PHILIPPINES DEVELOPMENT REPORT 2009

Battling the Global Recession :

Maintaining Macroeconomic Stability,
Ensuring Social Protection,
and Preparing for the Recovery

The World Bank Group in the Philippines

Making Growth Work for the Poor

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PHILIPPINES DEVELOPMENT REPORT 2009
MANAGING THE GLOBAL RECESSION, PREPARING FOR THE RECOVERY

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CURRENCY EQUIVALENTS

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Currency Unit = Philippine Peso (PHP)
P1.00 = US$ 0.022
US$ 1.00 = P46.33

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ACRONYMS AND ABBREVIATIONS

ADB	Asian Development Bank	HGC	Home Guaranty Corporation
APEC	Asia-Pacific Economic Cooperation	IBRD	International Bank for Reconstruction and Development
ASEAN	Association of South East Asian Nations	ICC	Investment Coordination Committee
BIR	Bureau of Internal Revenue	ILO	International Labor Organization
BOC	Bureau of Customs	IMF	International Monetary Fund
BOI	Board of Investments	IPP	Independent Power Project
BOP	Balance of Payments	IPPAs	IPP Administrators
BOT	Build-Operate-Transfer	IRA	Internal Revenue Allotment
BPO	Business Process Outsource	ITR	Income Tax Return
BSMED	Bureau of Small and Medium Enterprise Development	KALAHI-CIDSS	Comprehensive and Integrated Delivery of Social Services
BSP	Bangko Sentral ng Pilipinas (Central Bank)	LBP	Land Bank of the Philippines
BTr	Bureau of Treasury	LFS	Labor Force Survey
CAG	Corporate Affairs Group of DOF	LGUs	Local Government Units
CAR	Cordillera Administrative Region	LPI	Logistics Performance Index
CALABARZON	Cavite, Laguna, Batangas, Rizal and Quezon	LRTA	Light Rail Transit Authority
CB-BOL	Central Bank Board of Liquidators	LWUA	Local Water Utilities Administration
CCT	Conditional Cash Transfer	LTS	Large Taxpayers Service
CIIP	Comprehensive and Integrated Infrastructure Program	MDGs	Millennium Development Goals
CLEEP	Comprehensive Livelihood and Emergency Employment Program	MRTC	Metro Rail Transit Corporation
CLN	Credit-linked Notes	MRT3	Metro Rail Transit – 3
COLA	Cost of Living Allowance	MSMEs	Micro, Small and Medium Enterprises
COA	Commission on Audit	MTPDP	Medium-Term Philippines Development Plan
CSC	Civil Service Commission	MTPIP	Medium-Term Philippines Investment Plan
CPI	Consumer Price Index	MVUC	Motor Vehicle User's Charge
CSOs	Civil Society Organizations	MWSS	Metropolitan Waterworks and Sewerage System
DBM	Department of Budget and Management	NAIA	Ninoy Aquino International Airport
DBP	Development Bank of the Philippines	NAPC	National Anti-Poverty Commission
DIF	Deposit Insurance Fund	NCR	National Capital Region
DOF	Department of Finance	NDC	National Development Company
DOLE	Department of Labor and Employment	NEDA	National Economic and Development Authority
DOTC	Department of Transportation and Communications	NFA	National Food Authority
DepED	Department of Education	NFPS	Non-Financial Public Sector
DPWH	Department of Public Works and Highways	NG	National Government
DRMO	Debt and Risk Management Office	NHA	National Housing Authority
DTI	Department of Trade and Industry	NIA	National Irrigation Authority
EPIRA	Electric Power Industry Reform Act	NPC	National Power Corporation
EPI	Expanded Program on Immunization	NPL	Non Performing Loan
ERC	Energy Regulatory Commission	NSCB	National Statistical Coordination Board
ERP	Economic Resiliency Plan	NSO	National Statistics Office
FAO	Food and Agriculture Organization	OFW	Overseas Filipino Worker
FDI	Foreign Direct Investment	OTOP	One Town One Product One Million Pesos Program
FIES	Family Income and Expenditure Survey	PDF	Philippines Development Forum
GDP	Gross Domestic Product	PDIC	Philippine Deposit Insurance Corporation
GFI	Government Financial Institution	PDR	Philippine Development report
GIR	Gross International Reserves	PEFA	Public Expenditure and Financial Accountability
GNP	Gross National Product	PEZA	Philippine Economic Zone Authority
GOCC	Government-Owned and –Controlled Corporation	PNOC	Philippine National Oil Company
GSIS	Government Service Insurance System	PNR	Philippine National Railways
GOP	Government of the Philippines	PPP	Public-Private Partnership

ACRONYMS AND ABBREVIATIONS (Continued)

POEA	Philippine Overseas Employment Administration
PSALM	Power Sector Asset and Liabilities Management
PWPs	Public Works Programs
QFA	Quasi-Fiscal Activity
Quedancorp	Quedan and Rural Credit Guarantee Corporation
RA	Republic Act
SME	Small and Medium Enterprise
SSS	Social Security System
SULONG	SME Unified
SWS	Social Weather Station
TESDA	Technical Education and Skills Development Authority
TCCs	Tax Credit Certificates
TIDCORP	Trade and Investment Development Corporation
UCPB	United Coconut Planters Bank
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Program
VAT	Value Added Tax
WB	World Bank

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ACKNOWLEDGEMENTS

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The Philippines Development Report (PDR) is usually published as a background document to the Philippines Development Forum (PDF). Although in 2009 no PDF eventually took place, we feel that the analysis and the recommendations contained in the present report are still highly relevant.

PREFACE

i. While the Philippine was not spared by the global financial crisis and the ensuring global recession its economy proved resilient nonetheless. As the economy entered the global crisis from better initial conditions than in previous global or regional shocks, it weathered the global turmoil comparatively better than most comparator countries. To battle the global recession, the authorities introduced large and timely measures but important challenges for macroeconomic stability, social protection, and inclusive growth lie ahead.

ii. Large fiscal risks and limited assessment, analysis and management of these risks threaten the sustainability of the macroeconomic stability achieved by the Philippines; this would negatively affect the poor. There is a pressing need to strengthen the legal framework and institutional structure for risk management and the coverage, quality, analysis and dissemination of data on fiscal risk, including through the regular publication of a fiscal risk statement.

iii. Contrary to consensus forecast, remittances have been resilient during the global financial crisis and recession. At the onset of the global recession, most analysts predicted a contraction in remittance inflows. Past crises reveal that remittances have been counter-cyclical thanks to the country's extensive overseas workforce diversification, but that they fell significantly whenever the host country and the Philippines were simultaneously in a recession. As remittances continued to grow in 2009, the diversification effect seems to have been a dominating factor. Measures to improve the investment climate, tackle infrastructure bottlenecks and improve SMEs' access to finance could help to increase the development impact of remittances and promote their efficient use. Systematic tracking of returning OFWs would greatly improve monitoring and assistance during an economic downturn.

iv. High levels of poverty and vulnerability in the Philippines allow the impacts of the global recession to easily permeate the socio-economic fabric. While the global recession did not generate a recession in the Philippines, it is nonetheless estimated to be responsible for pushing 1.4 million Filipinos into poverty by 2010 (compared to the pre crisis estimates). The government was quick to respond to mitigate the adverse impacts of the crisis by introducing a stimulus plan and prioritizing spending on social protection. However, further prioritization and enhancements would improve the Philippines' social safety net.

v. A persistent and important challenge is the long term decline in the country's investment ratio. A weak investment climate, and in particular weak governance and business enabling environments account for a large part of this structural problem, as is the poor quality of infrastructure. The recent push for upgrading infrastructure as part of the fiscal stimulus package is welcome. Effective and efficient implementation of the additional resources as well as sustaining the efforts over time (including with private sector participation) will be critical to overcoming the existing infrastructure bottlenecks and boost the growth potential of the Philippine economy. To improve the quality and inclusiveness of the recovery, it is critical that micro, small, and medium enterprises can obtain better access to credit—which currently is both structurally and cyclically challenging for them.

EXECUTIVE SUMMARY

1. **The 2009 Philippines Development Report (PDR) builds on its predecessors and looks to the unique economic, financial, social and political landscape shaping up in 2009 and 2010**. The titles of the previous PDRs reflect the evolving nature of key economic and social issues confronting the Philippines: *From Short-Term Growth to Sustained Development* (2005); *Consolidating Fiscal Reforms for Sustained Growth and Poverty Reduction* (2006); *Invigorating Growth, Enhancing its Impact* (2007); and *Accelerating Inclusive Growth and Deepening Fiscal Stability* (2008). As the global environment is beset by shocks of historical proportions, the 2009 report focuses on *Managing the Global Recession, Preparing for the Recovery.*

2. **As with previous PDRs, the 2009 report is structured around and aligned with the government's 2004-2010 Medium-Term Philippine Development Plan** (MTPDP). Key pillars of the MTPDP are fiscal stability and consolidation (aiming towards a balanced national government budget, a small non-financial public sector deficit, and reducing the public sector debt-to-GDP ratio), increased competitiveness through improved governance, better infrastructure, improved human capital (through improved service delivery in health and education).

3. **However, as the global recession gathered momentum, the government's goal for 2009 focused on a fiscal stimulus package** (the Economic Resiliency Plan—ERP). The ERP called for a postponement of some MTPDP targets so as to achieve three overarching objectives, namely:

- Maintaining macro-economic stability;
- Ensuring social protection for the poorest and most affected citizens; and
- Preparing the economy for the recovery.

The 2009 Philippines Development Report is itself structured along these three overarching objectives.

MAINTAINING MACRO-ECONOMIC STABILITY

4. **The global recession did not spare the Philippines but the economy proved resilient thanks to stronger fundamentals, prompt policy measures, and continued remittance inflows** (Chapter 1). In 2009, while the Philippines posted its worst growth performance since the Asian financial crisis it nonetheless avoided a recession, contrary to most countries in the region. In contrast with past slowdowns, the country entered the global recession with relatively sound fundamentals—a current account surplus, and relatively sound finances for both the banking and, to a lesser extent, corporate sectors. Weaknesses, however, include public finances, a weak labor market and social protection system in a country with persistently high poverty. Prompt and significant fiscal and monetary policy measures helped buffer the economy. With its large exposure to remittance flows (that critically sustain most parts of the economy), the Philippines seemed particularly vulnerable to a global recession. Extensive diversification of its overseas workers likely played an important role in avoiding a contraction in remittance inflows in 2009.

5. **The monetary and financial authorities introduced timely, comprehensive, and effective measures to mitigate the global crisis' impact on the Philippines** (Chapter 1). Policy measures have tackled several stress points brought by the global financial crisis: maintaining the stability of the financial system, maintaining liquidity and confidence in the banking system, and conducting a monetary policy that, subject to price stability, is supportive of growth. Key financial stability measures include relaxed rules to enable banks to avoid mark-to-market losses on their government bond holdings and the opening of a US dollar repo facility to augment dollar liquidity in the foreign exchange market. Key monetary policy measures include cutting the key policy rate by a total of 200 basis points from December 2008 to July 2009 (bringing the policy rate to a record low at 4.0 percent), and targeted measures aimed at removing bottlenecks in the flow of private sector credit to the economy.

6. **To support an inclusive and sustainable recovery, a key challenge for the BSP (central bank) is to time and pace the exit strategy** (Chapter 1). The continuing challenge as the economy moves towards a likely slow growth recovery is to make accommodative policies and relaxed regulatory forbearance work without encouraging unacceptable risk-taking. Ultimately, the accommodative monetary policy measures will need to be reversed. This poses challenges as the strength of the underlying economic recovery is uncertain and uneven, the global environment remains subject to large risks, and commodity prices—especially food and fuel—could surge anew. Notwithstanding the above challenges, strong monetary policy credibility, a resilient banking system, and large foreign exchange reserves facilitate the return to a neutral monetary policy stance.

7. **To battle the recession, the government introduced a large and well-conceived fiscal stimulus plan ("ERP") thereby avoiding a recession** (Chapter 1). With a fiscal easing at the national government level of 2.6 percent of GDP from 2008 to 2009, the stimulus impact of the ERP was the largest on record since the 1986 People Power revolution and helped steer the economy away from recession. However, given limited fiscal space, the ERP has to be cost-effective, temporary and nested within a credible medium-term fiscal framework. This will ensure that the pace of the unwinding of the fiscal stimulus will be commensurate to the recovery in the private sector. However, unless promptly addressed, a structural decline in the tax effort—due to a series of large permanent tax cuts—risks undermining the counter-cyclical expenditure efforts and limiting the fiscal multiplier impact of the ERP.

8. **A comprehensive assessment of fiscal risks in the Philippines reveals diverse and large risks whose realization are likely to increase due to the global recession** (Chapter 2). Fiscal risks in the Philippines originate from a variety of sources, including macro-economic variables, the level and structure of the public debt, and contingent liabilities. These risks have been material in the past and, at times, have been the main drivers of debt and deficits. As a result, although debt is estimated to be broadly sustainable (assuming the deficit be brought to balance over the medium term), there is a non trivial probability that the national government debt could exceed 80 percent of GDP by 2013. International experience reveals that fiscal risks are particularly prone to materialize during periods of economic slowdown. 2009 is therefore a timely year for establishing a comprehensive fiscal risk profile of the Philippines. In the short-term, decreasing fiscal risk can be achieved by improving the institutional setup for assessing, approving, managing, and disclosing fiscal risk.

9. **The resiliency of remittances to the Philippines during a global recession** (Chapter 3). Workers' remittances play a crucial role in the Philippines. The country is the fourth largest remittances recipient in the world in dollar terms behind China, India, and Mexico. At over 10 percent of GDP, remittances more than offset a large and persistent trade deficit and enables the country to post a current account surplus. Remittances also contribute to the stability of the banking system, domestic consumption and investment. Chapter 3 investigates whether remittances to the Philippines are likely to continue playing the counter-cyclical role they have played during previous downturns. The findings are that, during past crises: (1) the counter-cyclical behavior of remittances was the result of the country's extensive overseas workforce diversification; and (2) remittances fall significantly whenever the host country and the Philippines are simultaneously in a recession. With most countries facing a recession in 2009, remittances were projected by most analysts to decline in nominal terms. As remittance continued to grow in 2009, the diversification effect seems to have been a dominating factor (strong OFW deployment in 2008 undoubtedly played an important role too). Measures to improve the investment climate, tackle infrastructure bottlenecks and improve SMEs' access to finance (see below) could help to increase the development impact of remittances in the short-term and promote their efficient use in the medium-term.

ENSURING SOCIAL PROTECTION FOR THE POOREST AND MOST AFFECTED CITIZENS

10. **Recent global developments have revealed how vulnerable Filipino households are to economic shocks** (Chapter 4). The 2008 food and fuel price shock and the global recession have significantly increased households' vulnerabilities. To improve policies aims at protecting the poorest and most affected citizens, Chapter 4 establishes a household vulnerability map of the Philippines. It then investigates channels through which the global recession likely impacted Filipino households. These impacts, such as on the labor markets and on deployment opportunities for overseas foreign workers, are expected to be lagging the economic cycle and would therefore take longer to recover than, say, industrial production. As such, hard data on the impact of the crisis on the Philippines to date do not point comprehensively to a major aggregate impact. Nonetheless, specific segments of the population are severely affected. To be more effective in responding to crises, the government could (1) enhance social protection policies, such as establishing an objective and unified targeting system and a national poverty database, (2) support employment and earnings via job creation, public works programs, training, and flexible working hours, and (3) support investments in human capital by protecting funds for basic social services and ensuring their timely delivery.

11. **A specific and extensive focus on the social sector and poverty reduction is studied in details in a companion report to the 2009 PDR**; it is entitled *Fostering More Inclusive Growth*. This report delves into both the macro and the micro issues of inclusive growth and is a natural companion to the 2009 PDR in understanding key gaps in the social protection systems, labor market, and poverty reduction.

PREPARING THE ECONOMY FOR THE RECOVERY

12. **Improving the investment climate, infrastructure, and access to finance for SMEs would help prepare the country for an inclusive economic recovery** (Chapter 5). The country's structural inability to attract sufficient investment undermines medium-term growth prospects and the inclusiveness of growth (i.e., the extent to which all members of society are able to share the growth benefits). A weak investment climate, and in particular weak governance and business enabling environments are key structural issues. The global recession and domestic slowdown adds opportunities, challenges, and urgency to these issues—opportunities include the large infrastructure outlays included in the government's fiscal stimulus package; challenges include maintaining and ultimately boosting access to finance for SMEs which during times of prosperity are already finding such access difficult; finally, the global crisis adds urgency to these issues as a downturn, if not tackled through rapid and appropriate policy measures, could generate irreversibilities. These could include the closure of otherwise viable SMEs as they cannot finance themselves, or the speeding up of re-allocation of FDI towards countries with a better investment climate as global operations are being revisited almost from a blank page since so much global production capacity was idle at the peak of the global recession and needs to be re-optimized. Priority reforms include accelerating governance reforms, improving the business climate and SMEs access to credit, and introducing further actions to relieve market failures affecting SMEs.

KEY 2009 PDR RECOMMENDATIONS

13. The following present an overview of the key recommendations included in the 2009 PDR. These cover a range of short-, and medium-term issues. The rationale for each of these recommendations, as well as more details around each of them can be found in the chapters of the report (the paragraph (¶) number where these are developed in the main text is indicated to facilitate quick access to specific recommendations).

Maintaining Macroeconomic Stability

Chapter 1: Monetary and Fiscal Policy

- R1. Approve the proposed amendments to the New Central Banking Act (¶42);
- R2. Nest the unwinding of the fiscal stimulus within a credible medium-term fiscal framework (¶54);
- R3. Create a strong revenue base (¶54); and
- R4. Rationalize expenditure, including off-budget spending (¶54).

Chapter 2: Fiscal Risk

Overall fiscal risk management (¶117):

- R1. Establish a dedicated Fiscal Risk unit; and
- R2. Publish a fiscal risk statement.

NG Budget (¶117):

- R3. Improve the quality, comprehensiveness, and timeliness of budget reporting.

Public Debt (¶117):
- R4. Establish a Debt Management Office (a goal already expressed in the government's 2004-2010 MTPDP);
- R5. Introduce and publish a debt management strategy; and
- R6. Improve the quality, comprehensiveness, and timeliness of public debt data.

GOCCs (¶117):
- R7. Re-institute a performance evaluation system and subject GOCCs to performance targets. Regularly publish these evaluations; and
- R8. Strengthen CAG's capacity to monitor GOCCs.

PPPs (¶117):
- R9. Establish a dedicated PPP Unit within government tasked with the technical, legal, and financial role of assessing, negotiating, and writing all PPP projects and contracts of the Republic.

Chapter 3: Remittances

- R1. Migration policies: to further improve the resiliency of remittances, policies promoting programs targeted at non-cyclical jobs should continue to be actively pursued (¶151).
- R2. Economic monitoring: systematically track and monitor returning OFWs (¶151).
- R3. Remittance policies: further improve access to formal financial services to poor migrants and their families (¶151).
- R4. Broader policy recommendations to increase remittances and their use for development and poverty reduction (¶151):
    - Improve the investment climate (and governance in particular);
    - Tackle infrastructure bottlenecks; and
    - Improve access to finance for SMEs.

Ensuring Social Protection for the Poorest and Most Affected Citizens

Chapter 4: Poverty and Labor Markets

Quick socio-economic monitoring of the crisis (¶203)
- R1. Monitor closely and quickly the socio-economic impacts of the crisis. A comprehensive monitoring of key indicators in "real time" is needed.

Enhance social protection policies to support household income (¶203)
- R2. Develop an operational social protection strategy and work-plan for the National Social Welfare Program cluster.
- R3. Enhance the capacity of agencies to efficiently implement the unified targeting system.
- R4. Carefully expand the CCT in urban areas to increase coverage of groups affected by the global crisis.

Support employment and earnings (¶203)

- R5. To be cost-effective public work programs (PWP) should follow best practices.
- R6. Consider scaling up existing programs as public work generating programs.
- R7. Improving the training content of PWPs would help increase employment prospects.
- R8. Strengthen the regional network of DOLE and other public employment offices that can help deliver services and information to job seekers.

Support investments in human capital (¶203)

- R9. Increase priority in delivering social services that support household investments in human capital to reduce the vulnerability of households to future income shocks.
- R10. Given the low levels of spending on education, health, and social protection, particular emphasis should be aimed to increase expenditure in these sectors.
- R11. It is also critical to ensure that funding is available for health and educational service delivery on a timely basis.

Preparing the Economy for the Recovery

Chapter 5: Investment Climate, Access to Finance, and Infrastructure

Improving the investment climate:

- R1. Implement the recommendation of the 2007 Philippines Development Report entitled *Invigorating Growth, Enhancing its Impact* and aimed at improving the business climate (¶218).

Improving MSMEs and SMEs access to finance (¶232):

- R2. Prudential requirements should shift to a more risk-based assessment of borrower's credit;
- R3. Streamline the business regulatory process in local governments;
- R4. Develop electronic banking to reduce financial services costs to SMEs;
- R5. Explore expanding the supply of financial services by non-traditional actors;
- R6. Promptly implement the credit information system;
- R7. Improve SMEs' managerial and financial acumen;
- R8. Improve the absorptive capacity of the small farmers and fisher folks, agri-enterprises and SMEs by increasing their productivity, thereby minimizing the lending risks of financial institutions;
- R9. Establish effective loan administration mechanisms, and minimize loan appraisal costs as well as transaction costs through the strengthening of linkages between financial institutions, intermediaries, and end-users;
- R10. Introduce programs to enhance capability of financial institutions to produce innovative financing schemes; and
- R11. Increase investments in infrastructure such as farm-to-market roads, irrigation facilities, and logistical infrastructures.

Improving infrastructure investment (¶255):

- R12. Increase total (public and private) spending on infrastructure, including spending for maintenance and operations;
- R13. Successful implementation of the large scale up in infrastructure spending calls for particular attention to: prioritization of and broad consensus on selected major projects, wider consultation with stakeholders, coordination among various agencies that will be involved throughout the project cycle, budgetary support over the life of the project along with demonstrable efficient use resources, adoption of a common and robust framework for PPPs ;
- R14. Introduce and scale up small scale infrastructure projects targeting the urban poor to mitigate the immediate social effects of the crisis;
- R15. Introduce innovative ways of engaging the private sector in infrastructure development; and
- R16. Strengthen the investment climate for infrastructure.

