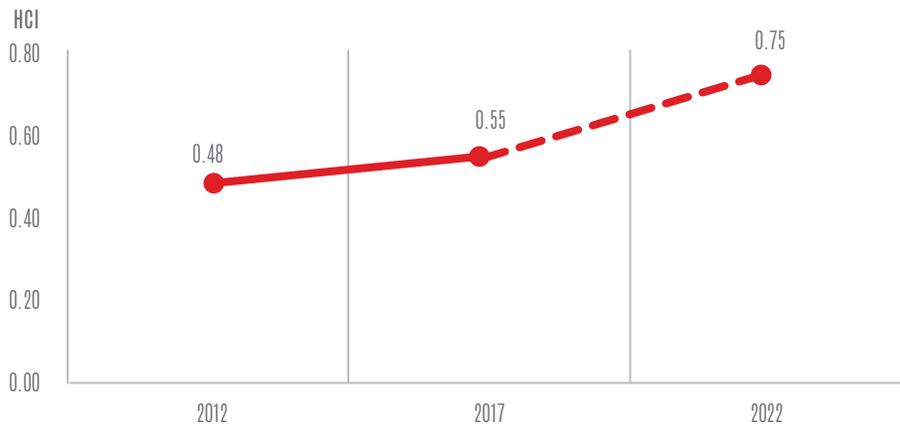
Beneficiaries of the cash-transfer program are selected using the National Household Targeting System for Poverty Reduction, or *Listahanan*, which uses a proxy means test methodology to estimate a household's level of economic welfare based on socioeconomic and demographic indicators. Aside from the *Pantawid Pamilyang Pilipino Program*, *Listahanan* has been used extensively to identify poor and near-poor beneficiaries of PhilHealth and other social programs. The Department of Social Welfare and Development is scheduled to update its database in 2019, which will be important to ensure that *Listahanan* is able to effectively target households and contribute to an improvement in the delivery of social services and the efficient allocation of human capital investments.

KEY POLICY LEVERS FOR HUMAN CAPITAL

There are a large number of initiatives in the Philippines focused on boosting human capital development. Specific initiatives include the Philippines Plan of Action for Nutrition, the new Philippines Professional Standards for Teachers, the new Universal Health Coverage Law, and ongoing efforts to improve the *Pantawid Pamilyang Pilipino Program*. The principal challenge facing policymakers is the effective implementation of these initiatives. If the country were to achieve all the human capital-related goals in the PDP, its HCI would increase to 0.75 by 2022, which would imply a 36 percent increase in the Philippines' future productivity and GDP (Figure 43).

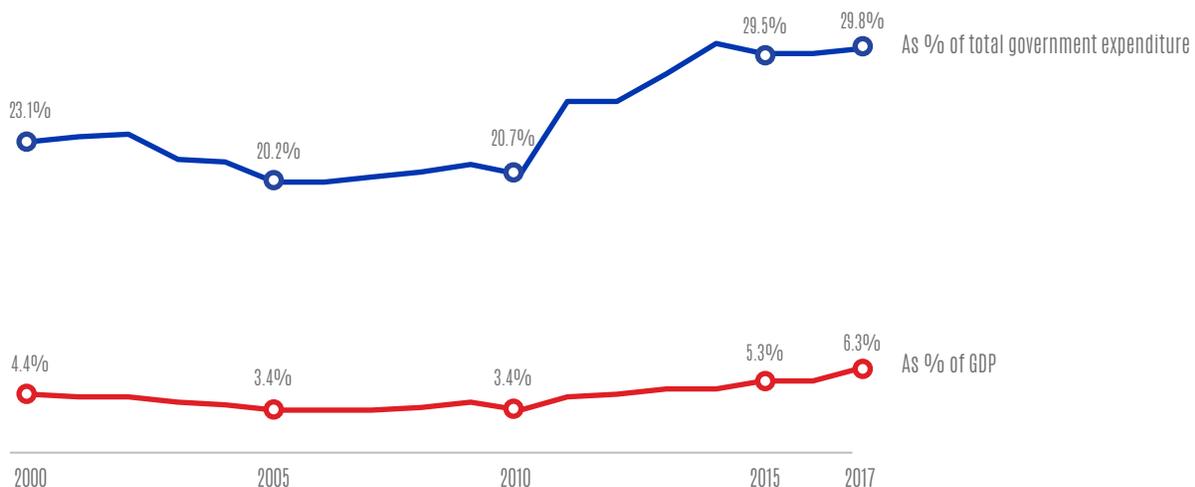
A necessary but not sufficient condition for improving human capital will be to sustain a high level of investment in relevant initiatives. Government human capital spending has increased in recent years both as a percentage of total government expenditure (rising from 20.7 percent in 2009 to 29.8 percent in 2017) and as a percentage of GDP (increasing from 3.4 percent in 2009 to 6.3 percent in 2017) (Figure 44). This improvement reflects the expansion of the *Pantawid Pamilyang Pilipino Program*, the growth of PhilHealth, and increases in education spending. Nonetheless, human capital spending as a percentage of GDP remains low compared to most other countries in the region.

Figure 43. Reaching PDP targets by 2022 would lead to a significant improvement in productivity and economic growth.



Source: World Bank staff analysis.

Figure 44. Human capital spending has increased over time, outpacing GDP growth.



Note: Human capital expenditures are defined as the total spending across the following sectors: (1) Education, culture and manpower development, (2) Health and (3) Social security, welfare and employment.
Source: DBM, PSA.



The Philippines' performance on the HCI points to three policy priorities to improve the country's human capital. The first is to make learning the central objective of the entire education system. This orientation can motivate implementation of the country's many education initiatives, including the Philippine Professional Standards for Teachers. The second priority is to tackle malnutrition of women and young children. The extreme level of child stunting is a drag on the country's economic growth potential. Although the government has a Philippines Plan of Action for Nutrition, and awareness about the issue is rising, wide recognition of how critical addressing this issue is to the country's future is missing. A third priority is leveraging expanded access to improve the quality of health care. Implementation of the Universal Health Coverage Law will provide this opportunity.

Greater use of data by both the government and outside researchers would make for more effective human capital programs. The Philippines collects extensive data that is not fully exploited for policy planning. For example, health administrative data and data from the Enhanced Basic Education

Information System is underutilized and could be a valuable tool for policymakers. Additionally, making timely data more widely accessible to outside researchers would catalyze work to inform policy. For example, microdata from the National Nutrition Survey could yield insights on how to address the country's nutritional challenges if were made more readily available to a broader audience. The Open Data Initiative of the Philippines Statistics Authority has improved access to survey data, but publicly available data from many agencies is outdated.

The Philippines economic future will be determined by the investments the country makes in its children. Many Filipinos born in 2019 will witness the dawn of the 22nd century, and live and work in a world very different from the Philippines of today. Although the future is inherently uncertain, it is clear that rapid technological advances will make knowledge, skills, and good health essential to success for both individuals and the country as a whole. Effective implementation of the government's human capital initiatives will make it possible for the Philippines and all Filipinos to achieve their full potential.

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