I. MAINTAINING MACRO-ECONOMIC STABILITY

1. RECENT SOCIO-ECONOMIC DEVELOPMENTS AND MAIN POLICY CHALENGES

14. The country, impacted by the global recession, experienced its lowest growth since the Asian financial crisis though it avoided a recession in contrast to most countries in the region. The global financial crisis and recession hit an economy that was in a relatively strong position, with previous vulnerabilities—public finances, the balance of payments, the banking sector, and, to a lesser extent, the corporate sector—significantly lowered. The economy is, therefore, better placed to withstand large external shocks than in the past. Faced with a global crisis of historical magnitude, the authorities promptly introduced a broad set of measures. These range from maintaining financial market confidence and liquidity, to the introduction of a comprehensive and ambitious fiscal stimulus package. Despite this, important challenges for macroeconomic stability, social protection, and inclusive growth lie ahead.

SOCIO-ECONOMIC DEVELOPMENTS

Global pressures

15. **The contraction in global output has been large and sudden and resulted in the first contraction in global output since World War II.**[1] World industrial production declined sharply and rapidly in the fourth quarter of 2008 (21 percent at an annualized rate). Output continued to decline in the first quarter of 2009, reducing the level of industrial production in high income countries by 17.3 percent in March 2009, relative to its level a year before, and in developing countries by 2.3 percent. The collapse in industrial production is truly global, with major producers of advanced capital goods particularly hard-hit. For the whole 2009, global output shrank by 2.2 percent, with growth in the developing world slowing to 1.2 percent. Excluding China and India, GDP in developing countries fell by 2.2 percent. International trade experienced the sharpest drop (14.4 percent) since 1945. Unemployment, soaring in industrial countries, also increased in East Asia, as high-income countries reel from an unprecedented asset-market bust, and global investors retreat from emerging markets. Meanwhile, private investment flows to developing countries plummeted by more than 40 percent in 2008 as access to international debt markets dried up and portfolio equity inflows all but ceased.

16. **The global financial crisis and asset price collapse led to similar sharp fall in asset classes in the Philippines in 2008.** Following the strong appreciation of the peso against the US dollar in 2007, the currency depreciated by about 14 percent in 2008 (end-of-period). The Philippines Stock Exchange index has tracked global developments, first exhibiting exuberance, then dropping by almost 50 percent in 2008,

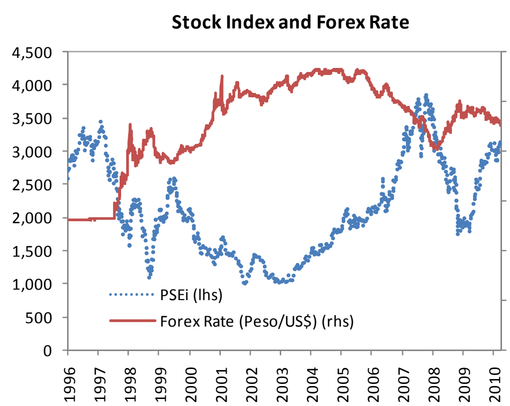
[1] World Bank, 2009, "Global Development Finance: Charting A Global Recovery," Washington DC, June.

before rebounding significantly in 2009 (Figure 1.1a). Borrowing spreads, have experienced similar trends: from lows of less than 200 basis points in 2007 they jumped to over 800 basis points in October 2008 before halving by March 2009 and have now returned to pre-crisis levels (Figure 1.1b). As less than 2 percent of the population is estimated to have investments in equities, fixed-income and other instruments, the wealth effect from these asset price swings should be limited.

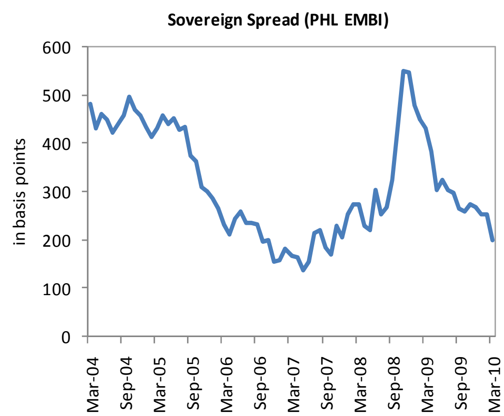
17. **East Asia's recovery from the economic downturn has been surprisingly rapid** (World Bank, 2009j). A vigorous and timely fiscal and monetary stimulus in most countries in East Asia, led by China and Korea, along with decisive measures in developed economies to prevent a financial meltdown after the collapse of Lehman Brothers, have stopped the decline in activity and set in train the regional recovery. The shift to inventory restocking since mid-2009 has also helped boost growth. As a result, real GDP growth in developing East Asia slowed to 7.0 percent in 2009 from 8.5 percent in 2008, a benign deceleration compared to the experience during the 1997-98 Asian financial crisis.

Figure 1.1. Philippines: Equity prices, Exchange Rates and Sovereign Spreads

(a) Equity prices collapsed as the peso depreciated



(b) Sovereign spread spiked in late 2008



Source: CEIC, Bloomberg

Output and Demand

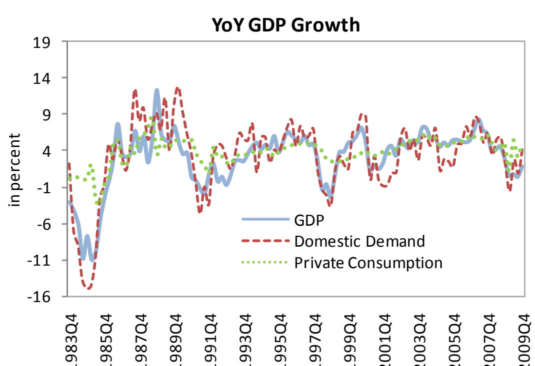
18. **The global recession did not spare the Philippines, though the country avoided a recession** (Figure 1.2). Between 2004 and 2007, growth improved on the back of renewed investor confidence, itself driven by fiscal consolidation, high global growth, strong global appetite for emerging markets and robust remittance inflows. The boom years, however, were disturbed by a series of major external shocks (food and fuel price shocks; global financial crisis; global recession). The food and fuel price shocks brought domestic inflation to a decade-high, reducing real household income and bringing significant hardship to the poor. The global financial crisis led to a sharp reduction in domestic asset prices, higher risk premium for emerging economies, a disruption of credit markets and a drop in global demand, bringing exports, corporate and financial sector earnings down and investments on hold. As a result, growth in 2008 slowed to 3.8 percent from a record high of 7.1 percent in 2007. With the global economy in a tailspin, economic growth decelerated sharply to 0.9 percent in 2009, the

slowest pace since the Asian financial crisis in 1998, while GDP per capita declined by 1 percent.

19. **Private consumption, the traditional backbone of the economy weakened in early 2009 but recovered in the last quarters** (Figure 1.2). Private consumption—accounting for over 70 percent of GDP—contracted in Q1 2009 (quarter-on-quarter, seasonally adjusted basis) before recovering in the latter part of the year. Private consumption has grown more sensitive to shocks since the 2008 global food crisis when it first registered its negative growth since 1992. The rebound in private consumption was likely driven by strong remittances inflows (in real peso terms) and improved global outlook. Public spending, which initially failed to support growth (as public construction untimely declined since 2008 and continued through Q1 2009), became strongly supportive to growth in 2009 as expenditure plans from the Economic Resiliency Plan started being implemented.

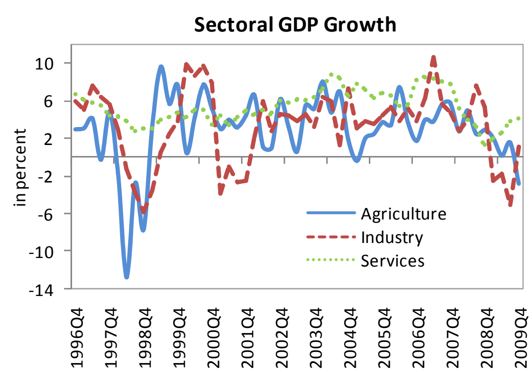
20. **Investment shrank by 9.9 percent, with investment in durable equipment posting the largest contraction since the Asian financial crisis.** The double-digit drop in capital formation observed during the last quarter of 2008 persisted through the third quarter of 2009 with business expansion on hold. While public investment grew for the year as a whole, private investment contracted significantly as the buoyant growth of private construction reversed in the second quarter of 2009, aggravating the sharp fall in investments in durable equipment. Investment as a ratio of GDP, which has been structurally low prior to the crisis at 15.6 percent (average 2003-2008), further worsened to 14.0 percent.

Figure 1.2. Philippines: GDP Growth and Private Consumption, 1982Q4-2009Q4



Source: National Statistical Coordination Board

Figure 1.3. Philippines: Contribution to GDP Growth by Sectors,1998-2009



Source: National Statistical Coordination Board.

21. **On the supply side, industrial production contracted, while the large services and agriculture sectors were anemic due to the crisis and the typhoons** (Figure 1.3). After reaching almost 5 percent growth in 2003-2008, industrial production contracted by 2.0 percent in 2009 as both external and domestic demand for manufactures came under intense pressure. The services sector, the growth driver of the past five years and which accounts for over half of GDP and of the total workforce, proved resilient but growth was moderate and uneven (Q4 2009 quarter-on-quarter seasonally adjusted growth was slower than in the previous two quarters) throughout 2009. Agricultural production suffered heavily because of weather disturbances

especially in the central and northern part of Luzon (especially due to typhoons Ondoy and Pepeng) which are heavy producers of rice. The contraction in rice production dragged down the full year growth of the whole agriculture sector to 0.1 percent from 2.9 percent in January to September 2009.

22. **The global recession and financial crisis severely impacted specific sectors of the economy.** Total net earnings of companies listed in the Philippine Stock Exchange fell in 2008—partly on account of foreign exchange transactions and hedging losses—but remained positive for most companies and recovered fully in 2009. Most firms in the electronics sector and to a lesser extent, vehicle, garment and other export-oriented manufacturers placed a large share of their workforce on reduced work hours or on forced leave during the worst of the global trade contraction; workforce retrenchment proved relatively limited. On the other hand, firms in the services sector, especially those catering mostly to domestic demand (and the BPO sector), have managed to weather the global recession relatively well.

23. **High accumulated profits and improved balance sheets provided companies with legroom to weather the global recession.** While recovering from the Asian financial crisis, Philippines companies took advantage of the strong global growth since the start of the 21st century and the resulting surge in corporate profits since 2003 (Figure 1.4b) to improve their balance sheets as evident from, e.g., the improved liquidity—measured with the quick ratio[2]—the deleveraging,[3] or the large reduction in foreign exchange exposure (Figure 1.4a). The short-term debt to long-term debt ratio also improved from 52 percent in 1998 to 39 percent in 2007.

24. **A small proportion (2.7 percent) of the top 900 non-financial companies, mostly from manufacturing industry, has been, however, highly exposed to the crisis**. These firms were identified using three risk factors that are most relevant to the current global financial environment and economic outlook: the degree of leverage, liquidity and profitability.[4] Most firms in this vulnerable group have three times the level of leverage of non-vulnerable firms, and they also have very low liquid assets in relation to their maturing liabilities. This makes them vulnerable to debt rollover and refinancing risks. However, these risks are relatively small on aggregate as these firms contribute only 2 percent to total net sales of the top 900 non-financial corporations (Table 1.1).

25. **The Business Process Outsourcing (BPO) industry continued to grow strongly during the crisis and is poised to emerge structurally stronger from the crisis.** In the last decade, the BPO industry has grown at impressive rates to contribute about 5.3 percent of GDP and employing about 371,965 people at end-2008. The

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[2] The quick ratio is calculated as follows: (cash and equivalent + short-term investments + accounts receivable) / current liabilities. The quick ratio measures the amount of the most liquid current assets available to cover current liabilities.

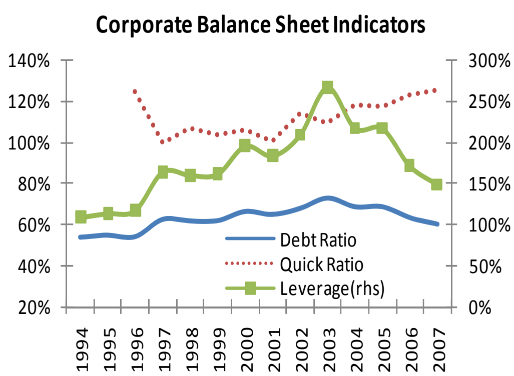
[3] Measured by a debt ratio constructed as total liabilities over total assets. Alternative measures of leverage (e.g., the sum of debt and equity over equity) lead to the same conclusion.

[4] Based on 2007 corporation data (latest available) from BusinessWorld. This dataset is the widest available to study the corporate sector in the Philippines. Vulnerability of firms was gauged based on the following criteria: (1) return on asset lower than zero percent; (2) current ratio lower than 100 percent; and (3) debt ratio greater than 100 percent.

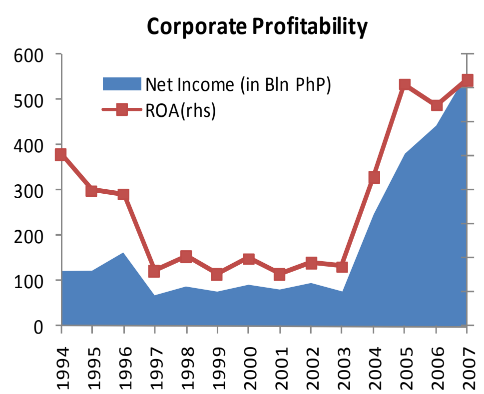
industry also contributed to the rapid growth of the commercial property sector in recent years. While the industry grew by 24.3 percent in 2008, it is projected to grow by about 23 percent in 2009, following a dip to 15 percent (year-on-year) during the first half of 2009. Despite reduced transactions per customer and reluctance of some of the hard-hit US business segments to invest effort and cash to transition to a third party service provider amidst uncertain times, industry growth remained good. The global recession intensified the need for companies to review their cost structures, operating processes, and value added chains. This is leading to a renewed wave of outsourcing with sectors that experienced large disruptions (e.g., banking) being the quickest to react: a large number of large banking groups are significantly expanding their presence in the Philippines. The global BPO sector is strategically looking for a back up to India (India plus one strategy) and the Philippines seems to have established itself as the preferred choice (given comparable cost, language and technical skills), thereby firmly establishing its relatively new industry on the global map. A key bottleneck to medium-term growth prospects, however, remains the availability of qualified staff (i.e., good command of English, willingness to work night shifts, technical knowledge).

Figure 1.4. Philippines: Corporate Sector Financial Indicators, 1994-2007

(a) Balance sheets improved from2004-07…



(b) … as did profitability



Source; BusinessWorld Top 1,000 Corporations. 2007 is the most recent year of available data.

Table 1.1. Philippines: Corporate Sector Vulnerabilities, 1996, 2000 and 2007

	1996	2000	2007
Number of Vulnerable Firms	20	44	22
Net Sales (In % of Total Sales of Firms)	1%	3%	2%
Long-term Loans (In % of Total Long-term Loans)	…	6%	4%
Short-term Loans (In % of Total Short-term Loans)	…	1%	4%
Industry (% of total vulnerable firms)			
Manufacturing	22%	32%	33%
TCS	22%	…	…
Wholesale and Retail Trade	...	16%	27%
Construction	…	7%	…
Memo Items: (For all non-financial firms)			
Total Net Sales (in million PhP)	1,633,694	2,705,261	4,891,688
Total Short -term (in million PhP)	…	377,127	440,228
Total Long-term (in million PhP)	…	1,023,513	1,124,220
Number of Non-financial Firms in Top 1000 Corp.	885	895	901

Source: BusinessWorld Top 1,000 Corporations and World Bank staff calculations.

26. **The banking sector's exposure to the global financial crisis and recession was mostly through their impacts on public finances and remittances.**[5] Since the Asian financial crisis, banks have significantly improved their balance sheets (Table 1.2), including through capital increases, and conservative lending and financing practices (lending to the private sector is relatively low, at 33 percent of GDP). Given high concentration of bank investments in Philippine government paper, a deterioration in government's fiscal position exposes banks to potentially high mark-to-market losses. Liquidity risk, on the other hand, is mitigated by banks' cash-rich position as seen in low loan to deposit ratios.[6] Similarly, while a deterioration in credit quality has occurred as the economy slowed down, banks' and corporations' relatively sound financial conditions entering the global crisis have provided significant buffer to absorb reasonable credit impairments.[7] A slowdown in remittance inflows would, however, affect banks both on the profit and loss (e.g., lower remittance fees and foreign exchange spreads; credit deterioration, especially on consumer lending for cars or real estate) and balance sheet (e.g., slower growth in cheap deposit sources).

Table 1.2. Philippines: Banking Sector Indicators, 2003-2009

	2003	2004	2005	2006	2007	2008	2009
	(in percent)						
Capital adequacy							
Total capital accounts to total assets	13.1	12.6	12	11.7	11.7	10.6	11.1
Capital adequacy ratio (consolidated basis) 1/	17.4	18.4	17.8	17.5	15.7	15.5	15.8
Asset quality							
NPL ratio 2/	16.1	14.4	10.3	7.5	5.8	4.5	4.1
NPA ratio 3/	13.2	11.8	8.8	6.9	5.8	5.1	4.5
Distressed asset ratio 4/	27	25.3	20	15.7	13	10.7	9.3
NPL coverage ratio 5/	51.5	58	73.8	75	81.5	86	93.1
NPA coverage ratio 6/	30.9	33.2	39.2	37.3	39.7	44.4	48.7
Profitability							
Return on assets	1.1	0.9	1.1	1.3	1.3	0.8	1.2
Return on equity	8.5	7.1	8.8	10.6	10.8	6.9	10.8
Cost-to-income ratio	..	65.5	64	66.5	65.2	74.2	65.8
Liquidity							
Liquid assets to deposits	47.9	53.2	53.1	52.1	51.9	52.3	52.7
Loans (gross) to deposits	80.3	73.4	72.4	69.3	70.9	69.7	68.1

Sources: Philippine authorities and IMF.
Note: ROPA (Real and Other Property Acquired) measures the stock of foreclosed properties held by banks.
1/ For 2009, as of the second quarter.
2/ Nonperforming Loan (NPL) Ratio (excluding IBL).
3/ (Nonperforming loans + ROPA) over total gross assets.
4/ Ratio of (NPLs + Gross ROPA + current restructed loans) to (Gross total loan portfolio + Gross ROPA).
5/ Ratio of loan loss reserves to NPLs. 6/ Ratio of valuation reserves (for loans and ROPA) to NPAs.

[5] This section is based on the findings of a June 2009 World Bank study on the impact of the global financial crisis and recession on the banking system in the Philippines and on the joint IMF-World Bank FSAP update (IMF and World Bank, 2010).

[6] The BSP's has been injecting significant liquidity into the system since Lehman Brothers' failure. However, at the individual bank level, some banks may face greater risk due to (1) smaller deposit base, (2) dependence on high net-worth depositors who can easily move funds elsewhere should there be a crisis of confidence and (3) minimal counterparty lines. Moreover, the interbank market lacks depth.

[7] It is estimated that based on average 2006-08 pre-provision profits, banks can afford to write off 3 percent of currently performing loans without charges to equity. Credit risk is, however, heightened by the increasing concentration of lending to a few large conglomerates.

27. **Bank earnings have so far remained resilient despite pressures on interest rate margins to be squeezed, loan growth to decelerate and cost of lending to rise**. Through the third quarter 2009, the net income of PSE-registered financial sector has increased by almost 50 percent. The more difficult operating environment has tested the appropriateness of individual bank capital in terms of covering unexpected losses and/or higher risk taking. While the financial system's liquidity may have provided opportunities for capital raising, some small banks may have found it more difficult to increase capital, resulting in pressure for further consolidation of the banking system.

Employment and Poverty

28. **In contrast to the relatively sound macroeconomic fundamentals prior to the global recession, the Philippine labor market already faced challenges before the crisis.** For the past seven years through 2008, while the economy grew at record rates, the labor market was characterized by (1) a high unemployment rate (7.4 percent in 2008); (2) even higher under-employment rate (19.3 percent) with a high incidence among the youth, and even skilled (graduates) youth; (3) high informal sector (mostly in agriculture and services); (4) a rigid labor market environment (World Bank, 2009f); and (5) and a falling trend in real wages since 2001. Chapter 4 reviews in details the impact of the global recession on Philippines households, especially the vulnerable ones.

29. **Progress in poverty reduction has historically been slow and, since the mid-2000s, disappointing as renewed per capita growth did not reduce poverty.** The Philippines was making progress in the fight against poverty during the 1980s and 1990s, but very slowly (per capita GDP growth averaged 0.1 percent from 1980 to 1999). Using the $1.25-a-day income threshold measure of poverty, it succeeded in reducing poverty from around 30 percent in the early 1980s to just over 22 percent at the end of the 1990s. Though significant, the decline of poverty in the Philippines over this period was quite weak compared to other countries in the region. While per capita GDP growth picked up significantly after the Asian financial crisis, and especially in the mid 2000s (reaching 3.5 percent from 2003 to 2006), measures of poverty and its intensity remained about the same between 2000 and 2003 but then increased between 2003 and 2006 (Table 1.3).

Table 1.3. Philippines: Poverty Estimates, 2000-2006 1/

	Poverty Headcount 2/			Poverty Gap 2/			Poverty Severity 3/		
	2000	2003	2006	2000	2003	2006	2000	2003	2006
Urban	16.8	17.3	19.5	4.6	4.7	5.4	1.8	1.8	2.2
Rural	44.7	44.4	45.9	14.0	14.4	14.6	5.9	6.3	6.2
Total	31.0	31.1	32.9	9.4	9.6	10.0	3.9	4.1	4.2
Memo item: Poverty headcount based on variable National Poverty Lines (official estimates)	33.0	30.0	32.9						

Source: World Bank estimates based on Family Income and Expenditures Surveys 2000, 3003, 2006.
1/ The estimates of poverty incidence are based on a constant (2006) national poverty line and are calculated on the basis of per capita income and expressed as shares of the total population.
2/ The poverty headcount ratio measures the proportion of the population with incomes below the national poverty line; The poverty gap measures how far households lie below the poverty line; while poverty severity also takes into account the poverty gap, but places a higher weight on households that are further away from the poverty line.

30. **The Philippine has a large share of its population which is near poor (i.e., just above the poverty line).** Raising the poverty threshold to the international from \$1.25 to \$2-a-day poverty line reveals that an additional 19.4 percent of the population in 2006 would be classified as poor. According to the Medium-Term Philippine Development Plan 2004-2010, 22 percent of the country's population is chronically poor, while 32 percent moves in and out of poverty. The large proportion of vulnerable population or "near poor" makes the challenge of poverty reduction even more daunting.

31. **Progress on the non-income dimensions of poverty reduction, as measured by the MDG indicators, has been mixed.** Considerable progress has been made in areas related to child mortality, gender equality, and water supply and sanitation. However, the Philippine has fallen behind in critical areas such as universal access to primary education, with the net enrollment rate at the elementary level declining since 2002 and net enrollment rates at the secondary level leveling out to between 58-60 percent over the past five years. Based on progress to date, the MDGs for maternal health and reproductive health are unlikely to be achieved by 2015. The maternal mortality rate in 2006 was 162 deaths per 100,000 live births, which is high for a country at the Philippines' level of development. Malnutrition also remains a major issue, with the Philippines being among 20 countries in the world with the highest burden of child malnutrition (See World Bank, 2009f, for details).

32. **The lack of robust and inclusive growth explains the failure in reducing poverty since 2000** (World Bank, 2009f). While growth picked up since 2000 in the Philippines, it has been modest by regional standards. Once the data biases discussed below are accounted for, economic growth in the Philippines is likely to have been even more modest than is indicated in the national accounts. At the same time, the relatively high degree of income inequality has the effect of reducing the income elasticity of poverty, posing a further barrier to faster poverty reduction. These findings imply that the modest growth that did take place during 2003-06 must have had an anti-poor bias or been associated with a deteriorating distribution of income.

33. **Several factors may have contributed to an anti-poor bias of growth and a worsening distribution of income.** Such factors, as detailed in World Bank (2009f) include:

- An unequal sectoral distribution of growth, which could slow progress in poverty reduction if the poor are concentrated in the sectors that are stagnating or contracting,
- An unequal spatial or regional distribution of growth, which could have a similar effect as the unequal sectoral growth (If the poor are concentrated in declining or stagnating regions and population mobility is limited, poverty may not change or may even worsen despite rapid overall growth),
- Changes in the relative price of labor provided by the poor or of the goods consumed by the poor,
- Changes in the returns to human capital that limit the opportunities of the poor to benefit from growth, and
- Changes in public spending and policies that reduce the welfare of the poor.

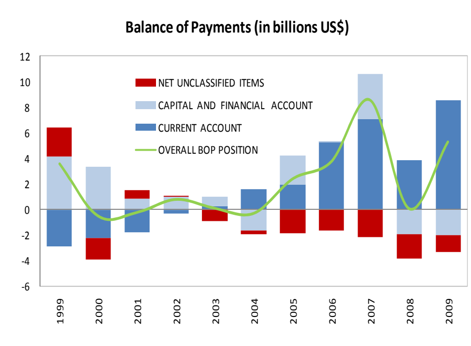
34. **Notwithstanding measures taken by the Philippine authorities, the global recession is projected to throw 1.4 million Filipinos into poverty by 2010** (see Chapter 4 for details). Based on a macro-micro simulation exercise for the Philippines, the poverty rate is estimated to be 0.9 and 1.5 percentage points higher in 2009 and 2010 respectively as a result of the global recession, compared to what would have been without it (Habib et al., 2010). The impact of the crisis on urban areas, the manufacturing and services sectors, and for female-headed households is expected to be particularly high. Aside from reduced employment and labor earnings due to the slowdown in economic activity, non-labor income is also estimated to be lower due to slower overseas remittances (compared to the no-crisis scenario), both in terms of the number of households receiving and amounts received.

Balance of Payments and External Debt

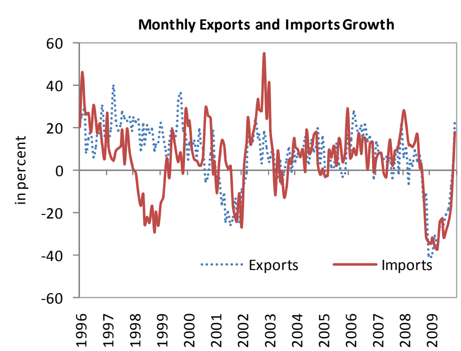
35. **Contrary to past crises, the country entered the current slowdown with a current account surplus that is expected to persist over the medium-term.** The encouraging current account position (Figure 1.5a) and prospect masks a sharp trade contraction (Figure 1.5b). All major exports categories, such as electronics, electrical machineries, minerals and furniture contracted at record pace since Q4 2008 and remain well below their pre-crisis level one year later. As imports, also shrank by similar magnitudes, the previously large trade deficit narrowed slightly. Offsetting the large trade deficit, aggregate remittances proved resilient in 2009 in dollar terms, and strong in both nominal and real peso terms. While the surge in global unemployment mitigates prospects for the domestic labor market as it is closely integrated with the global labor market through the large deployment of Filipino workers abroad, the global financial crisis has also proved beneficial to Filipino workers. Robust deployment of workers overseas (17 percent YoY growth in January-November 2009) partly reflects global recession-induced global staffing restructuring and the price-quality competitiveness of Filipino workers in the global labor market (Chapter 4).

Figure 1.5. Philippines: Balance of Payments, 1996-2009

(a) While BOP shrank, the current account remained resilient.



(b) Exports and imports contracted sharply but have started to recover at the end of 2009



Source: Bangko Sentral ng Pilipinas, National Statistics Office.

36. **Meanwhile, gross and net international reserves have remained robust**. GIR reached $37.6 billion in end-2008, an increase of $3.8 billion compared to end-2007. This level can cover 6 months of imports of goods and services and, more importantly,

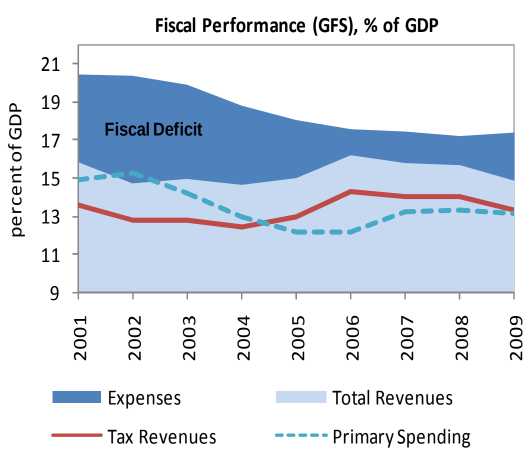
is equivalent to 3.3 times the country's stock of short-term external debt based on residual maturity. GIR steadily increased throughout 2009, ending the year with a record-high of $44.2 billion, equivalent to 9.0 months of import.

Public finance

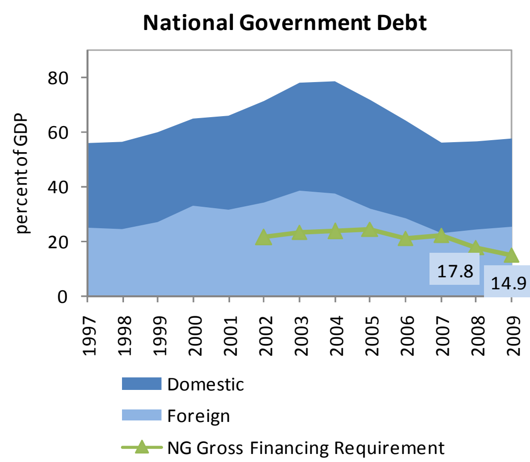
37. **While tax reforms in 2005-06 successfully increased revenue, the gains were not sustained, mainly due to subsequent tax cuts and weak administration** (Figure 1.6a). Notwithstanding several positive one-off developments (windfall from high fuel and commodity prices in 2008 and amnesty collection), there was no improvement in 2008 as the latter were not sufficient to offset the structural decline in collection from the Bureau of Internal Revenue (BIR). BIR collection grew by less than nominal GDP in 2008; in 2009 the annual growth rate of nominal tax collection is negative, pushing the tax-effort down from 14.1 percent of GDP in 2008 to 12.8 percent of GDP in 2009. Key reasons for the drop in collection include the slowing economy (and sharp import contraction for BOC collection), recent tax policy and administrative measures such as the effective tax cut on personal income tax (July 2008) and on corporate income (January 2009), the weakening of the Large Taxpayers Service (LTS) of the BIR (May 2008),[8] and negative incentives that the Attrition Act generates (see World Bank, 2008a, for details).

Figure 1.6. Philippines: Fiscal Consolidation and Public Debt Dynamics, 1996-2008

(a) Fiscal consolidation weakened after 2006 [1/]



(b) Public debt stopped declining since 2008 [2/]



Source: Bureau of Treasury, National Statistical Coordination Board.
1/ Fiscal consolidation refers to a reduction in the primary structural fiscal balance.
2/As of Q3 2009.

38. **Primary spending pressures are on the rise since 2008.** As the food and fuel price shock hit the economy early in 2008, the government increased non-interest (i.e., primary) spending through discretionary measures (e.g., scaling up the conditional cash transfer program, increasing capital spending) and letting automatic stabilizers run their course (the main one during the food crisis being the NFA rice subsidy program; a large share of NFA's quasi-fiscal activities are off-budget). Rapidly declining interest

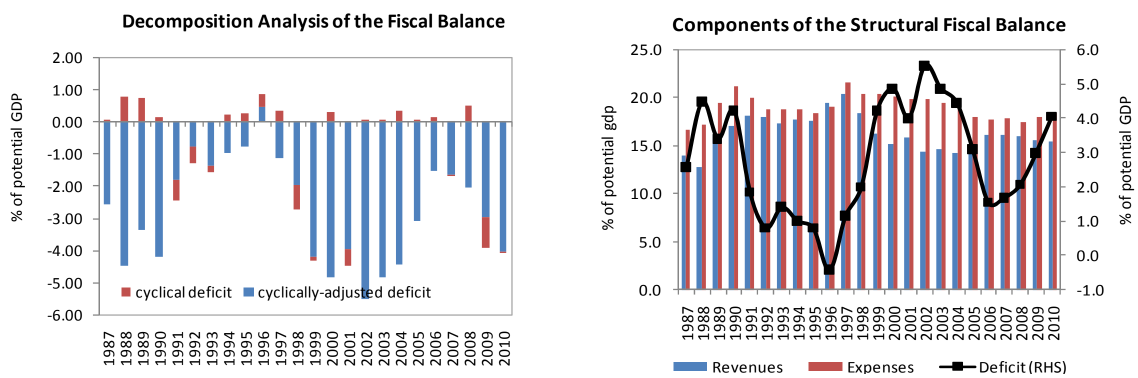
[8] Large taxpayers that were delisted in May 2008 were subsequently re-enlisted in the LTS in January 2009. However, all specialized LTS staff that belonged to the LTS as of May 2008 and were placed elsewhere, have not been re-assigned to the LTS.

spending—owing both to the sharp decline in outstanding debt and declining interest rates on Philippines debt (both in absolute terms but also relative to other emerging markets)—offset the pressure on primary spending so that total expenditure remained broadly stable from 2006 to 2008.

39. **The change in fiscal balances from 2008 to 2009 was mostly due to a sharp deterioration of the structural fiscal balance, and structural revenue in particular**—Figure 1.7. While the structural fiscal balance (i.e., excluding cyclical component and one-off items) had significantly improved from 2002 to 2006, the balance remained broadly unchanged from 2006 to 2007. However, in 2009 it deteriorated markedly. Most of the deterioration stems from the revenue side. Since the global food and fuel price shocks in 2008, Government and Congress have responded to the global shocks by introducing permanent tax cuts or exemptions. As a result, a large share of the gains from the 2005 reforms (e.g., eVAT) has been undone.[9]

Figure 1.7. Philippines: Fiscal Policy Over the Business Cycle, 1987-2009

(a) A sharply deteriorating structural fiscal balance… 1/ (b) …mostly due to a structural decline in the BIR's tax effort



Source: WB staff calculation based on the second method presented in Fedelino et.al., 2009, "Computing Cyclically Adjusted Balances and Automatic Stabilizers", IMF, FAD Technical Notes and Manual, Washington DC.
1/ The small share of cyclical factors in the overall fiscal balance is common in developing and emerging markets as automatic stabilizers are rather modest.

Policy Responses and Options

Monetary and Financial Regulation Policies

40. **The policy response from the monetary and financial authorities has been timely, comprehensive, and effective**. Policy measures have tackled several stress points brought by the global financial crisis: maintaining the stability of the financial system, maintaining liquidity and confidence in the banking system, and conducting a monetary policy that, subject to price stability, is supportive of growth. In particular:

- Financial stability measures: (1) The Philippines Stock Exchange introduced a circuit breaker to halt the trading should the benchmark PSE index were to drop by 10 percent from the previous day; (2) the BSP relaxed accounting rules to

[9] The most important tax eroding measures are: the reduction in the corporate income tax (0.5 percentage points of GDP), the cut in personal income tax (0.3 percentage points of GDP), the replacement of the VAT by a lower-yielding franchise tax on power transmission (0.15 percentage points of GDP).

enable banks to avoid mark-to-market losses on their government bond holdings, [10] it allowed exclusion of unrealized market-to-market losses in computing FX asset cover, it eased its rules on the 100 percent asset cover of bank's foreign currency deposit units, it opened and the opening of a US dollar repo facility to augment dollar liquidity in the foreign exchange market, and provided dollar liquidity in spot and swap markets. Although domestic liquidity was adequate, the BSP also took preemptive measures to prevent a possible credit crunch.[11] (3) A doubling of the limit up to which deposits are insured to P500,000 (about six times annual GDP per capita) was signed into law in April 2009 alongside a strengthening of PDIC's supervisory power. (4) Through the central bank's timely communication on the meager exposure of the banking system to troubled financial assets, panic at the onset of the crisis was averted and helped preserved financial stability[12]

- Monetary policy measures: since December 2008, as disinflation set in and the economy softened, the central bank cut the key policy rate by a total of 200 basis points from December 2008 to July 2009, bringing the key policy rate to a 17-year low at 4.0 percent. To remove bottlenecks in the flow of private sector credit to the economy, the BSP also: (1) temporarily suspended a regulation requiring banks to lend money only to (corporate) borrowers that submit financial statements audited by BSP-accredited auditors;[13] and (2) relaxed rules on related-party lending by excluding from this limit lending to affiliates and subsidiaries engaged in power projects certified urgent under the Philippine medium-term investment plan.

[10] Financial institutions were allowed to reclassify their investments in debt and equity securities from their Held-for-Trading or Available-for-Sale categories to the Held-to-Maturity or the Unquoted Debt Securities Classified as Loans.

[11] These include the lowering the reserve requirement ratio of bank deposits and deposit substitutes by 2 percentage points, doubling the peso rediscounting facility to P40 billion in November 2008 and further increasing it to P60 billion in February 2009. The BSP also increased the loan value of all eligible rediscounting papers from 80 to 90 percent of the outstanding balance of a borrowing bank's credit instrument and launched the Credit Surety Fund (CSF) program which provides guarantee to small cooperatives to ensure continued access to financing of small businesses. In addition, the rates for the peso rediscounts were also aligned with the BSP's overnight reverse repurchase (RRP) rate, less 50 basis points. The Monetary Board also raised the ceiling of the NPL ratio requirement to ten percentage points above the latest available industry average, from the current ceiling of two percentage points above the industry average. Other revisions to the rediscounting guidelines include: the lifting of the requirement to execute a Surety Agreement (SA) by any single stockholder, natural or juridical, owning more than 50 percent of the voting stocks of a bank with approved rediscounting lines with the BSP; and the imposition of a ceiling on the outstanding papers that a bank may rediscount equal to the rediscounting bank's single borrower's limit (25 percent of its net worth) or P3 billion, whichever is lower.

[12] About 97 percent of the number of bank accounts are now insured (but only 31 percent of total deposits). The measure was deemed necessary to maintain confidence (especially as several regional banks from the Legacy group were closed in December 2008). The law also strengthens PDIC's supervisory power by giving it authority to determine insured deposits, conduct special bank examinations upon impending closure of a bank, and to examine deposit accounts in case unsafe or unsound banking practices are discovered. The examiners are now also immune from lawsuits. The associated strengthening of the PDIC's balance sheet, however, will only take place over time. In the meantime, the law imposes large contingent liabilities onto the NG (Chapter 2).

[13] As the number of such accredited auditors is relatively small, a large number of companies did not qualify for bank borrowing. The ultimate goal remains to increase the number of accredited auditors.

- Other measures: the BSP (1) strengthened its surveillance measures by enhancing its monitoring activities and by conducting stress tests; and (2) supported regional cooperation and initiatives by sharing information, discussing emerging developments and pooling resources among regional peers.

41. **Overall, the BSP has been appropriately supportive to growth and financial system stability and liquidity; the key challenge is to time and pace the exit strategy.** The continuing challenge as the economy moves towards a likely slow growth recovery is to make accommodative policies and relaxed regulatory forbearance work without encouraging unacceptable risk-taking. Ultimately, the accommodative monetary policy measures will need to be reversed. This poses challenges as the strength of the underlying economic recovery is uncertain and uneven, the global environment remains subject to large risks (including the risk of heightened sovereign crises as the Greek turmoil revealed in 2010), and commodity prices—especially food and fuel—could surge to the highs they reached in 2008. Notwithstanding the above challenges, strong monetary policy credibility, a resilient banking system, and large foreign exchange reserves enables the conduct of an appropriately prudent and forward-looking monetary policy.

42. The following measure would help the BSP in performing its supervisory functions even more effectively:

> R1. Approve the proposed amendments to the New Central Banking Act. The proposed amendments would provide the supervisory authorities with legal powers and protection commensurate with their mandates. These include (1) the lifting of bank secrecy laws for examiners; (2) improved scope for risk-based banking supervision; and (3) enhancements to the existing prompt corrective action framework.[14]

Fiscal Space in the Philippines

43. **The concept of fiscal space and how to assess it**. Fiscal space is the availability of budgetary room to enable a government to provide resources for a desired purpose without prejudice to the sustainability of its financial position (Heller, 2004). The following set of indicators can be used to asses a country's fiscal space (IMF REO, May 2009): (1) financing constraints, based largely on the size of savings-investment gaps; (2) sustainability constraints, based largely on the average projected debt-to-GDP ratio; (3) credibility constraints, based on the projected overall fiscal balance; (4) macroeconomic constraints, based on inflation, current account deficits, reserve coverage, and an indicator of the potential crowding out of the private sector; (5) institutional constraints, based on fiscal rules or laws, earmarking provisions, and revenue-sharing arrangements; (6) capacity constraints, based on whether investment projects and social safety nets can be expanded quickly; and (7) efficiency constraints, based on perception of the efficiency of public spending, as well as structure of the tax base.

[14] The proposed amendments to the BSP charter also include: (1) removal of monetary ceilings; (2) establishment of BSP's authority to issue its own instrument; (3) enhancement of BSP's power to obtain data from the non-banking sector; and (4) allowing the BSP more flexibility to impose appropriate and proportionate criminal and administrative penalties for violation of banking laws and regulations.

44. **Thanks to improved macro-fiscal fundamentals going into the global recession, the Philippines did have some fiscal space**. Key macro-economic indicators are broadly indicative of room for fiscal expansion (Table 1.4). First, the country enjoyed a higher tax-to-GDP ratio compared to pre-2006 ratios, benefiting from the tax reforms implemented during the fiscal consolidation. Secondly, it had and retains a current account surplus. Inflation has moderated significantly and reserves have increased markedly. Third, while its gross external financing needs are large in relation to its reserves, a large share of these securities are held by domestic residents (and similarly for the public sector's external debt on the RoPs side). Domestic residents have a much stronger incentive to roll-over their debt than foreign holders. Moreover, there is no sign of potential crowding out so far as corporate issuances in the domestic bond market have not softened.

Table 1.4. Philippines: Fiscal Space Indicators, 2004-2008
(as a percent of GDP unless otherwise indicated)

	Indicators	2004	2005	2006	2007	2008	2009
Sustainability constraints	NG Debt	78.2	71.4	63.8	55.8	56.9	57.3
Credibility constraints	Fiscal Balance	-3.8	-2.7	-1.1	-0.2	-0.9	-3.9
	Expenditure	18.3	17.7	17.3	17.3	17.1	18.5
	Revenues	14.5	15.0	16.2	17.1	16.2	14.6
	o.w. Tax	12.4	13.0	14.3	14.0	14.1	12.8
Macroeconomic constraints	Inflation (YoY percent change)	6.0	7.6	6.2	2.8	9.3	3.2
	Current Account	1.9	2.0	4.5	4.9	2.3	5.3
	International Reserves (in billion US$)	16.2	18.5	23.0	33.8	37.6	44.2
	Corporate Bond Issuances/T-Bond Issuances (in %)	3.0	2.0	5.0	7.8	11.6	20.7
Institutional constraints		Ability of Congress to approve the General Appropriations Act on time Government's target to balance the budget					
Capacity constraints		Absorptive capacity of implementing agencies					

Source: Bureau of Treasury, Bangko Sentral ng Pilipinas, Asian Development Bank, National Statistical Coordination Board, World Bank Staff calculation
1/ Projected; Nominal GDP for 2009 is based on World Bank Staff projection
2/ Actual for January to September 2009

45. **Several fiscal space indicators, however, point to limited scope for prolonged fiscal expansion.** These include a structurally declining collection of tax revenues, a rapidly expanding share of non-discretionary spending to total spending, a still relatively high public debt level, large principal repayments due on total external debt and rollover rates for short-term debt in relation to foreign exchange reserves, and large and rising gross financing needs for the public sector. Fiscal risks are also large and have a significantly higher likelihood of materializing during and immediately after an economic downturn, especially when combined with a global financial crisis (Chapter 2). Finally, limited absorptive capacity could constrain the timely and/or effective spending of additional allocation. Thanks to measures to improve disbursement, government spending was able to buoy the economy through 2009.

46. **Rapidly evolving macroeconomic and financial conditions and sentiments warrant caution in fully using up the existing fiscal space.** Rapidly changing investor sentiment and international financial market capacity could profoundly impact the assessment of fiscal space in the Philippines (as the events in Greece have shown in 2009 and 2010). Discounting existing fiscal space to reflect the extra-ordinary level of uncertainty seems warranted. Alternatively, contingency planning linked to frequent re-assessment of macro-economic conditions and fiscal space is required.

Fiscal policy

47. **To counteract global recessionary forces, the government introduced a fiscal stimulus plan in 2009 and postponed its balanced budget goal to 2013** (instead of the initial 2010 target year). The plan, named Economic Resiliency Plan (ERP), aimed to: (1) boost growth in 2009 to reach the government's upper end of the real GDP growth target (initially 4.1 percent) while also ensuring sustainable growth; (2) save and create as many jobs as possible; (3) protect the most vulnerable sectors, the poorest citizens, returning OFWs, and workers in export industries; (4) ensure low and stable prices to support consumer spending; and (5) further enhance competitiveness in preparation for the global economic recovery (NEDA, 2009). To achieve these goals, measures totaling P330 billion (4.1 percent of GDP) have been announced as part of the ERP; these include both on and off-budget operations (Table 1.5). The ERP also called for front-loading the ERP into the first half of 2009. Front-loaded measures include tax cuts, and the accelerated disbursement and implementation of discretionary spending, especially capital expenditure.[15]

Table 1.5. Philippines: Overview of the Economic Resiliency Plan 1/

	Amount (Billion Peso)	Aim
National Government Budget	200.0	
Expenditure	160.0	Fund programs identified as priority in ERP 1/
Revenue	40.0	Cost of CIT rate cut and PIT exemption increases 2/
Other Public Sector	80.0	
SSIs	30.0	Provide temporary additional welfare benefits
GOCCs and GFIs	50.0	Finance and undertake large expenditure projects
Development Bank of the Philippines	12.5	Possible financing source
Land Bank of the Philippines	12.5	Possible financing source
Government Service Insurance System	12.5	Possible financing source
Social Security System	12.5	Possible financing source
Private Banks	50.0	
Total ERP Stimulus	330.0	

Source: NEDA
1/ See Tables 3.2 and 3.3. for the key programs of the ERP and their budgeted allocation
2/ CIT: Corporate Income Tax; PIT: Personal Income Tax.

48. **The budgetary stimulus content of the ERP came from higher allocation to priority sectors: infrastructure, agriculture and social services** (Table 1.6). The strategies devised to ensure timely implementation of the ERP, include maximizing the utilization of budget for personal services and MOOE by: (1) fast-tracking hiring of teachers, policemen, doctors and nurses for hospitals in underserved areas; (2) stepping-up repair and rehabilitation of government buildings and purchasing supplies and equipment; and (3) continuing support for the FIELDS program of the Department of Agriculture. To ensure rapid disbursements, the government aimed to improve the

[15] Off-budget spending includes (1) P100 billion in infrastructure spending through PPPs, to be finance via a mix of GOCCs, GFIs and private sector; and (2) time-bound and targeted intervention from social security institutions (PhilHealth, GSIS, SSS) such as additional benefits to its members. Other measures also include payback packages for OFWs and support for sectors hardest hit by the crisis.

absorptive capacity of infrastructure agencies by awarding contracts no later than the first semester, realigning portions of the budget from projects that may be difficult to implement (e.g., right of way issues; no detailed engineering plans) and downscaling or deferring implementation of new projects without Investment Coordination Committee approval. Equally important is expanding social protection by increasing allocation for conditional cash transfers, scholarship, training, hospitals and fully covering national contribution to National Health Insurance Program (which covers the poor).

Table 1.6. Philippines: ERP Implementation Strategies

Strategies	Specific Interventions
Implement budget interventions	• Maximize the personal services budget by spending more on improving public order and minimizing health risks. Hence, more teachers, policemen, soldiers, doctors and nurses will be hired in 2009. • Allocate more for maintenance and other operating expenditures to step up repair and rehabilitation of government buildings; fast-track purchases of supplies and equipment like patrol cars and ambulances; continue support to the agriculture sector via the P40 billion (USD851 million) for Fertilizer, Irrigation, Extension work, Loans, Dryers, and Seeds (FIELDS) program of the Department of Agriculture (DA).
Accelerate spending for small infrastructure projects	• Front-load resources for full and quick spending, focusing on projects that are quick-disbursing, high impact and labor intensive (examples include accessibility facilities for the disabled and irrigation facilities). • Implementing agencies to spend 60 to 80 percent or P84.3 billion to P112.3 billion (USD1.8 billion to USD2.4 billion) of the productive portion of the 2009 budget during the first semester.
Expand social protection program	• Increase the allocation of the Department of Social Welfare and Development (DSWD) for conditional cash transfers, adding another P5 billion (USD106.4 million) to cover an additional 321,000 poor households. • Add P1 billion (USD21.3 million) to PhilHealth, representing the full contribution of the national government to the national insurance program. • Increase the allocation for the Technical Education and Skills Development Authority (TESDA) by PhP2 billion to help equip more Filipinos with skills that can help them take advantage of opportunities for income generation. • Add P1.97 billion (USD42 million) to the Department of Health (DOH)'s budget to improve the facilities and manpower of primary and secondary hospitals. • Match grants to local government units and allocate funds for student loans.
Save and create jobs	• Department of Labor and Employment (DOLE) and Overseas Workers Welfare Administration (OWWA) to: monitor overseas labor market displacements, monitor contracts of job orders to determine any decrease in overseas labor demand, facilitate worker registration, facilitate redeployment services to other emerging labor markets, identify and develop new market niches, provide repatriation assistance, expand livelihood/business formation programs, strengthen reintegration and business counseling services, and undertake skills upgrading and retooling services. • For export workers, DOLE to create quick response teams in its regional offices. Together with local companies, these teams will establish an early warning system to know which firms are likely to shut down or shed workers. Affected workers get assistance in claiming unpaid salaries, job placement and/or livelihood programs. • DOLE to push for alternatives to laying off workers, including shortened work shifts, maximized vacation leaves and rotating forced leaves, among others. • Put in place the Comprehensive livelihood and emergency employment programs (CLEEP) to support job generation. These programs are aligned to Super Region 1/ priorities, the needs of the 12 poorest and food poor provinces, and the food poor in Metro Manila.
Implement off-budget interventions	• Raise P100 billion (USD2.1 billion) with support from the private sector, government financial institutions, and social security institutions to lower financing costs for capital expenditures. • Accelerate spending for infrastructure under the comprehensive and integrated infrastructure program (CIIP). The CIIP uses public and private sector sources of financing, namely: official development assistance, national budget/general appropriations act, national-local government cost sharing, public-private partnership/joint venture, corporate funds, and proceeds from those mandated by law (i.e. Electric Power Industry Reform Act).
Other measures	• Ramp up housing programs; expand trade with China and West Asia, and pursue other strategies to boost investment growth; and implement programs to encourage exporting firms to diversify, innovate and upgrade their

Source: NEDA.

49. **While reporting on the outturn of the ERP is not yet available, implementation of key parts of the program have enabled it to achieve key goals**. While there is no final full report yet on ERP implementation, primarily because of the lag in collecting data from the implementing agencies, reporting on the outturns is frequently done in Cabinet presentations through the Global Recession Impact News, as well as via hearings in the Senate and the House of Representatives. Reports of the status of the different programs are released by the respective implementing agencies, and NEDA likewise monitors implementation. Overall, NEDA-NPPS reports that the ERP achieved its goals based on an initial assessment on implementation.

50. **The ERP's re-prioritization of the expenditure side of the budget towards social protection and infrastructure is appropriate.** Strengthening the social protection and poverty reduction content of the budget such as through the doubling of the CCT program, creates a better social safety net (both in terms of coverage and targeting) for its poor citizens, and is an effective fiscal stimulus in times of economic slowdown. The decision to select infrastructure projects that have a high employment content will also help cushion the impact of the slowdown on the labor market (see Chapter 4 for details of the impact of the crisis on the labor market).

51. **The frontloading of the ERP buffered growth in 2009, at a time when it was most needed.** With output growing by 0.9 percent in 2009 and potential output growth of more than 4.0 percent, a sizeable output gap arose during that year. The frontloading of the implementation of the ERP helped maintain economic activity by filling some of the gap created by the private sector. The ERP, nonetheless, could only partially buffer economic activity in 2009 since: (1) the headline ERP number includes a significant share of re-allocated spending (i.e., limited "new money"); and (2) the fiscal multiplier impact of the package is expected to have been moderate. Capacity constraints for off-budget spending are also likely to be challenging.[16] More specifically:

- <u>Limited new money to be spent</u>: the supplementary budget (containing the ERP) only contains P11 billion in additional spending compared to the draft budget submitted to Congress in August 2008. This reflects the fact that, while P160 billion in new spending programs have indeed been identified in the budget, some 2008 program allocations have been reduced or eliminated.[17] Second, most of the P100 billion in large infrastructure projects will be implemented after 2009.
- <u>Modest fiscal multiplier.</u> Several factors point to such a likely outcome:
  - *Revenue-driven fiscal easing is less effective in stimulating aggregate demand.* The tax effort has shrunk significantly in 2009 so that actual fiscal easing is projected to come, to a large extent, from the revenue side. Furthermore, broad/non-targeted tax cuts are found to be even weaker.[18]
  - *Fiscal expansions have limited stimulus impact on aggregate demand and output in developing countries in the short run* (Suescún, 2007; Kraay and Servén, 2008). Perotti (2007) suggests that, for developing countries, data and methodological problems are sufficiently severe that the effects of fiscal policy on short-term fluctuations are unknown.

[16] On the budget side, thanks to measures introduced by DBM to specifically accelerate the disbursement of budgetary allocations to departments ("use it or loose it policy"), implementation of key budgetary components of the ERP have taken place.

[17] Such examples include (1) the additional P3 billion for school building construction included in the ERP; this "additional" allocation makes up for the cut in the School Building Program that was originally included in the 2009 budget submitted to Congress; and (2) the additional budget for the provision of drugs, medicines and supplies in the Economic Stimulus Fund of P1 billion also merely offsets the decrease in MOOE for the Disease Prevention and Control program.

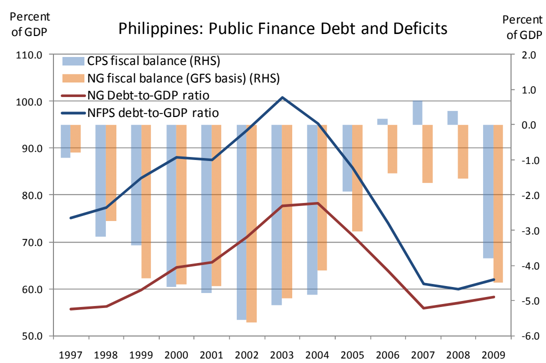
[18] For example, of the recent 2008 general tax cuts introduced in the US only 18 percent is estimated to have been consumed (Feldstein, 2009).

- *Fiscal policy in emerging markets has proved to be pro-cyclical* (Kraay and Servén, 2008). While the interpretation of this correlation is still open to debate, recent evidence suggests that it mostly reflects a mis-timing of fiscal interventions.[19] The latter is often attributed to weak institutions that place deep underlying limits on the ability of emerging market countries to generate successful fiscal responses.[20] A pro-cyclical fiscal bias during downturns is also clearly present in the Philippines (IMF, 2009c).

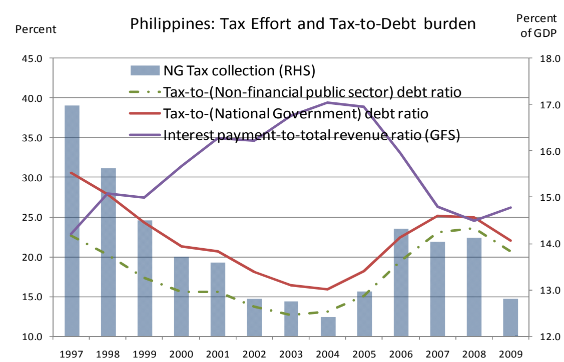
52. **Partly owing to the ERP, the fiscal deficit reached 4.1 percent of GDP in 2009, the highest level since the implementation of fiscal reforms in 2005-2006** (Figure 1.8a). The worsening of the fiscal balance was broadly evenly divided between higher spending (1.4 percentage points of GDP), and lower revenue (1.2 percentage points of GDP). On the spending side, 40 percent of the increase was due to discretionary primary spending (related to the Economic Resiliency Plan) and more than 20 percent due to the increases in the wage bill due to the adoption of the Salary Standardization Law (SSL III). On the revenue side, the decrease stems from a sharp drop in the tax effort (1.3 percentage points of GDP) so that the tax effort is now lower than in 2005 (the year of tax reforms). As a result, indicators of fiscal sustainability, such as the share of interest payments to total revenue is growing rapidly even though the country is currently borrowing at record low rates (Figure 1.8b).

Figure 1.8. Philippines: Public finance during the Crisis

(a) Gapping fiscal deficits and rising debt



(b) Rapidly declining tax effort, and rising share of interest payments to total revenue



53. **The overall structural fiscal balance deteriorated noticeably in 2009**—Figure 1.7. On the revenue side, the tax effort fell by 1.3 percentage points of GDP in 2009, of which 0.8 percentage points stems from permanent tax cuts and base eroding measures (e.g., the cut in the corporate income tax by 5 points to 30 percent, the lower personal income tax base due to the increase in the PIT threshold (RA9504) and the

[19] See Gavin and Perotti (1997), Kaminsky, Reinhart and Végh (2004), Ilzetzki and Végh (2008), and Calderón and Schmidt-Hebbel (2008). These papers find that fiscal procyclicality in developing countries arises from both the weakness of automatic stabilizers (mostly income taxes and transfer programs—these are often too small to have much effect) and the procyclical bias of discretionary policies.

[20] Fatas and Mihov (2002) find that the volatility of fiscal policy is substantially higher in countries with weak institutions. Calderón and Schmidt-Hebbel (2008) find strong empirical support for both institutional failures and credit constraints as determinants of countercyclical fiscal policy in emerging economies.

PERA law (RA 9505), the erosion of the VAT base due to the removal of VAT on electricity transmission). On the expenditure side, the implementation of the Salary Standardization Law 3 starting in July 2009 is further increasing the share of non-discretionary spending in the budget and contributes to reducing fiscal space.

54. As the Philippine transitions from a growth slowdown to a period of likely slow economic recovery, the following set of recommendations would help the country in fully realizing its growth potential and improve the inclusiveness of growth:

R2. Nest the targeted unwinding of the fiscal stimulus within a credible medium-term fiscal framework. A permanent reduction in the tax effort due to tax cuts, and a large increase in the share of non-discretionary spending in total spending, have significantly reduced fiscal space since 2008. Limited fiscal space and relatively high and rising debt level could increase pressure on interest rates and crowd out the private sector. A specific medium-term plan and path for unwinding the fiscal stimulus would minimize such risk. While the Government aims to achieve an overall fiscal balance by 2013, accompanying this commitment with detailed measures (and their likely timing and yield) and embedding them within a medium-term fiscal framework would be desirable.

R3. Create a strong revenue base to support sustained, inclusive growth, improve the economy's resiliency, preserve fiscal space, and improve the effectiveness of fiscal easing. The tax effort structurally weakened in 2009, mostly due to large and permanent tax cuts.[21] The following measures could be considered to efficiently and equitably strengthen the revenue base:

- *Tax policy*: (1) A moratorium on new tax eroding policy measures should be introduced until the tax effort has returned to, at least, its 2008 level; (2) Rationalization of fiscal incentives. Such a measure would broaden the base, eliminate tax redundancies (estimated at 1 percent of GDP by the IMF), improve horizontal equity among firms, not distort capital allocation, and facilitates tax administration and governance. The government is supporting one of the rationalization bills currently in Congress; (3) Adoption of the simplified net income taxation scheme (SNITS);[28] and (4) Increase excises on tobacco, alcohol, and gasoline. The latter, aside from being efficient as consumption has a low demand elasticity is also highly progressive, easy to collect, has the best revenue potential, and gasoline and diesel taxation is comparatively low in the Philippines—Figure 1.9 and Figure 1.10).

- *Tax administration*: such reforms would both help with short-term revenue gains while paving the way for long-term improvement in

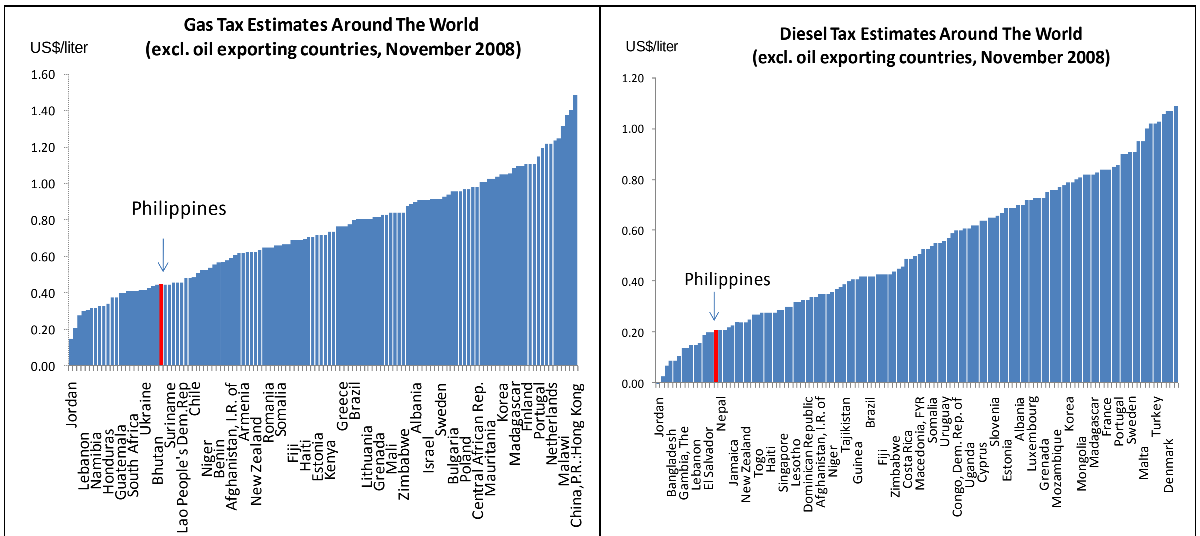
[21] It should be noted that the assessment that some fiscal space exists in the Philippines is based on the tax-to-GDP ratio existing prior to the onset of the global recession. However, this ratio is now projected to be back to pre-fiscal consolidation levels. At that time (2002, 2003), weak tax effort combined with large expenditure demands (especially ex post, from GOCCs—see Chapter 2) led to a fiscal crisis in the country.

[28] A bill on the simplified net income taxation scheme (SNITS) was recently passed by the Lower House and is projected by the DOF to raise P11 billion in annual revenue. The aim is to improve compliance and tax collection from self-employed and professionals through limiting expense deductions to core ones.

administrative efficiency. Through improved tax compliance they would also improve horizontal and vertical equity. Increased budgetary resources for BIR and BOC would enable such efforts, especially through the recruitment of skilled professionals. The renewed focus of the BIR leadership to strengthen its Large Taxpayers Service (LTS) is also commendable (e.g., the relisting of large taxpayers in January 2009). Such a reform has the potential of not only increasing revenues but also improving taxpayer services and providing a pilot reform that could later provide a blueprint for further reforms. At the same time, ongoing tax compliance and collection reform measures should be forcefully pursued.[31] Focus on these compliance-improving measures is warranted by a provision in the 2009 budget to institutionalize the RATE, RATS, and RIPS programs as permanent offices in the BIR, BOC, and DOF respectively. Improving performance monitoring and evaluation in BIR and BOC would help strengthening accountability, professionalism, and transparency of the Bureaus.

R4. Rationalize expenditure, including off-budget spending: to increase fiscal space and make room for more effective and targeted spending, reforms aimed at streamlining costly and non-targeted social spending programs such as the rationalization programs of the NFA and NIA should be a priority.[22]

Figure 1.9. Gasoline and Diesel Tax Estimates Around The World, 2008 1/



Source: OECD, International Energy Agency, "Energy Prices and Taxes".
1/ Excluding oil exporting countries. Data as of November 2008.

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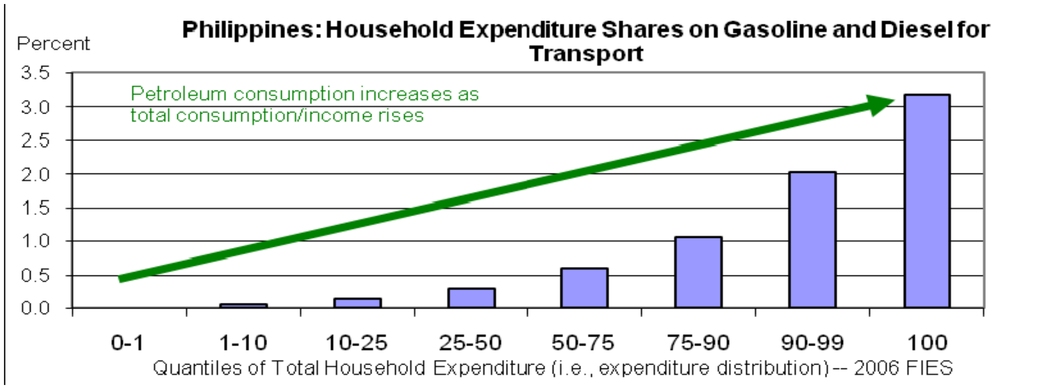
[31] These include expanding the tax base via third party information sharing and strengthening enforcement via the Run After Tax Evaders (RATE), Run After the Smugglers (RATS), and Revenue Integrity Protection Service (RIPS) programs. See the November 2008 WB Philippines Quarterly Update for details.

[22] See World Bank, 2008, for an extensive analysis of the issues and detailed recommendations, and Box 3 of World Bank, 2009i, for a comparison of the efficiency and cost-effectiveness of the NFA and the CCT program as social safety net programs. The analysis concludes that, by reallocating the fiscal transfers from the NFA to the CCT, 100 percent of the poor would receive coverage, against 25 percent, with each poor household receiving 7 times the benefits it receives with the NFA.

Figure 1.10. Philippines: Petroleum Taxation and the Poor, 2006



Source: FIES 2006 and World Bank staff computations.

Conclusions and Policy Recommendations

55. **The monetary and financial authorities' response to the global financial crisis and recession has been timely and effective; a key challenge is to time and pace the exit strategy**. Policy measures have tackled several potential stress points brought by the global financial crisis: maintaining the stability of the financial system, maintaining liquidity and confidence in the banking system, and conducting a monetary policy that, subject to price stability, is supportive of growth. The challenge as the economy moves towards a likely slow growth recovery is to make accommodative policies and relaxed regulatory forbearance work without encouraging unacceptable risk-taking. Ultimately, the accommodative monetary policy measures will need to be reversed. While this poses challenges, strong monetary policy credibility, a resilient banking system, and large foreign exchange reserves would enable the central bank to conduct monetary policy that is prudent and forward-looking. The following measures would ease the needed adjustment process and at the same time, authorize the BSP to issue its own securities, to remove monetary ceilings, ensure greater flexibility to adjust the reserve requirement, to obtain information from non-bank corporate sector and incorporate the financial stability goal in the conduct of monetary policy:

R1. Approve the proposed amendments to the New Central Banking Act (¶42).

56. **The Economic Resiliency Plan was an important factor in avoiding a recession in the Philippines in 2009**. Thanks to the front-loading of the expenditure part of the ERP, and to large and permanent tax cuts, the fiscal stimulus of the economy in 2009 has been significant and relatively timely.

57. For the Philippines to restore fiscal space and prepare the economy for a strong and inclusive recovery, the following set of measures (as developed in the previous section) are recommended (¶54):

R2. Nest the unwinding of the fiscal stimulus within a credible medium-term fiscal framework.

R3. Create a strong revenue base, and

R4. Rationalize expenditure, including off-budget spending.

2. FISCAL RISKS: ASSESSMENT AND RECOMMENDATIONS

Large fiscal risks, a weak legal and institutional structure for risk management, and gaps in fiscal data coverage, quality, and analysis threaten the sustainability of the macroeconomic stability achieved by the Philippines and, hence, of achieving inclusive growth. These risks are of a considerable magnitude and the government currently does not have a proper system to monitor and manage them. There is a pressing need to strengthen the legal framework and institutional structure for risk management and the coverage, quality, analysis and dissemination of data on fiscal risk, including through the regular publication of a fiscal risk statement. Such measures would greatly improve fiscal transparency and accountability.

IMPORTANCE AND ROLE OF FISCAL RISK ASSESSMENTS

58. **Fiscal risks—defined as the threat of significant variations of fiscal outcomes from budgetary plans or forecast—is an intrinsic part of fiscal policymaking and budget planning.** Cross-country experience reveals that fiscal risks are mostly related to macroeconomic shocks and the realization of contingent liabilities. The former include mostly shocks to GDP growth, exchange rates, interest rates, and oil prices. These can directly affect revenues, expenditures or the financing of the budget and public debt, as well as the operations and balance sheets of other parts of the public sector such as government-owned or controlled corporations and local government units.[23] The latter includes both explicit and implicit contingent liabilities such as debt guarantees being called and bailouts of the banking sector.

59. **Large fiscal risks have materialized in the Philippines.** These include two large banking bailouts episodes (early 1980s and 1997/98—with an estimated fiscal cost exceeding 10 percent of GDP), the recapitalization of the former central bank in 1993 (cost of 22 percent of GDP), of the Development Bank of the Philippines in 1986 (cost of 10 percent of GDP), the repeated recapitalization of the Philippine National Bank before its complete privatization in 2007, and the government assumption of part of the National Power Corporation debt in 2002 (5 percent of GDP). The sheer size of these risks have, at times, helped push the Government to default on the Philippines debt.[24]

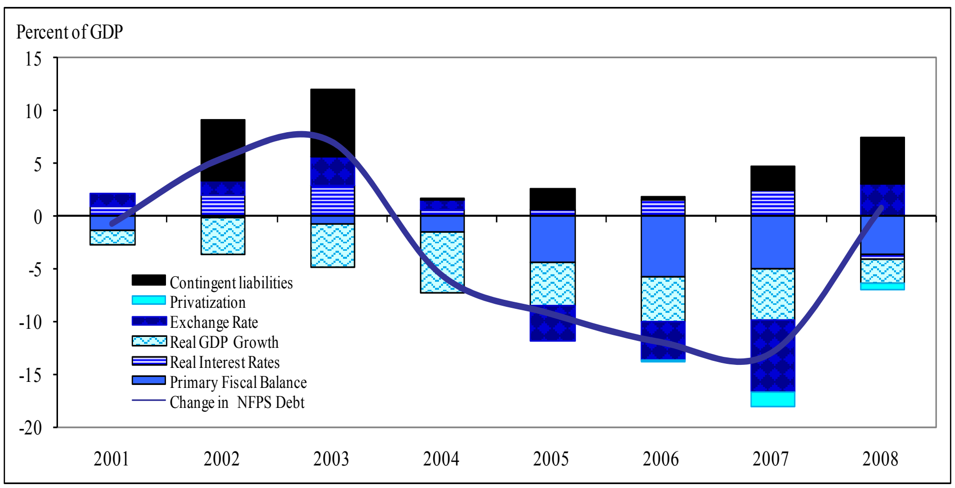
[23] The non-financial public sector in the Philippines includes the national government, CB-BOL (the old central bank), 14 monitored GOCCs, social security institutions, and local governments.

[24] In 1985 and 1987, the Government rescheduled principal debt maturities of most medium- and long-term liabilities owed to commercial bank creditors. It also rescheduled portions of the Philippines obligations to official creditors five times since 1980 (1984, 1987, 1989, 1991, 1994) on securities with face value of USD5.794 billion (Republic of the Philippines, 2009).

60. **Some previously large fiscal risks have decreased since the onset of the fiscal consolidation program in 2004**. The fiscal consolidation program centered on revenues and expenditures measures but also on the privatization of GOCCs. Coupled with structural reforms and privatizations, this improved the primary fiscal balance, which contributed significantly to lowering public debt; GOCCs proved to be large source of realized fiscal risk. Other key drivers of the debt-to-GDP ratio include the exchange rate,[25] economic growth, and contingent liabilities (Figure 2.1).

61. **Fiscal risks remain sizeable, and their likelihood of realization has increased with the ongoing global financial crisis and recession.** Notwithstanding the recent fiscal consolidation efforts, public debt remains high and sensitive to a growth slowdown and exchange rate shocks; rollover risks are also important given the large and rising gross financing requirements of the non-financial public sector; and contingent liabilities are large. All these risks have a higher likelihood of occurrence since the onset of the global financial crisis (e.g., through tightening of credit supply and increased risk premia) and the ensuing global recession.

Figure 2.1. Philippines: Public Debt Dynamics and Indicative Sources of Realized Fiscal Risks, 2001-2008



Source: World Bank staff based on various IMF Staff Reports for the Philippines.
1/ "Contingent liabilities" includes the recognition of implicit or explicit contingent liabilities, other identified debt-creating flows such as bank recapitalization, and other residuals including asset changes (see Debt Sustainability Analysis of IMF (2009) for details).

62. **The Philippines would benefit from disclosing fiscal risks in terms of improved risk management, economic efficiency, and reduced borrowing costs.** Having to publicly disclose the extent to which ongoing projects or policies subject the budget to fiscal risks is likely to better internalize their potential future costs (be it at the executive decision-making, Congress approval, execution, or even at a later election stage). Transparency should thus lead to better risk management and/or to the modification of policies that entail too large a risk for the budget; it could also strengthen accountability for risk management (such as a better understanding of the correlation among the various types of risks). Consistent with these benefits, empirical

[25] De Bolle et al. (2006) estimate that exchange rate depreciation accounted for half of the increase in the Philippines' debt-to-GDP ratio in 1998.

evidence reveals that fiscal transparency is associated with better sovereign bond ratings[26] and greater access to international capital markets in the long run (Hameed, 2005; Glennerster and Shin, 2008; and IMF, 2008).

63. The rest of the chapter is structured as follows. The next section assesses fiscal risks in the Philippines; first it provides a brief overview of fiscal policy objectives and their relation to fiscal risks, then it analyzes the three main types of risks to public finances: (1) macro-economic risks and budget sensitivities; (2) the public debt, in particular its structure and management; and (3) contingent liabilities. The latter include risks stemming from GOCCs, PPPs, the financial sector, LGUs, tax credit certificates, and natural disasters. Finally, the last section concludes and offers policy recommendations.

Fiscal Risks in the Philippines—A Preliminary Integrated Assessment

64. Assessing fiscal risks in the Philippines is complex as information is not widely disseminated or aggregated. Basic assessments regarding the predictability of the budget are difficult to undertake due to (1) the difference in reporting budget plans and outturns; and (2) extensive within-year reallocation of the approved budget between line agencies and special purpose funds.[27] More generally, the budget document does not include a clear statement on off-budget operations that create a risk of becoming on-budget (e.g., contingent liabilities and quasi-fiscal operations). The reporting of GOCC operations and their fiscal impact could also be improved (PEFA, 2009).

65. The fiscal risk assessment below is a first and preliminary attempt at mapping such risks in the Philippines; it is based entirely on publicly available information.

Fiscal Policy Objectives

66. **Fiscal strength is one of the key pillars of the country's Medium-Term Philippine Development Plan** (MTPDP) covering the period 2004-2010. Prior to the onset of the global recession, the government was aiming, by 2010, to (1) balance the national budget; (2) reduce the consolidated public sector deficit to 1 percent of GDP; and (3) reduce public sector debt to 90 percent of GDP. The government decision to postpone its 2010 budget balance goal because of the impact of the global recession on the domestic economy is a clear reminder of the fiscal risk (to a slowdown in economic growth in that case) surrounding the budget.

Macroeconomic Risks and Budget Sensitivity

Nature of Fiscal Risks

67. **How realistic is the budget and how sensitive is it to the macro-economic environment?** As budget outturns often deviate from the approved ones, understanding the underlying reasons is crucial to the credibility of the budget, its transparency, and

[26] Countries moving from no disclosure of macro-fiscal risks, contingent liabilities, or QFAs to providing information on all these counts would improve their credit ratings, on average, by a full notch (IMF, 2008).

[27] IMF Fiscal ROSC assessments of 2002 and 2004, and PEFA assessment of 2009.

its policy-making relevance. Determining the accuracy of budget forecasts, of macro-economic assumptions used for the budget and the sensitivity of the budget to key macro-economic variables and scenario provides valuable insights for policy-makers and wider stakeholders.

Quantification of Fiscal Risks

Accuracy of Budget Forecasts

68. **No systematic bias in the overall fiscal balance occurred over the past five years, although some pattern seems to emerge over sub-periods** (Table 2.1). The overall fiscal balance turned out to be higher than budgeted during the fiscal consolidation period of 2004-2006. This was the result of a moderate over-performance on the revenues front and significant under-spending compared to plans. Over the past two years, as the fiscal consolidation paused (based on GFS fiscal balances), the overall fiscal deficit turned out to be larger than budgeted, mostly on account of weak revenues performance (measured on a GFS basis). More specifically:

- *Revenues.*[28] Over the past five years, tax revenues were over-estimated compared to the budget. This overestimation has been significant and growing over time, to reach 1.1 percentage points of GDP in 2008. In contrast, non-tax revenues were regularly under-estimated.

Table 2.1. Philippines: Differences Between Targets and Outturn of Fiscal Aggregates 1/

	2004	2005	2006	2007	2008	Average Difference 2004-2006	Average Difference 2007-2008
	(in percent of GDP, unless otherwise stated)						
Total revenue 2/	-0.2	-0.1	-0.1	0.5	1.0	-0.1	0.7
Tax revenue 3/	0.3	0.2	0.2	0.9	1.2	0.2	1.1
Nontax revenue	-0.3	-0.3	-0.3	-0.6	-0.2	-0.3	-0.4
Total expenditure 2/	0.2	0.8	1.1	0.1	-0.1	0.7	0.0
Current Expenditures	0.5	0.7	0.6	0.4	0.2	0.6	0.3
Personnel services	0.3	0.2	0.1	0.2	0.5	0.2	0.4
MOOE	0.1	0.3	0.1	0.0	0.1	0.2	0.0
Allotment to LGUs	0.1	0.2	-0.1	-0.1	0.0	0.1	0.0
Tax expenditures	…	…	…	-0.2	-0.6	…	-0.4
Subsidies	0.0	0.0	-0.1	-0.2	-0.1	0.0	-0.2
Interest payment	0.3	0.8	0.6	0.7	0.4	0.6	0.5
Capital and equity expenditure 4/	-0.3	0.0	0.4	-0.3	-0.2	0.0	-0.2
Net lending	0.1	0.1	0.1	-0.1	0.0	0.1	0.0
Overall Fiscal Balance 2/	-0.3	-0.9	-1.2	0.3	0.9	-0.8	0.6
Balance (Government definition)	0.0	-0.9	-1.2	-0.8	0.9	-0.7	0.1
Memorandum Items:							
Interest Payment for CB-BOL	0.0	0.1	0.2	0.2	0.0	0.1	0.1
Nominal GDP (Billions of Peso) 6/	-158.6	-315.9	-33.6	62	-212.5	-169.4	-75.4
Privatization	…	…	…	-1.4	0.4	…	-0.5

Source: World Bank staff calculations based on IMF Staff Reports (various years).
1/ A positive value indicates that actual realizations were lower than budgeted.
2/ Using GFSM definition: privatization receipts are treated as a financing item and interest payments related to operations of the Central Bank-Board of Liquidators (CB-BOL) are counted as expenditures.
3/ Includes other percentage taxes, documentary stamp tax, and non-cash collections. Non-cash collections are also reflected as tax expenditures.
4/ The IMF includes equity in this item.
5/ Less changes in cash and non-budgetary accounts.
6/ For the budget, this refers to the lower bound of the range of GDP estimates

[28] The revenues bias would be less significant under the authorities' definition of revenues that differs from international standards (e.g., GFS) in treating privatization receipts as a revenue item. Indeed, since 2007, large tax revenue shortfalls have been "offset" by large privatization receipts.

- *Spending*. Up until 2008, actual spending has been below budgeted amounts (here defined to include both the budget appropriations and the carry-overs). The under-spending mostly arose in current expenditure. In particular, spending on personnel services, MOOE, and interest payments have turned out to be systematically over-budgeted; positive surprises in interest payments have been significant in three of the past five years with under-spending averaging 0.7 percent of GDP.

Accuracy of Macroeconomic Assumptions

69. **Macroeconomic forecasts have been reasonably accurate—except for price forecasts—and do not exhibit any systematic bias** (Table 2.2). The accuracy of macroeconomic assumptions is a key ingredient underlying the quality of fiscal outturns. Over the five years through 2008, the average forecast error for real GDP growth was 0.4 percentage points of GDP. The same pattern emerges for inflation. However, as with most countries and analysts, price forecasts have differed significantly from the outturn with oil prices and the exchange rate being key examples. Despite these occasional large price forecast errors, there does not seem to be any systematic forecast bias.

Table 2.2. Philippines: Accuracy of Macroeconomic Assumptions, 2004-2008 1/

Particulars	2004	2005	2006	2007	2008	Average Difference 2004-2008	Average of Absolute Difference 2004-2008
	(in percentage points, unless otherwise specified)						
GDP Real Growth	-1.0	0.8	1.4	-1.1	1.8	0.4	1.2
Inflation rate	-1.5	-3.2	1.3	1.8	-1.5	-1.5	2.7
91-Day Treasury Bill 2/	0.7	1.6	2.6	2.3	-0.9	1.3	1.6
Exchange rate (PHP/USD, period	-2.5	-0.1	4.7	5.9	2.5	2.1	3.1
L|IBOR Rate (6 Months)	-0.2	-0.6	-0.9	0.4	2.2	0.2	0.8
Dubai oil price (US$/Barrel)	-9.8	-16.6	-7.8	-3.4	-27.8	-13.1	13.1
Export growth 3/	0.2	6.2	-5.6	4.1	13.6	3.7	5.9
Import growth 3/	3.0	5.0	0.1	3.3	6.0	3.5	3.5

Sources: DBM, NSCB, BSP, and World Bank staff calculations.

1/ Differences between budget assumptions and outturns for selected macroeconomic variables from 2004 to 2008. A positive value indicates that actual realizations were lower than budgeted. For the exchange rate, a positive value implies that the currency was stronger (appreciated) than budgeted. Refers to the macro assumptions provided in the Budget of Expenditures and Sources of Financing submitted by the executive branch to Congress for the preparation of the General Appropriations Act.

2/ Weighted average in percent per year.

3/ Based on the Balance of Payments concept

4/ For variables where a range is budgeted, the difference is taken with respect to the midpoint of that range.

Budget Sensitivity to Macroeconomic Variables and Scenario

70. This section provides a preliminary attempt at estimating the sensitivity of the fiscal outturn to changes in key macroeconomic variable. As shown in Table 2.15 (Annex 4.1), several countries disclose such sensitivity analysis to Congress and to the public at large so as to better inform the policy debate and, ultimately, improve the quality of decisions. The analysis undertaken here is illustrative and therefore relatively simple.

71. **The budget is particularly sensitive to a few macroeconomic variables**, namely (Table 2.3)

- *Economic growth*: mostly affecting tax revenues. A decrease in real GDP growth lowers tax collection, especially income taxes, VAT, and import duties.[29] On the expenditure side, assuming no change in budgeted primary spending, the impact of lower growth will be higher interest spending (to finance the higher deficit arising from the revenues shortfall). A large impact on expenditure, however, arises in three years time as automatic NG transfers (IRA) to LGUs decrease.

- *Inflation:* impacts both revenues and expenditures. An increase in inflation leads, ceteris paribus, to higher tax and non-tax revenues. The former mostly thanks to VAT and income taxes. The latter would mostly benefit revenues from the Bureau of the Treasury and dividends from GOCCs. On the expenditure side, inflation would, with a hard budget constraint, lead to lower real purchasing power for MOOEs, capital spending, interest rates, and, to a lower extent, wages and salaries.

- *Exchange rate:* impacts both revenues and expenditures. A depreciation of the peso against the US dollar improves revenues collection, mostly through customs tariff, and to a lower extent VAT on imported goods. On the expenditure side, key categories to be affected include MOOEs, foreign interest rate payments, subsidies (e.g., for NFA rice), and capital spending.

Table 2.3. Philippines: Fiscal Sensitivity to Key Macroeconomic Variables

Nature of Shocks	Magnitude of Shock	Within year impact on	
		Overall fiscal balance	Primary fiscal balance
		(in billions of Pesos)	
Domestic shocks			
Real GDP Growth (in percentage points)	-1.0	-14.7	-14.4
Inflation Rate (in percentage points)	1.0	4.5	4.3
91-Day Treasury Bill (in percentage points)	1.0	-9.6	0.9
External shocks			
World Oil Price (US$/Barrel) (in US$/barrel)	10.0	3.9	3.9
Exchange Rate (Rp/US$) (in percentage point)	1.0	-1.0	1.4

Source: World Bank staff estimates.

72. **While the sensitivity of the budget to key variables is informative, alternative scenarios are more suited in capturing fiscal risks**. The inclusion of alternative sets of macroeconomic assumptions to the budget ones is intended to capture a different macroeconomic environment—e.g., a challenging global outlook such as the one currently experienced. This would affect all macroeconomic variables simultaneously. Scenarios therefore provide a better assessment of the extent of fiscal risk the budget could be exposed.

73. **Scenarios point to large risk surrounding the overall fiscal deficit; they also illustrate the role that policy reaction functions can play**. For illustration, two scenarios, developed in early 2009, are articulated around the 2009 budget. One is the World Bank's baseline projection (as of April 2009) that assumes the deficit will be

[29] Non-tax revenue are also expected to be negatively (e.g., lower GOCC dividend payments) affected but to a lower extent and their impact is difficult to quantify given the lumpy nature of some of these revenue.

contained, even in the face of falling revenue. The other, a low case scenario (Table 2.4). The "low case" scenario assumes economic prospects are gloomier than the baseline but, in contrast with the previous scenario, the government decides to implement its expenditure plans so as to stimulate the economy and close some of the output gap created by the private sector. The 2009 budget execution reveals that the fiscal deficit is near the midpoint of the low case and the base case, illustrating the value added that scenarios have in informing policymakers, legislators and the public at large.

74. **Although the budget document does not contain alternative scenario, the government's reaction function to key shocks is known and extensive executive powers enables quick reaction to shocks.** The government has a clear communication strategy detailing how it would react should the environment become, say, more challenging. During the 2009 budget, as the global economy turned into a recession, the government repeatedly committed to implementing its ERP so as to stimulate the economy. The President has significant budgetary execution powers that provide for extremely rapid adjustment of the budget, if needed. This materially reduces fiscal risks.

Table 2.4. Philippines: Budget Sensitivity to Macroeconomic Scenario (GFS basis)

	2008	2009			
	Est.	Budget	Scenarios 5/		Actual
			WB base case	Low Case	
	(in percent of GDP unless stated otherwise)				
Revenue and grant	15.6	15.9	14.8	14.4	14.6
Tax revenue	14.0	14.3	13.2	12.7	12.8
Net income & profits	6.3	6.2	5.9	5.7	5.4
Excise tax	0.8	0.7	0.8	0.8	0.8
Sales taxes and Licenses	2.7	3.4	2.6	2.6	2.8
Other 1/	0.7	0.6	0.7	0.7	0.6
Tariff (collection from the BOC) 2/	3.5	3.5	3.1	2.9	3.2
Nontax revenue 2/	1.6	1.6	1.6	1.6	1.8
Total expenditure	17.2	19.0	17.9	19.3	18.7
Current Expenditures	14.0	15.3	14.9	15.8	15.0
Personal services	5.0	5.4	5.3	5.5	5.4
MOOE	1.8	2.4	1.9	2.3	2.2
Allotment to LGUs	2.3	2.6	2.6	2.6	2.7
Subsidies	0.2	0.1	0.1	0.2	0.2
Tax expenditures	0.8	0.7	0.7	0.7	0.7
Interest payment	3.8	4.1	4.2	4.4	3.8
Capital Outlays 3/	3.0	3.5	2.9	3.3	3.6
Net lending	0.2	0.2	0.2	0.2	0.2
Balance (GFS definition)	-1.5	-3.1	-3.1	-4.9	-4.1
Balance (Government definition) 4/	-0.9	-2.5	-2.6	-4.4	3.9
Memorandum item					
Privatization receipts	0.4	0.4	0.4	0.2	0.0
Inflation (period average)	9.3	2.5 to 4.5	4.5	2.7	3.2
Real GDP growth	4.6	3.1 to 4.1	1.9	0.0	0.9
Nominal GDP (PHP billions)	7,498	7,968	7,984	7,700	7,669

Source: BTr, DBM for historical and budget numbers, World Bank staff estimates for the scenarios.
1/ Includes document stamp tax and tax expenditures
2/ Excludes privatization receipts (these are treated as financing items, in accordance with GFSM)
3/ Includes equity, capital transfers to LGUs and CARP - land acquisition and credit.
4/ Treats privatization receipts as revenues and does not include interest expenditure related to the CB-BOL.
5/ Scenario (developed in April 2009) assume that the budgeted expenditures are fully undertaken (aside from minor under-execution, especially capital spending reflecting capacity constraints); on the revenue side, no new measures are introduced.

Public Debt

Nature of Fiscal Risks

75. What are the risks that could generate pressure on the debt stock? How effective is the legal and institutional debt management framework in safely managing the public debt? How exposed is the public debt structure to key risks (rollover, exchange rate, interest rate changes)?

Legal Debt Management Framework

76. **The legal framework underpinning public debt management is fragmented and complex** (ADB 2007). Legal responsibility for public debt issuance, collection of information on public debt and guarantees, and debt management is devolved to several authorities and government entities, including the President, the BSP, the DOF (with at least six agencies in charge of specific components), NEDA, CoA, and less directly, DBM. Such a highly dispersed framework in debt management responsibilities puts a premium on having a high-level coordinating mechanism. In the Philippines, no such mechanism formally exists; coordination effectively takes place through ad hoc meetings.

77. **The Government plans to set up a Debt and Risk Management Office (DRMO) to address the shortcomings of the legal debt management framework.** Cognizant of the benefits of having a comprehensive approach to public debt management, the government's 2004-2010 MTPDP calls for establishing a DRMO. Such an Office is part of the new organizational structure of the Department of Finance under its rationalization plan; the plan, however, has yet to be ratified.

78. **No formal debt management strategy exists in the Philippines.**[30] Countries have found that establishing and publishing a debt management strategy, setting out the goals and objectives within which debt managers have to perform and are accountable to, helps in improving the overall risk structure of the portfolio and better understanding the various trade-offs in structuring the debt portfolio. A strategy establishing key objectives and priorities for debt management is a founding stone for building capacity in public debt management. The strategy then enables a coherent approach to: (1) designing prudent risk management strategy and policy; (2) allowing for the strengthening middle office analytical capability; (3) defining a framework for risk management; (4) ensuring consistency with other macroeconomic policies and objectives; (5) establishing an organizational structure that ensures clear accountability and transparency of responsibilities; (6) establishing a sound legal framework; and (7) recruiting trained staff, and selecting and implementing effective management information systems.

[30] It should be noted, however, that the MTPDP 2008-2010 laid out the indicative guidelines for the country's debt management strategies. These are (1) manage debt service and interest rate and exchange rate risks; (2)tighten guarantee guidelines for GOCCs as well as push for the removal of automatic guarantee provisions of certain GOCCs through the Fiscal Responsibility Bill; (3) improve governance of GOCCs/other government corporate entities (OGCEs) by strengthening oversight of departments over GOCCs; (4) enhance the capacity of DOF/ BTr to effectively manage public sector debt financing through the Debt Risk and Management Division; and (5) sourcing of least cost and least risky financing.

79. **A typical debt management strategy seeks to ensure that the government's payments and financing needs are met at the lowest feasible cost, subject to an acceptable level of risk.** The adoption of such formal strategies is becoming common practice in the region recently (e.g., Indonesia and Thailand in 2005); Indonesia also consolidated its external loans and domestic securities directorates into one Directorate General for Public Debt in 2006. To successfully implement the government's strategy, Indonesia's DG Debt is expected to: (1) favor domestic over foreign currency borrowing so as to lower foreign exchange risk (and foster the development of the domestic bond market); (2) increase the share of fixed rate debt to reduce interest rate risk, (3) lengthen maturities to reduce refinancing risk; and (4) rely mostly on concessional external financing (to the extent possible) to reduce external borrowing costs. Thailand's debt structure is an extreme example as it is almost all domestically issued, with fixed rates.

Quantification of Fiscal Risks

80. **Standard debt sustainability analyses reveal that the Philippines public debt is broadly sustainable** (e.g., IMF, 2010). Based on its projections of the primary fiscal balance and the macroeconomic environment for 2009-2013, the IMF finds that the non-financial public sector (NFPS) debt is projected to rise slightly in 2009 but then to the slowly decline by 2013. The downward debt dynamics is, however, vulnerable to the exchange rate and GDP growth developments.

81. **A probabilistic debt sustainability analysis using a "fan chart" methodology reveals that risks to the debt-to-GDP ratio are on the upside** (Figure 2.2). The "fan chart" approach (Celasun et al., 2006) builds on the baseline debt path projected in a standard debt sustainability analysis by adding confidence intervals around this central projection.[31] Fan charts summarize risks to debt dynamics by representing the frequency distribution of a large sample of debt paths generated by means of stochastic simulations. The fan chart reveals that while the baseline scenario (50th percentile) projects a debt path that is broadly stable, there is significant uncertainty surrounding this projection. Indeed, based on historical shocks that have hit the Philippines, there is a 90 percent probability that, by 2013, NG debt would be within the 42-140 percent of GDP range. The fan chart also clearly reveals an asymmetrical risk profile, with more risks on the upside than on the downside. There is, for example, a 40 percent probability that the debt-to-GDP ratio would return to its pre-fiscal consolidation level of 2004 (80 percent debt-to-GDP) by 2014.

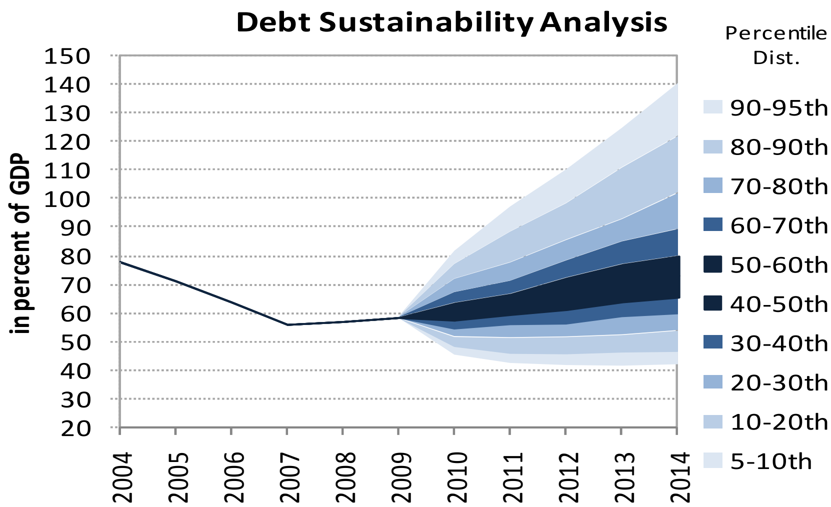
82. **Substantial progress was made in reducing fiscal risks stemming from the public debt since 2003.** The government has significantly improved the resilience of the public debt through: (1) a sharp decrease in the debt level; and (2) an increase in the share of public debt denominated in domestic currency thereby reducing exposure to exchange rate shocks (Table 2.5).

83. **Debt-related fiscal risks remain at an elevated level.** The debt-to-GDP ratio of the public sector remains high and, since 2008, started increasing again. The average time to maturity is relatively short (Table 2.6). These result in large and rising gross

[31] The confidence interval is constructed by drawing on the joint distribution of historical shocks to key macroeconomic variables (e.g., economic growth, the exchange rate, domestic and foreign interest rates).

financing requirements for the public sector, from 15.7 percent of GDP in 2008 to an estimated 19.4 percent of GDP (USD31.0 billion) for 2009, and 19.1 percent of GDP for 2010 (IMF, 2010). Although the government maintains a large pool of liquidity, including through its Bond Sinking Fund, these large needs expose the public sector to both rollover and interest rate risks. The share of foreign-currency denominated non-financial public sector debt remains high and exposes the country to exchange rate shocks.

Figure 2.2. Philippines: NG Debt Sustainability Analysis Using a Fan Chart Model 1/



Source: World Bank staff based on Celasun, Debrun, and Ostry (2006).
1/ The baseline scenario used for the 2009-2013 projections are the same as in the macro-economic framework of Table A.1

Table 2.5. Philippines: NG Debt Level, Composition and Guarantees, 2005–2008 [1/]

	2005	2006	2007	2008
	(In percent of GDP, unless otherwise stated)			
Total	82.2	73.3	63.0	59.8
Actual Debt	71.4	63.9	55.7	52.8
Domestic	39.8	35.7	33.1	30.7
Securities	39.2	35.3	32.8	30.4
Non-securities	0.6	0.4	0.3	0.3
Foreign	31.6	28.2	22.6	22.1
Securities	18.7	17.0	13.4	13.4
Non-securities	13.0	11.2	9.2	9.7
USD	21.2	19.3	15.4	14.6
JPY	7.5	6.2	5.1	5.3
Other	2.9	2.6	2.2	2.2
Guaranteed Debt	10.8	9.5	7.2	7.0
Domestic	0.9	1.2	1.0	1.0
Foreign	9.9	8.3	6.3	6.0
Memorandum item				
Nominal GDP (billion of peso)	5,444	6,033	6,648	7,498
Nominal Exchange Rate (PHP/USD, eop)	53.1	49.1	41.4	44.8

Source: Republic of the Philippines, Global Bond Prospectus, January 2009
[1/] Data as of June 2008.

Table 2.6. Philippines: Cost (2005-08) and Maturity (2008) of NG Debt

	2005		2006		2007		2008	
Effective Interest Rate	(in percent)							
Total	7.9		8.0		7.0		7.3	
Domestic	9.5		9.1		7.3		7.7	
Foreign	6.0		6.5		6.5		6.7	
Average time to maturity	Total		Zero coupon		Fixed Int. Rate		Floating Int. Rate	
(ATM)	ATM 1/	Share 2/	ATM 1/	Share 2/	ATM 1/	Share 2/	ATM 1/	Share 2/
Total NG debt	7.5	96.0	8.3	3.0	8.8	67.1	4.3	25.9
Domestic NG debt 5/	3.0	53.5	1.8	1.7	4.0 3/	32.0	1.5 4/	19.8
Foreign NG debt	13.2	42.5	16.7	1.3	13.1	35.1	13.5	6.1

Source: World Bank staff estimates based on publicly available data.
1/ As of June 2008. In years.
2/ Share to total National Government debt (in percent). Share does not sum up to 100 because of lack of available information regarding the type of a few debt issuances (see notes 3/ to 5/ for details).
3/ This does not take into account the P131.7 billion fixed-rate domestic securities that matured within July-Dec. 2008.
4/ These are mostly Treasury-bills issued to GOCCs. P10 billion debts with unstated maturity period are not included.
5/ A total of P22 billion domestic debt (about 0.6 percent of NG debt) are in the form of securities, of which P2 billion have a maturity based on demand of the creditors while the rest have unstated maturity period.

84. **Stress tests reveal that key macroeconomic shocks present a fiscal risk through their impact on NG debt**[32] (Table 2.7), in particular:[33]

- A 10 percent nominal depreciation of the peso's nominal effective exchange rate immediately increases the NG debt ratio by 2.9 percent of GDP. For lack of detailed data, a broad estimate of such a shock on NFPS debt could be about 3.7 percent of GDP; this would offset about 10 percent of the decrease in the NFPS debt from 2003 to 2008.

- A temporary (2009 only) 100 basis points increase in the average effective interest rate on NG debt, increases the NG budget's interest rate bill by 0.2 percent of GDP in 2009, and by 0.8 percent of GDP within five years.

Government Contingent Liabilities

85. **The realization of contingent liabilities accounts for a large share of fiscal risks in the Philippines** (Figure 4.1; Medalla and Jandoc, 2009). Government guarantees and other off-budget operations are often undertaken as a means to relax hard budget constraints. This partly stems from the Philippines' cash accounting approach to public finance, the limited short-term cash impact of approving contingent liabilities, and limited disclosure of fiscal risks surrounding contingent liabilities.

[32] Due to a lack of publicly available disaggregated data on the consolidated public sector debt, a stress test was conducted simulating a shock of key macroeconomic variables on the NG debt. NG debt is both lower than NFPS debt, it is also less risky, at least as far as exchange rate exposure is concerned.

[33] The magnitude of the historical volatility of interest and exchange rates is broadly in line with the sensitivity shown in the table (based on data for the past ten years, one standard deviation of the average nominal effective interest rate (exchange rate) on the public debt reached 0.5 (6.1) percentage points.)

Table 2.7. Interest and Exchange Rate Sensitivities of NG Debt and Debt Guarantees [1/]

	1 year impact	3 year impact	5 year impact
	(in billion of Peso)		
Interest Rate Sensitivity (1 percentage point increase [2/])	13.8	36.4	59.1
Direct NG debt	10.6	32.4	54.3
Domestic Interest Rate	7.9	29.7	51.5
Floating interest rate	0.5	0.5	0.5
Rolled over fixed rate debt	7.4	29.2	51.0
Foreign Interest Rate	2.6	2.7	2.8
Floating interest rate	2.6	2.6	2.6
Rolled over fixed rate debt	-	0.1	0.2
Guaranteed debt	3.2	4.0	4.8
Domestic Interest Rate	1.6	1.6	1.6
Foreign Interest Rate	1.6	2.4	3.2
Rolled over fixed rate debt	1.6	2.4	3.2
Foreign Exchange Rate Sensitivity (10 percent depreciation [3/])	231.9	…	…
Direct NG debt	180.3	…	…
of which against the US$	109.2	…	…
of which against the JPY	39.8	…	…
Guaranteed debt	51.6	…	…
of which against the US$	22.9	…	…
of which against the JPY	26.4	…	…
	(in percent of 2009 GDP)		
Interest Rate Sensitivity (1 percentage point increase [2/])	0.2	0.5	0.7
Foreign Exchange Rate Sensitivity (10 percent depreciation [3/])	2.9	…	…

Source: data from RoP 2009 Global Bond Prospectus; estimates from World Bank staff.
1/ Assuming maturing debt is rolled over on a fixed term. The analysis does not include cost of financing future deficit and other off-budget items.
2/ Assuming the shock is temporary and lasts only from January 1-December 31, 2009.
3/ Results show the immediate impact on the peso-value of the NG debt stock of a 10 percent effective nominal depreciation of the Peso in 2009.

Government-Owned and –Controlled Corporations (GOCCs)

86. **Philippines GOCCs, given their size and history of being a large fiscal drain, are a large source of fiscal risk**. Notwithstanding the privatization program that started in the late-1980s, 736 companies still remain as government owned and controlled; these account for a large share of economic activity, and are dominant players in a few sectors. Excluding the BSP, assets of GOCCs reached 56 percent of GDP in 2007, while liabilities amounted to 30 percent of GDP, most of which are foreign currency-denominated. Of the 736 GOCCs, 14 were identified in the 1980s as having a large macro-fiscal relevance and are closely monitored by the DoF (Table 2.8).

87. **In the Philippines, conflicting GOCC mandates expose these companies to administrative and regulatory risks.** GOCCs often have dual mandates—social and commercial objectives—that can be contradictory. While their attachment to line departments is intended to achieve consistent sectoral planning, this often leads to agency concerns taking precedence over the companies' commercial objectives. Frequently, GOCCs are directed to bear the cost of social programs that should ideally be funded out of the budget (quasi-fiscal activity (QFA)). Public utilities in particular face considerable regulatory risk as user charges are often maintained at subsidized levels. Financial institutions are usually asked to finance "socially-desirable" projects that may not be financially viable (another QFA).

88. **Most Philippines GOCCs receive preferential treatment vis-à-vis the private sector, which weakens financial discipline and ultimately raises fiscal risk**. GOCCs receive an array of preferential treatment compared to private sector companies

and financial links between public sector entities are often not properly recorded and disclosed; among these are (1) exemptions from various taxes; (2) captive government deposits for GFIs that shield them from market discipline and provide a financial edge over competitors; (3) access to budgetary support in the form of operational subsidies, advances for debt service payments and new equity infusions; (4) access to loans from GFIs and IFIs, although with credit safeguards; (5) receipt of proceeds of bonds issued by the National Development Company (NDC); and, (6) receipt of (sometimes automatic) sovereign guarantees on their foreign and domestic debts.

Table 2.8. Philippines: Summary Financial Statistics of Selected GOCCs, 2007

GOCCs	Assets	Equity	Total Income	Net after tax income	Total Liabilities Dom. 1/	Total Liabilities Foreign
			(in percent of GDP)			
Total GOCCs	56.2	24.4	12.5	4.7	…	…
14 Main Non-Financial GOCCs	24.1	5.5	7.2	3.2	6.0	12.3
HGC	0.4	0.1	0.0	0.0	0.3	0.0
LRTA 2/	0.7	0.0	0.1	0.0	0.2	0.5
LWUA	0.3	0.1	0.0	0.0	0.0	0.1
MWSS	0.9	0.6	0.1	0.0	0.1	0.2
NDC	0.1	0.0	0.0	0.0	0.1	0.0
NEA	0.3	0.0	0.0	0.0	0.2	0.1
NFA	0.4	-0.7	0.5	-0.1	1.0	0.0
NHA	0.4	0.3	0.0	0.0	0.1	0.0
NIA 3/	0.8	0.3	0.0	0.0	0.5	0.0
NPC/TRANSCO/PSALM	17.1	2.9	5.1	2.3	3.0	11.0
NPC 4/	16.3	2.7	4.8	2.0	…	…
PSALM	0.9	0.2	0.3	0.3	…	…
PEZA	0.1	0.0	0.1	0.0	0.0	0.0
PNOC (Consolidated)	1.0	0.7	1.1	1.0	0.1	0.1
PNR	0.2	-0.1	0.0	0.0	0.3	0.1
PPA	1.4	1.2	0.1	0.0	0.1	0.1
Government Financial Institutions 5/	9.3	1.2	0.7	0.1	0.6	2.0
DBP	3.5	0.5	0.3	0.1	0.6	1.2
LBP	5.8	0.6	0.4	0.1	0.0	0.8
TIDCORP 6/	0.0	0.0	0.0	0.0	0.0	0.0
Social Security Institutions 7/	10.4	10.1	2.5	0.8	0.0	0.0
SSS	3.7	3.7	1.2	0.2	…	…
GSIS 8/	6.6	6.5	1.3	0.6	…	…

Source: CoA 2007 GOCC Audit Report; and DoF for liabilities data. For full names of the GOCCs, please refer to the acronyms and abbreviations table at the beginning of the report. Assets less equity may not sum up to liabilities because of the difference in datasets and exclusions of items that constitute liabilities in DoF data, especially for GFIs (see other notes). CoA financial data have been adjusted as follows: (1) BSP and CB-BOL were excluded; (2) LBP, GSIS and PNR were directly added without further adjustments. Net income numbers exclude subsidies.

1/ Domestic Liabilities include accruals, miscellaneous liabilities, interest payables, deferred credits and payables to non-bank/non-financing entities.

2/ Outstanding BTR advances amount to P9,815 million.

3/ NIA liabilities include P2.0 billion loans from NDC from Agri-Agra. Hence, deferred credits are not yet deducted.

4/ NPC liabilities includes Transco and PSALM. They do not include inter-agency account between NPC & PSALM. They include P10.77 billion in electric cooperative loans assumed by PSALM.

5/ GFI liabilities in this table are only domestic and foreign loans. They do not include deposit liabilities, accounts payable, accrued expenses, taxes payable, and similar items.

6/ From TIDCORP annual report, except for liabilities.

7/ SSI liabilities in this table are only domestic and foreign loans. They do not include accounts payable, insurance expense payable, fund held in-trust, deferred income, and similar items.

8/ GSIS-Social Insurance Fund and GSIS-Administered Fund.

89. **Excluding privatization receipts, GOCCs have continued to be a net financial drain on the NG budget** (Table 2.9). After netting out non-recurring privatization receipts, net transfers from the NG budget to GOCCs have been positive in six of the past eight years. The dependence of non-financial GOCCs on NG support is

evident with positive NG transfers in seven of the past eight years (reaching 1 percent of GDP in January to November 2008). With dividend payments mostly lagging subsidy payouts, reform of leading loss makers is needed to minimize risks to the budget.

90. **GOCC financial losses and associated public debt issuance have at times been substantial and continue to represent significant fiscal risks** (Table 2.10). The 14 major GOCCs have in the past accounted for as much as 36 percent of the consolidated public sector deficit (2004) and a third of the public sector debt (2003). The improvement in 2005-07, following adjustment of power rates of the NPC and significant privatization revenues in the energy sector in 2007 lowered these losses substantially. However, 2008 saw a large (1 percent of GDP) and unexpected surge in losses from the National Food Authority (NFA) on account of rice subsidies. Other major GOCCs that have high debt stock and have a poor operating track record include the Light Rail Transit Authority (LRTA), Philippines National Railway (PNR) and the National Irrigation Authority (NIA); LRTA's debt-equity ratio is over 19 in 2007 while PNR has negative equity. While GOCC debt ratios have been declining on the back of strong economic growth, peso appreciation, low interest rates, and operational developments, the sensitivity of GOCC debt to macroeconomic developments, including foreign exchange and interest rate movements, would have to be assessed individually and as a group to enable government to better understand and manage these risks. Lack of publicly available data prevents this assessment from being undertaken here.

Table 2.9. Philippines: Net Budgetary Flows to GOCCs, 2001-08

	2001	2002	2003	2004	2005	2006	2007	2008 1/	2001-08
				(in percent of GDP)					
I. NG Flows from GOCCs	0.5	0.4	0.4	0.2	0.2	0.4	1.7	0.2	4.1
Dividends	0.3	0.2	0.1	0.1	0.1	0.3	0.1	0.1	1.3
Interest on NG Debt Advances	0.0	0.0	0.1	0.0	0.0	0.0	0.1	0.0	0.2
Guarantee Fees Collected	0.2	0.2	0.2	0.1	0.0	0.0	0.2	0.0	0.9
Privatization Recepits	0.0	0.0	0.0	0.0	0.0	0.1	1.4	0.1	1.7
II. NG Flows to GOCCs	0.4	0.3	0.8	0.5	0.5	0.4	0.8	1.1	4.9
Subsidy	0.3	0.2	0.3	0.3	0.2	0.2	0.4	0.2	2.2
Equity	0.0	0.0	0.1	0.0	0.0	0.1	0.1	0.0	0.3
Net Lending	0.1	0.1	0.1	0.1	0.0	0.0	0.1	0.3	0.9
Tax Expenditures	0.1	0.0	0.2	0.1	0.2	0.1	0.2	0.6	1.6
III. Net NG Flows to GOCCs (I - II)	0.1	0.1	-0.4	-0.3	-0.3	0.0	0.9	-0.9	-0.8
Excluding privatization receipts	0.0	0.1	-0.4	-0.3	-0.3	-0.1	-0.5	-1.0	-2.5
Government Financial Institutions	0.1	0.1	-0.1	0.0	0.0	0.1	0.0	0.0	0.2
Major Non-Financial Gov't Corp.	-0.1	0.1	-0.3	-0.3	-0.1	-0.1	-0.2	-0.8	-1.8
Other Government Corporations	0.0	0.0	-0.1	0.0	-0.2	-0.2	-0.2	-0.2	-0.9

Source: Bureau of the Treasury
1/ 2008 Figures are as of end-November

91. **Fiscal risks from some GOCCs' large and unhedged foreign exchange exposure are high**. Because of the cheaper financing terms (on a non-risk-adjusted basis) and cash flow constraints, GOCCs have often raised bonds in foreign rather than domestic currency. As a result, foreign loans of the 14 major GOCCs and three GFIs account for over 60 percent of their stock of debt of P1.5 trillion as of June 2008. In some cases, GOCCs have incurred large foreign loans but have limited foreign exchange earnings. GOCCs do not seem to have entered into derivative transactions to hedge their exposure. Preliminary estimates show that a 10 percent peso depreciation

translates into over P100 billion (1.3 percent of GDP) of losses for that GOCC group, under current international/Philippine accounting rules.[34]

92. **GFIs have also been a key source of realized fiscal risks, as directed credit and investments have weakened them to the point where large bailouts were needed**. Notable examples of government bailouts include the old Central Bank in 1993 which generated a fiscal cost of 22 percent of GDP,[35] the Development Bank of the Philippines in 1986 (10 percent of GDP[36]), and the repeated recapitalization of the Philippine National Bank before its complete privatization in 2007. In other cases, while short-term fiscal costs were avoided, the long-term sustainability of the institution's functions was weakened. Examples include the Social Security System (SSS) and the Government Service Insurance System (GSIS) that were both directed to finance, among others, a nationwide failed housing program in the 1980s that saddled their portfolios with nonperforming loans. The National Development Company (NDC) and the Home Guaranty Corporation (HGC) are two other GOCCs performing financial functions that have seen earnings deteriorate as a result of directed investments.

Table 2.10. Philippines: Consolidated Public Sector Financial Position, 2002-08

	2002	2003	2004	2005	2006	2007	2008 1/
			(in percent of GDP)				
Consolidated public sector financial position	-5.6	-5.1	-4.8	-1.8	0.2	0.6	0.4
Non-financial public sector financial position	-6.8	-6.4	-5.9	-3.4	-1.3	0.8	-1.2
Financing position of 14 monitored GOCCs	-1.2	-1.5	-1.8	-0.5	0.0	0.9	-0.2
Consolidated public sector debt	110.2	117.6	108.7	92.5	81.9	71.8	73.1
Non-financial public sector debt	93.7	100.8	95.2	86.4	73.9	61.1	61.0
Outstanding debt of 14 monitored GOCCs	34.7	38.4	31.9	28.9	24.0	18.2	18.4

Source: Department of Finance
1/ As of September 2008 for deficit data; as of June 2008 for debt data.

93. **National government guarantees on GOCC loans and bonds explicitly expose the budget to GOCC credit risk** (Table 2.11). As of October 2008, the NG has guaranteed exposures of P610 billion (8.2 percent of GDP), predominantly on foreign borrowings of GOCCs (6.2 percent of GDP). The 14 GOCCs and three GFIs account for 85 percent of the foreign GOCC loans guaranteed by the NG. Data on government's past assumption of guaranteed debts are only part of the true extent of GOCC guarantee calls as the NG often provide Treasury advances for GOCC debt service payments before any default happens. These advances bring the current portion of the contingent liabilities on budget and effectively increase corporate sector debt by

[34] Based on foreign debt stock of P942 billion as of June-08 for the 14 GOCCs and 3 GFIs. Exchange rate is based on end-June08 rate of P44.76 per USD.

[35] This represents the amount of liabilities retained with the Central Bank Board of Liquidators (CB-BOL) that the government continues to service today. The restructuring was based on a good bank (BSP)–bad bank (CB-BOL) division of the old central bank's balance sheet. Of its outstanding assets as of July 2, 1993, 47 percent were transferred to the BSP while liabilities transferred to the BSP were mostly currency issues and deposit liabilities (Tetangco, 2003).

[36] This represents liabilities transferred to the NG (www.devbankphil.com.ph/offering_circular.pdf).

about 10 percent. While advances are booked as assets of the BTr, the repayment record to date is poor.

94. **Fiscal risk stemming from exchange rate movement is compounded by NG provision of forward cover on foreign exchange risk of GFI loans**. On top of the foreign exchange risk that it is indirectly exposed to by guaranteeing GOCC foreign loans, the NG has also provided forward cover for foreign exchange risks on the multilateral loans of two of its banks (DBP and LBP).[37] Government exposure on these guarantees depends on (1) whether the guarantee fees charged capture expected exchange rate movements, or alternatively, whether they are reflective of the interest rate differential (the latter seems to be the case); and (2) the timing of the peso depreciation vis-à-vis loan drawdown and repayment (the NG may be exposed in the short-term especially if the Peso depreciates by a large percentage). Irrespective, collected fees are not cumulated as reserves to cover varying exchange rate movements from year to year. Risk on the budget in any year thus arises from extreme currency movements, especially pertaining to the maturing portion and interests.

Table 2.11. Philippines: Outstanding NG Guarantees to GOCCs, 2002-08

	2002	2003	2004	2005	2006	2007	2008 1/
				(in percent of GDP)			
Direct Loan Guarantee	14.5	16.1	16.8	10.6	9.4	7.2	7.2
Domestic	0.5	0.5	0.7	0.9	1.2	1.0	1.0
Foreign	14.0	15.5	16.2	9.7	8.2	6.2	6.3
Assumed GFI Guarantee	0.4	0.4	0.3	0.2	0.1	0.1	0.1
Domestic	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Foreign	0.4	0.4	0.3	0.2	0.1	0.1	0.1
Guaranteed Corporate Issues	0.5	0.5	0.6	0.8	1.1	1.0	0.9
Domestic	0.5	0.5	0.6	0.8	1.1	1.0	0.9
Foreign	…	…	…	…	…	…	…
Total NG Guarantees	15.4	16.9	17.7	11.5	10.5	8.3	8.2
Domestic	1.0	1.0	1.3	1.6	2.3	2.0	1.9
Foreign	14.4	15.9	16.4	9.9	8.3	6.3	6.3

Source: BTr, FPPO-DOF
1/ As of November 2008

95. **The poor financial health of one GFI exposes the government to its guarantee obligations.** By charter, the government backstops the guarantees issued by three institutions, primarily to the housing, agriculture and export sectors (Home Guaranty Corporation (HGC); Quedan and Rural Credit Guarantee Corporation (Quedancorp); and Trade and Investment Development Corporation (TIDCORP)). Of the three, HGC has the largest amount of outstanding guarantees totaling P72.8 billion at end-2007 (1.1 percent of GDP), and the weakest financial condition, namely: it has (1) persistent losses since 2002; (2) not remitted dividends to the government since 2003; and (3) received persistent equity support from the NG budget to help cover finance

[37] Latest available data for LBP (2007) show that its foreign loans with foreign exchange risk cover amounted to $305 million, JPY 23 billion and EU 8.8 billion. As of 2007, DBP has the equivalent of P64.7 billion in foreign loans with NG foreign exchange risk cover (Source: COA reports of LBP and DBP).

charges that were two to three times greater than total income in 2006 and 2007. HGC is expected to cost the NG budget P10 to P15 billion (cost of operations, NG equity, cost of equity, foregone taxes) for the next five years (ADB, 2008). HGC is planning to issue bonds in 2009 to refinance maturing loans; these carry sovereign guarantee and interest earnings up to a certain rate are exempted from taxes.

96. **Major reduction in fiscal risks from GOCCs have occurred through privatization and offloading of activities to the private sector.** The case of the NPC is instructive. While the company continues to need fiscal support,[38] its privatization (54 percent of its power plants has successfully been auctioned off) as well as the off-loading of the operations of the Transmission Company to a private company via a concession arrangement has effectively transferred market, financial and operational risks of the power plants and the transmission assets, including future investment responsibility, to the private sector. In the past, the company was one of the largest sources of fiscal drain and risk. The recent Energy Regulatory Commission decision to allow power rate adjustment helps mitigate fiscal risk.[39]

97. **Significant fiscal risk seems to remain from large GOCCs that already receive budget support**. In contrast to the NPC, several other GOCCs appear stuck in loss-making operations and would require major restructuring to improve their performance (Table 2.12). These include the NFA, which has consistently operated at a loss in the past ten years, PNR, which likewise has negative equity, and LRTA, which in addition to fare subsidies is operating under a huge debt overhang. In the short-term, additional risks to GOCC performance include (1) lower revenues as the economy slows down in 2009; (2) peso depreciation that would lead to rising debt service costs and foreign exchange losses; (3) inability to recover costs through price adjustments for political / social / regulatory reasons; and (4) for GFIs, the need to raise additional capital, including possibly from the NG, due to potential adverse impact of economic downturn (e.g., rise in non-performing loans, mark-to-market losses[40]).

98. **Managing fiscal risk from GOCCs is challenging as no mechanism exists to limit annual government off-budget exposures to them**. While the outstanding stock of NG guarantees on foreign debt is limited by law to $7.5 billion, certain GOCC loan guarantees as well as guarantees under build-operate-transfer arrangements are excluded from this ceiling. Domestic debt guarantees are also excluded and are not capped. Moreover, many GOCCs enjoy automatic sovereign guarantees in their charters. Efforts from DOF, DBM and NEDA are ongoing to improve upon the current situation and include a system that will estimate the extent and cost of exposure to contingent liabilities of BOT projects. In January 2010, the Executive Boards of the

[38] Outstanding BTr advances to NPC increased by over P10 billion in 2008 and the 2009 budget also includes support to NPC. Planned borrowings by PSALM will require sovereign guarantees.

[39] The more challenging investment and operating climate in the near term, in light of global recession, may slow down government's privatization efforts and will likely increase fiscal risk as (1) receipts from additional asset sales may not be forthcoming and (2) NPC's financial condition may deteriorate since it will be operating less efficient plants (as the most efficient ones were the first to be privatized) and with reduced demand, it will have to sell excess supply competitively through the wholesale spot market.

[40] This may be truer of Land Bank, which, according to news reports, has a capital adequacy ratio of 14.7 percent (10.7 percent on Tier 1). DBP on the other hand has a capital adequacy ratio of 25.4 percent.

DBCC and the ICC decided to install an evaluation scheme for projects going through the ICC.

Table 2.12. Philippines: Financial Strength of Selected GOCCs

GOCC	BTr advances (billion Peso) 1/	Financial condition
NPC	16.7	After generating profits in 2005-07, NPC reverted to a net loss in 2008. DBM data forecast losses at the operating level of P14.8 billion in 2008 and P28.7 billion in 2009 4/. The deterioration reflects the impact of the power privatization program on power generation operations (i.e., declining energy sales and higher cost of generation per kWh associated with remaining, less efficient, plants that has not yet been reflected in tariff rates).
LRTA 2/	8.7	While LRTA revenues are currently enough to cover operations and maintenance costs, without fare adjustments, it will need nearly P800 million annual subsidy from government through 2015, in addition to support to meet debt payments of P3 to P4 billion annually.
NIA	22.9	The national government has been advancing payments for NIA's outstanding loans to multilateral agencies (mostly ADB, IBRD) and to meet NIA's obligations under the Casecnan multi-purpose BOT project (P5.8 billion for January to November 2008). No information on the NIA is available in budget documents.
NFA 3/	3.5	Despite a P1.1 billion national government equity infusion in 2007, NFA remains capital deficient with continuing losses projected through 2009. Government has been providing increasing amounts for NFA's price stabilization and food security program (2009 budget allocates P4 billion) on top of tax expenditures amounting to an estimated P32 billion in 2009. NFA losses are estimated at 1 percent of GDP in 2008 following high international rice prices and large rice imports.
PNR 2/	9.5	PNR is able to recover only 15 to 25 percent of operations and maintenance costs, with government subsidizing operations by an average of P235 million annually. It requires P4 to P5 billion over the next five years to meet its debt obligations.

Source: World Bank staff.
1/ Outstanding as of November 2008.
2/ Based on ADB GOCC Technical Assistance, 2008 (www.adb.org)
3/ Data based on financial statements posted at www.dbm.gov.ph.
4/ Based on 2009 National Expenditure Program of the DBM (www.dbm.gov.ph). The reported net losses are P63 billion in 2008 and P2.5 billion in 2009 (significantly reduced thanks to a projected large foreign exchange gains). These forecasts were prepared before the recent ERC decision to adjust power rates.

99. **Institutions have been established, mainly at the DoF, to address some of the fiscal risks stemming from GOCCs.** Administrative Order 19 (2001) attempts to address problems with unmonitored GOCC borrowings by requiring all GOCCs to submit their foreign currency denominated loan proposals to the DoF for approval prior to loan negotiations. As part of its screening process, the DoF establishes the legal basis for government to extend a particular guarantee, ensures that amounts guaranteed are within the legal ceiling, reviews the financial condition of the GOCC, including track record of dividend payments and requests for advances, as well as financial terms of the GOCC loan. For capital market operations, the DoF also ensures that GOCC borrowings are coordinated with the Republic's own borrowing program.

100. **Erosion of DoF technical capabilities to monitor and evaluate GOCC performance underlines difficulties in managing GOCC-related fiscal risks**. The DoF's Corporate Affairs Group (CAG) has the direct mandate to evaluate GOCC performance in line with fiscal risk management. CAG concentrates on monitoring fiscal risks arising from 14 major GOCCs as well as three GFIs. However, given CAG's limited manpower resources—31 staff compared with about 55 positions in its

rationalization plan—monitoring of other GOCCs occurs when these require government guarantees, and not on a continuous basis.[41] CAG aims to reintroduce a GOCC performance evaluation system.

Public-Private Partnerships (PPPs)

101. **The Philippines has a relatively long history of financing large infrastructure projects through PPP arrangements.** The build-operate-transfer (BOT) law of 1993 (Republic Act 7718) and its implementing rules and regulations provide the regulatory framework for private sector participation in infrastructure projects. The law requires national level BOT projects to be approved by the inter-agency Investment Coordination Committee (ICC). The ICC reviews projects in terms of their fiscal, monetary, and balance of payments implications. ICC clearance is a pre-condition for projects to secure government guarantees.

102. **PPP arrangements generate a diverse, complex and often large array of fiscal risks** (Table 2.13). The large BOT projects (defined broadly to include other forms of PPPs such as concessions) are currently in power (independent power producers, Transco), water (mainly MWSS concession) and transport (rail lines, toll roads). Fiscal risks stemming from these projects include risks related to right-of-way, political/regulatory risk, change in law, currency convertibility, events of termination and other events of force majeure. A typical IPP contract, however, would also pass fuel supply and market risks to government, risks that the private sector absorbs in for example, toll roads. The form of market risk guarantee, whereby fixed contractual payments are denominated in dollars, would expose government to foreign exchange risks as well. All these risks have varying probabilities of occurrence and once triggered, have varying impact on the budget.

103. **A strong legal and institutional framework for project selection, approvals and contract negotiations is needed to comprehend fiscal risks involved in PPPs**. The implementing agencies responsible for identifying and selecting BOT projects for ICC approval have limited technical, legal and financial capabilities to negotiate and write BOT contracts that minimize fiscal cost and risks. Additional due diligence by oversight agencies (NEDA, DoF, DBM), while often resulting in long negotiation periods, therefore helps to limit fiscal risks. Nonetheless, in some cases, despite concerns of the ICC technical team about a project's financial feasibility, these were set aside in light of a project's social desirability. These latter decisions have tended to increase fiscal risks as government assumes long-term risks to make projects financially attractive for the private sector. To expedite the long BOT approval process, a recent proposal includes assigning to line agencies the responsibility of project approval. While improving the efficiency of the approval process is desirable, the proposed reduction in the role of oversight agencies might ultimately increase fiscal risks significantly (Llanto, 2007b).

104. **The institutional setup for a comprehensive monitoring and management of fiscal risks stemming from BOT projects does not exist**. No government unit is responsible for undertaking a comprehensive, exhaustive and timely information on

[41] The two large pension institutions—despite their large unfunded liabilities—are lightly monitored.

BOT projects.[42] While the DoF's review process would involve stress testing project parameters to determine the range of outcomes and government exposures, this is done in isolation at the individual project level without reference to the wider risk profile of public sector debt and other contingent liabilities. Moreover, because of limited resources (manpower, technology), there is no system to bring together information on BOT projects to be able to continually monitor risk parameters and their likely impact on the budget. Further analyses involving sensitivity tests, scenario analyses or expected value assessments have periodically, and confidentially, been undertaken by consultants.

Table 2.13. Philippines: Fiscal Risks Arising from Selected BOT Projects

Project	Type	Cooperation period	Project cost	Description	Key risks to govenrment	Estimated buy-out price
		(years)	(USD million)			(USD million, 2003)
IPPs	Various, mostly BOT or BOO	15 to 30	22 to 1,200	Power plants	Fuel supply Market (take-or-pay on electricity delivered) Foreign exchange (payments in dollars) Regulatory (tariff adjustment) Buy-out / events of termination Force majeure	10,448
MRT 3	BLT	25	655	Light rail transit along EDSA	Market (15% return guarantee) Foreign exchange (payment in dollars) Regulatory (fare adjustment) Buy-out / events of termination Force majeure	568
Casecnan multi-purpose	BOT	20	650	Water for irrigation & power	Hydrology (take-or-pay on water) Market (take-or-pay on electricity) Foreign exchange (payments in dollars) Buy-out / events of termination Force majeure	1,160
MWSS water concessions	Contract-Add-Operate-and Maintain	25	7,000	Retail water supply & sewerage	Regulatory (tariff adjustment, rate rebasing) Buy-out / events of termination Force majeure	East: 169 West: 322
Skyway	JV	15	419	Tollroad	Regulatory (toll fee adjustment) Buy-out / events of termination Force majeure	798

Sources: Department of Budget and Management and Llanto (2005).

105. **Events of default that trigger buy-out provisions in BOT contracts are a major source of contingent liabilities, though their likelihood seems limited.** Llanto (2007a) shows that the aggregate buyout price—the government's maximum exposure to BOTs—was about 12 percent of GDP in 2005. This exceeds the 10 percent of GDP in government contingent liabilities arising from guarantees on public corporations' loans and guarantee institutions. History reveals that government and its BOT partners have generally been able to work out areas of disputes (e.g., IPP contract re-negotiations in 2005) and generally avoided the need for buy-outs.[43]

[42] While the BOT Center, is responsible under the law for coordinating and monitoring BOT Projects, its functions do not deal with fiscal risk specifically. For projects that require a government guarantee, the DoF reviews government exposures and issues a performance undertaking. DoF-CAG is in charge of reviewing projects where GOCCs are the implementing agencies, while projects sponsored by line departments may be reviewed by other groups, e.g., the Privatization Office.

[43] One case of early termination (with the Maynilad water concession) occurred when, because of the Asian financial crisis, the private partner issued a notice of early termination five years into the project. As a result, Maynilad's outstanding debts to MWSS, consisting of unpaid concession fees (P7.9 billion),

106. **Fiscal risks from government guarantees on fixed contractual payments are material and a high likelihood of occurrence.** In some BOT contracts, the government has assumed market risks by guaranteeing the private partner a minimum revenue stream. Evidence shows that, in contracts with these clauses, the revenue stream from the project has mostly fallen below projected levels, largely because of (1) optimistic original forecasts; and (2) user charges that have been kept at subsidized levels (Box 2.1). Similar problems have arisen for take-or-pay guarantees in the power and water sectors (Casecnan). In these cases, the fiscal cost has been indirect as GOCCs were the partners to the private sector: this has weakened their balance sheets and resulted in the need for Treasury advances (e.g., NPC, NIA), recapitalizations, reduced dividend transfers, as detailed in the GOCC section above.

107. **Continuing progress in power sector privatization helped reduce a large source of realized fiscal risk but significant and high probability risks remain**. Under the 2001 EPIRA Act, NPC is prohibited from entering into new power purchase agreements with IPPs, removing risks arising from this source. At the same time, PSALM, which manages NPC's assets and liabilities, is expected to off-load NPC's IPP liabilities starting in 2009. This would result in upfront pricing of the cost to NPC of these contracts. While this may give rise to fiscal risk (if priced negatively) in the short-term, it will remove a major source of contingent liabilities (i.e., market risk) in the longer run. NPC has contracted capacity of 5,940MW from IPPs, with remaining obligations amounting to about $11 billion. EPIRA also allows the imposition of a universal consumer charge to pay for NPC's stranded costs and debt under eligible BOT projects but these are subject to significant political/regulatory risk. Large continuing sources of fiscal risks relate to the recently awarded Transco concession,[44] to the timing and pricing of the remaining power privatization assets (the global financial crisis and recession slowed down the program), and the weak balance sheet, cash flow position and large short-term gross financing requirements of PSALM.[45]

108. **Large and frequent realized fiscal risks arise from political/regulatory actions**; these can trigger financial penalties and legal recourse against the state. In BOT contracts where the private proponent shoulders market risk, tariff adjustments are typically undertaken periodically by formula; failure to abide by the formula, usually for regulatory, political and/or social reasons, triggers compensation provisions. This risk seems particularly frequent and material for utilities in the power, water and transport sectors, where price increases affect the general population. One such example is the less than full-cost recovery of NPC's generation and distribution costs from the late 1990s to 2004, which eventually saw the NG assume over P45 billion of NPC debt during that period (De Dios et al., 2004). Another example (ongoing) relates to water

were restructured. Because Maynilad suspended concession fee payments starting 2001, MWSS had to incur new loans, guaranteed by the NG. Partly as a result, MWSS did not remit dividends in 2001 and 2003.

[44] Similar to the water concession, the NG provided performance guarantees relating, for example, to timely rate adjustments, recovery of capital expenditures, and indemnification for losses in case of breach. In case of early termination, the NG will have to take over Transco's debt and expenses related to operating, maintaining and expanding transmission assets.

[45] PSALM has a significant share of its debt maturing over 2009-2011. Over that horizon, its cash balances are expected to be significantly strained. In June 2009, PSALM requested its lenders to waive debt-service covenants to enable it to issue $1 billion in international bonds.

tariff adjustments. In the past, these contract disputes have resulted in court cases and/or international arbitration and may give rise to fiscal costs.[46]

Box 2.1. MRT 3: From BOT to Nationalization in Ten Years

The MRT 3 project is a 16.9 kilometer metro rail system in Manila. In this project, the DOTC, backed up by the NG, provided a 15 percent return guarantee to the private partner, Metro Railways Transit Corp (MRTC), irrespective of rail ridership. This guarantee is incorporated in a stream of fixed dollar "rental fees" over the 25-year cooperation period covering debt and equity payments. The NG has already been servicing the debt portion through annual debt appropriations. The equity portion is an escalating amount that started at about $800 thousand per month in 2000, reached $3.3 million in 2008 and is expected to increase further to over $10 million by 2010 (the escalation offsets the declining debt payments thus leveling the annual lease payments over time).

By design, passenger revenues were expected to cover for these payments but in practice, ridership has been significantly lower than initially projected (reportedly over 50 percent lower than projected in 2006[1/]) and government has opted to maintain rail fares at subsidized levels (subsidy reported at P48 per passenger/ride; passengers pay P15 per ride[2/]). The reported monthly gross revenues of P165 million are inadequate to meet operations and maintenance (O&M) costs and rental fee payments, much less capital outlays needed to expand system capacity (which has resulted in observed overloading because of underinvestment in capacity). As a result, government has had to extend subsidies to the MRT 3 in the DOTC budget.

In its 2009 budget, the Government appropriated P1.2 billion for subsidies for MRT 3 (in addition to P645 million for O&M), but is subject to exchange rate risk as payments are due in US dollars while revenues are in pesos[3/]. Without fare adjustments, government subsidies are expected to rise significantly by 2010 because of the equity payment structure (back-loaded to yield a 15 percent return to MRTC while giving minimal yield in the early years).

Because of the high equity return payments, the Government and MRTC has in the past tried to buy out the owners of the MRT 3 have (with reported buyout amounts of $865 million in late 2008 or 0.5 percent of GDP)[4/]. Recently however, government has announced a market-based approach mandating the government banks, DBP and LBP, to buy from local and foreign institutions (who require liquidity at this time), at discounted prices, the various classes of securities of ownership and payment entitlements (original debt and equity, securitized bonds, preferred shares). News reports reveal that the two banks already own a majority of the securities5/, which would give the government more control over the timing of actually buying out other holders of these securities (as well as firmer operational and investment control), minimizing fiscal risk.

1/ Leini Lectura, "Government, consortium reps revive negotiations," Business Mirror, June 20, 2008.
2/ Darwin Amojelar, "No service boost seen for MRT 3 buyout", Manila Times, Sep. 24, 2007.
3/ The NG budget assumes an exchange rate of P42-P45/$ for 2009 vs. current exchange rate of P47/$.
4/ Calderon, "State lenders seek exit strategy in government-MRTC buy-out deal," Business World, 9/18/2008.
5/ Eileen Mencias, "NDC to own Metro Rail Transit shares", Manila Standard Today, April 17, 2009.

[46] One such case is the NAIA International Passenger Terminal 3 unsolicited BOT project. The project started in 1997 and was almost completed by 2002—at a cost of USD640 million—when the Philippine Supreme Court nullified the contract. The NG took over the terminal after USD64 million expropriation payment. International arbitration as well as negotiations to reach a settlement are ongoing.

Financial Sector

109. **The financial sector has been an important source of realized fiscal risk in the Philippines.** The domestic banking system came under severe stress in two recent episodes: (1) in the early 1980s as a result of a major financial and balance of payments crisis; and (2) to a lesser extent, in 1997-98 in the aftermath of the Asian crisis. In both episodes, bank asset quality deteriorated, bank credit contracted and central bank financial assistance rose significantly. In the earlier case, the government actively participated in rescuing the banking sector (IMF, 2000).[47] In the latter case, the government took a more hands-off approach, with assistance limited to extending tax incentives under the Special Purpose Vehicle Act to hasten bank cleanup of bad assets. In both cases, the fiscal cost has been substantial (Laeven and Valencia, 2008). The fiscal costs of GFIs and the old central bank have also been large, as detailed in Section B.4.1.

110. **Although the impact of the global financial crisis and recession on domestic banks has been limited, fiscal risks stemming from the sector remain.** According to the BSP, direct exposures of domestic banks to potentially "at risk" international financial institutions are at most 1 percent of banking sector asset, the banking system remains adequately capitalized with over 15 percent capital adequacy as of June-2008, and the non-performing loan ratio has dropped below 4 percent as of November 2008 from 15 percent at end-2002. Several sources of fiscal risks nonetheless remain:

- *The Philippine Deposit Insurance Corporation (PDIC)—Table 2.14.* The banking system's deposits are insured through the PDIC, a GOCC attached to the DoF. PDIC charges banks an insurance premium, part of which is set aside in a deposit insurance fund (DIF). At end-2008, DIF assets totaled over P60 billion (6.5 percent of insured deposits). An estimated pay-out of P14 billion linked to the recent closure of rural banks would significantly cut into DIF's assets. A 2009 law doubling deposit insurance to P500,000 per account, increased deposit coverage to 31 percent of total deposits but would have reduced DIF coverage to 4.9 percent. To improve PDIC's financial strength, the new law therefore provides for (1) the NG to directly guarantee deposits between P250,000 and P500,000 in the first three years of implementation (generating an estimated P297 billion or 3.7 percent of GDP in direct NG contingent liabilities); and (2) automatic government guarantees of PDIC bonds (another contingent liability for the budget).
- *The BSP's indirect assistance to troubled banks.* While the BSP is not allowed under its charter to extend financial assistance to banks beyond its role as the lender of last resort, it has been able to do so indirectly by lending to the PDIC. Outstanding BSP loans to PDIC, which are low yielding but collateralized, reached about 1 percent of GDP at end-2007. The positive spread earned by PDIC by investing these loans in Treasury securities is used to extend assistance to banks. However, while PDIC has been income generating in the last five years,

[47] Several operations took place: (1) GFIs took over weak financial and non-financial institutions; (2) the government rehabilitated GFIs and absorbed their NPLs; and (3) the NG restructured the old central bank.

returns are low relative to equity (i.e., DIF), partly due to a large interest burden (reaching 45 percent in 2005). These loans have fiscal implications as they lower both BSP and PDIC profits and dividends to the NG.

- *Government Financial Institutions.* Aside from the GFIs, the government also controls a local commercial bank, United Coconut Planters Bank (UCPB).[48] This bank is experiencing financial difficulties, to the point where the NG is expected to subsidize the operations of UCPB through off-budget income support, mainly through P30-billion worth of government deposits in the bank. Fiscal risks from UCPB could be material (e.g., to the extent that market rates decline, income generated from Treasury security investments may fall short of targeted subsidy amounts, which may then require even higher government deposits).

111. **Fiscal risks from the remaining parts of the financial sector have not been material and should remain so.** The remaining parts of the financial system consists of the two government pension institutions, private insurance companies, investment houses, finance companies, pawnshops, lending investors, securities dealers, etc. A less stable but small segment of the non-bank financial sector is the pre-need industry.[49] In the early 2000s, a crisis in the sector led to the bankruptcy of several pre-need companies with government refraining from extending any financial assistance and instead, strengthening SEC regulation of these institutions, including specifying permissible investments. In 2004, the assets of the sector comprised about 3.7 percent of the assets of the banking system. The industry is likely to have shrunk further relative to the banking system.

Table 2.14. Philippines: Selected Financial Accounts of PDIC, 2003-07 [1/]

	2003	2004	2005	2006	2007
	(In billion Peso, unless otherwise stated)				
Assets	125.6	127.6	126.4	137.9	131.6
o/w Financial assistance to banks	68.3	65.2	39.3	45.8	39.4
Liabilities	87.0	85.7	78.9	88.6	77.4
o/w BSP	83.4	80.7	73.1	82.0	69.5
Deposit insurance fund	38.6	41.9	47.6	49.3	54.3
o/w Permanent insurance fund [2/]	3.0	3.0	3.0	3.0	3.0
Net Income	0.2	0.2	0.3	0.4	1.2
Return on equity (percent)	0.4%	0.5%	0.6%	0.9%	2.2%
Interest expense (percent of total income)	21.5%	30.9%	45.0%	40.7%	35.6%
Memorandum items:					
Insured deposits [3/]	462.6	735.7	777.8	852.7	888.3
Insured deposits (percent of total)	18.8%	26.7%	26.3%	24.4%	24.3%
DIF (percent of insured deposits)	8.3%	5.7%	6.1%	5.8%	6.1%

Source: PDIC Audit Reports 2006-07, 2004 (www.coa.gov.ph)

[1/] PDIC adopted Philippine Accounting Standards /Philippine Financial Reporting Standards PASs/PFRSs in 2006; 2005 accounts were re-stated to conform with the new standards. Prior periods are not comparable, including "financial assistance to banks" account.

[2/] Full capitalization reached in 1994 with conversion of P980 million of PDIC obligations to the Central Bank into NG equity.

[3/] Deposit insurance was increased in 2004 to P250,000 from P100,000 per account.

[48] The Supreme Court declared UCPB shares sequestered by government in 1986 "public in character".

[49] A group of smaller institutions offering pre-need products (e.g., educational plans, memorial plans).

Local Government Units

112. **Built-in checks on local government units' (LGUs) ability to incur debt minimizes fiscal risk from this source.** Except in 2001, LGUs have consistently earned more (including from their 40 percent share of national internal revenue taxes) than they have spent and have thus contributed positively to the consolidated public sector financial position. Fiscal risks from LGUs are also limited by the following legal requirement and institutional setup: (1) the NG is not allowed to guarantee LGUs foreign borrowings, which has prevented such borrowing from occurring (instead the NG may relend borrowed funds to LGUs); (2) LGUs' borrowings are limited by a requirement under the Local Government Code that LGU annual debt servicing may not exceed 20 percent of regular income and that LGUs must provide fully for debt repayments in their budgets or their budgets become inoperative; and (3) the Bureau of Local Government Finance under the DoF vets the maximum borrowings of LGUs.

Tax Credit Certificates

113. **Reduced issuance of tax credit certificates limit fiscal risk arising from an upsurge in their usage**. A tax credit is an alternative to a refund of overpaid taxes which may be applied to offset tax liabilities. A tax credit certificate (TCC) is the document certifying the amount of tax credit for which the tax payer is allowed or entitled to in accordance with applicable laws; the TCC and can be used to settle the holder's tax obligations due to the national government.[50] Data from the Bureau of Internal Revenue (BIR) shows outstanding TCCs of P4.9 billion at end-2008. Issuances have averaged P3.4 billion a year since 2000 (down from over P10 billion in the mid-90s), while tax debit memos have averaged P3.37 billion over the same period. Risk of outstanding TCCs accumulating over time are somewhat mitigated by expiry periods of up to 10 years for Board of Investments (BoI) and BIR-issued TCCs. There is also an active secondary market for TCCs that ensures regular utilization considering implied foregone interest.

Natural Disasters

114. **The Philippines, given its geographical circumstances, is one of the most disaster prone countries in the world, creating large fiscal risks for the budget.** For the past two decades, the average direct annual cost to the economy associated with disasters is estimated at about 0.5 to 1 percent of GDP (indirect impacts would further increase this cost) (ADB, 2008). Recently, massive flooding in the last quarter of 2009 wrought about substantial damage and losses (estimated at 2.7 percent of GDP), of which about 0.3 percentage points are that of the public sector (World Bank 2009h). Given the frequency and cost of these disasters, the public sector has set up various contingency funds to address the fiscal needs they generate. For 2009, these total 0.2 percent of GDP (P2 billion included in the Calamity Fund of the national budget and P14 billion at the local level[51]). In practice the bulk of the costs of disasters has

[50] See http://taxcredit.dof.gov.ph/faq.htm for details on TCCs in the Philippines.

[51] Sub-national governments are mandated to set aside around five percent of their income for emergency relief, rehabilitation and mitigation purposes. Sectoral agencies also provide for the repair and rehabilitation of their damaged assets, such as roads, bridges, schools, and hospitals under their respective

remained with the national government as a LGU's mandatory five percent of income that needs to be set aside for emergency relief, rehabilitation and mitigation purposes is rapidly depleted in the event of a disaster hitting that specific LGU.

CONCLUSIONS AND POLICY RECOMMENDATIONS

115. **The Philippines faces large and diversified fiscal risks.** The analysis reveals that fiscal risks (1) have been, and remain, material—sometimes to the point of endangering the sustainability of the public debt and pushing the country to default on its debt obligations—and (2) are diverse in origins, including key macro-economic variables (especially the exchange rate and economic growth), but also the financial sector, GOCCs, PPPs, and natural disasters. The main sources of fiscal risk—in terms of likelihood of occurrence and magnitude when occurring—are listed below in declining order of importance:

- *Macroeconomic shocks impact on the NG budget.* Unexpected movements in growth, exchange rate, and inflation significantly affect revenue collection. In recent years, revenues have been systematically underestimated (by up to 1.1 percent of GDP in 2008). The government has mitigated the impact of lower revenues on the deficit by cutting down expenditures by about 0.7 percent of GDP.

- *Size and structure of the public debt.* Although debt is broadly sustainable, a "fan chart" point to large upside risks over the medium term. The debt structure also entails risks, in particular the large share of debt denominated in foreign currencies; and the short debt maturity which generates large gross financing requirements (estimated at almost 20 percent in 2010).

- *Contingent liabilities, especially bail-outs of GOCC liabilities and distressed financial institutions, buy-outs of PPP, and natural disasters.* Total liabilities of GOCCs are estimated at about 30 percent of GDP and guarantees are over 8 percent of GDP. Total buy-out price of PPP projects is estimated at 11 percent of GDP in 2005. In addition, guarantees on the deposit insurance fund and the central bank's assistance to troubled banks have historically been relatively frequent and extremely costly (up to 10 percent of GDP or more during systemic banking sector failures). Finally frequent natural disasters are directly costing the government 0.5 to 1 percent of GDP.

  The above key risks can also be classified between the recurring (high likelihood event within the fiscal year) and non-recurring ones. The former include the bias in revenue estimation, the gross financing requirements, and natural disasters. The latter include non-natural disasters contingent liabilities. In doing so, one finds that total recurring fiscal risk is about 20 percent of GDP while non-recurring fiscal risks amounts to about 60 percent of GDP.

116. **The legal framework and institutional structure to manage fiscal risks contains some weaknesses.** These include: (1) for the budget, among others, a lack of transparency due to differences in reporting standards between budget plans and

budgets. Private sector and donor support is also tapped, but the contributions are not systematically or comprehensively accounted for.

outturns (¶64); (2) for public debt, a fragmented and complex legal framework (¶76), a dispersed institutional responsibility for information gathering and debt management (¶76), and a lack of operational and strategic mandate in managing public debt (¶78); and (3) for contingent liabilities, the cash-based approach to public finance followed in the Philippines under-weighs the risks and costs from government guarantees and other off-budget activities (¶85). Weaknesses related to GOCCs include conflicting mandates, preferential treatments that erode financial discipline and transparency, and no limits in off budget exposure of the budget to GOCCs (¶¶87-88, 98). For PPPs, the legal and institutional framework for project selection, approvals, and negotiations is weak and so in the monitoring of fiscal risks (¶¶103-104).

117. **For the Philippines to improve its assessment and management of fiscal risks, the following set of priority legal and institutional reforms are recommended** (these address weaknesses in assessing, approving, managing, and disclosing fiscal risks):

Overall fiscal risk management:

- <u>R1. Establish a dedicated Fiscal Risk unit</u>, presumably within the Department of Finance, tasked with centralizing all information pertaining to fiscal risk (e.g., from the budget, public debt, GOCCs, PPPs, LGUs).[52] The Fiscal Risk Unit could also be tasked with providing an assessment on fiscal risks generated by large operations, such as PPP projects.

- <u>R2. Publish a fiscal risk statement</u>. (Annex 4.1 provides an overview of emerging international best practices in this area.) The statement should provide a comprehensive view of major risks that would impact public finances. It should be updated regularly (e.g., submitted along with the annual budget to Congress. The statement could expand on the material provided in the present chapter (and its more detailed background paper—Le Borgne et al., 2009). Its specific structure could be as in IMF (2008). An important area for development would be a discussion of (1) the overall fiscal risk management strategy, including priority areas for risk mitigation; and (2) existing mechanisms to manage fiscal risks. The fiscal risk statement should from the start be considered as a live document that would evolve over time and incorporate more refined, comprehensive and quantitative information as knowledge about specific risks increases.

NG Budget:

- <u>R3. Improve the quality, comprehensiveness, and timeliness of budget reporting</u> (¶64).

Public Debt:

- <u>R4. Establish a Debt Management Office</u> (a goal already expressed in the government's 2004-2010 MTPDP) (¶77).

[52] Recent reforms undertaken in Indonesia's Ministry of Finance both for the DMO and the Fiscal Risk unit would seem especially relevant for the Philippines.

- R5. Introduce and publish a debt management strategy (¶79).

- R6. Improve the quality, comprehensiveness, and timeliness of public debt data.

GOCCs:

- R7. Re-institute a performance evaluation system and subject GOCCs to performance targets. Regularly publish these evaluations

- R8. Strenghten CAG's capacity to monitor GOCCs (¶100).

PPPs:

- R9. Establish a dedicated PPP Unit within government tasked with the technical, legal, and financial role of assessing, negotiating, and writing all PPP projects and contracts of the Republic.

Annex 2.1. Emerging Best Practices in Fiscal Risks Disclosure

118. **A large number of countries have selectively disclosed, elaborated, and/or quantified fiscal risks.** Among the most widely disclosed risks are those associated with (1) macroeconomic shocks; the impact of key macroeconomic variables on the fiscal are analyzed through a variety of methods, such as sensitivity analysis, macroeconomic scenarios, and/or stress tests; and (2) contingent liabilities, especially explicit ones such as loan guarantees.[53] Disclosure is less consistent across countries for other key sources of fiscal risks, namely SOEs, sub-national governments, quasi-fiscal activities, and off-budget entities. More recent types of risks are less commonly disclosed though the number of countries disclosing them is growing fast (e.g., PPPs) as are risks that are difficult to quantify (e.g., legal claims), and "policy risks" such as potential changes in government or regulatory policies. Table 2.15 provides an overview of fiscal risks.

Table 2.15. A Fiscal Risk Matrix of Philippines Government Obligations

	Direct (obligation in any event)	**Contingent** (Obligation if a particular event occurs)
Explicit (Government liability created by a law or contract)	• Sovereign debt (domestic and external) • Expenditures - non-discretionary and legally binding in the long term (civil service salaries and pensions)	Government guarantees: e.g., • Direct guarantees on obligations of GOCCs • Performance undertakings under BOT contracts • Guarantees on guaranteed institutions' borrowings and guarantees • Guarantees on currency risks of GFIs' foreign loans • Outstanding tax credit certificates • Guarantees on benefits (unfunded liabilities) of the social security system • Future health care financing • Deposit insurance (per account for deposits between P250k and P500k)
Implicit (A "political" obligation of government that reflects public and interest-group pressures)	• Longstanding and popular social spending that government could, in theory, cut.	• Deposit insurance (first P250k per account) • Bank failure (beyond state insurance) • Possible recapitalization of the central bank • Possible need to recapitalize government banks • Cleanup of the liabilities of privatized entities • Support to enterprises (covering losses and assuming non-guaranteed obligations) • Support to local government units

Source: World Bank staff based on Brixi and Schick (2002).

119. **An emerging international best practice—including in the region—is for countries to disclose a comprehensive assessment of their fiscal risks**. Starting with Australia and New Zealand's pioneering fiscal risks statements,[54] a few countries have introduced such self-contained statements, often as part of the annual budget document submitted to congress (Table 2.16). The context for these statements vary extensively, ranging from a legal requirement—as part of a broader approach to fiscal policy and disclosure found in Fiscal Responsibility Laws and/or public financial management legislations (e.g., New Zealand, Brazil[55])—or as the result of a

[53] Methodologies for quantifying risks stemming from explicit contingent liabilities vary among countries from simply reporting gross exposure to risk ratings, stochastic simulations, or option pricing models.

[54] New Zealand's Public Finance Act of 1989 requires the disclosure of all government decisions and other circumstances that may put pressure on the forecast spending amounts, and/or have a material effect on the fiscal and economic outlook.

[55] Brazil's Budgetary Fiscal Risk report started in 2002 as a requirement of its FRL states that "the federal government must prepare an annual report demonstrating the budget's main contingent assets

discretionary decision of a Minister of Finance to foster the identification, disclosure, and management of fiscal risks (e.g., Indonesia in 2007). The practice of greater disclosure of fiscal risks is also driven by international accounting and statistical standards requiring the disclosure of certain material risks as well as recent transparency initiatives.[56] Policymakers in the region are at the forefront of the push for better fiscal risk assessment, management and disclosure, as shown by the 2007 APEC Finance Ministers' Meeting in which this topic was prominently discussed.

Table 2.16. Scope of Existing Fiscal Risks Statements

	Australia	Brazil	Chile	Colombia	Indonesia	New Zealand	Pakistan
Economic Risks:							
- Alternative scenario						√ 1/	
- Sensitivity analysis		√ 2/			√ 3/	√ 4/	
Specific risks:							
- Pension schemes			√	√	√		
- Banking system					√		√
- Regional funds		√					
- Debt guarantees	√	√	√	√	√	√	√
- Non-debt guarantees	√	√	√	√	√	√	√
- Legal disputes	√	√		√	√	√	
- Uncalled capital	√				√	√	
- Natural disasters					√	√	
- Central bank quasi-fiscal activities			√				

Source: IMF (2008) and World Bank staff.
1/ Fiscal implications of two possible growth paths for the economy when key assumptions underlying the central forecast are altered.
2/ Sensitivity of revenues and expenditures to changes in real GDP growth, inflation, exchange rate, nominal interest rate, and minimum wage. Sensitivity of the federal public debt to fluctuations in interest rate, exchange rate, and inflation.
3/ Sensitivity of revenues and expenditures to changes in economic growth, inflation rate, 3-month interest rate, exchange rate, crude oil price, and oil production.
4/ Sensitivity of the operating balance and sovereign-issued debt to changes in nominal GDP growth and interest rates.

120. **Preparing and publishing a comprehensive fiscal risk statement is an integral part of the fiscal risk cycle**. The fiscal risk cycle comprises four distinct stages: (1) a risk assessment/awareness profile; (2) a disclosure statement; (3) an accounting, budgeting, and fiscal planning stage; and (4) a risk management stage (Table 2.17). *All* of these four stages are required for the government to reduce fiscal risks, both in terms of their occurrence and their magnitude. Skipping the disclosure stage, for example, increases the likelihood that higher risk will be taken as public accountability is weakened and might also increase the country's risk premium as borrowers are uncertain about the extent of fiscal risks.

and liabilities and their associated risks." In addition to the annual BFR report, the Ministry of Finance must prepare a quarterly report updating fiscal risks and present it publicly to the legislature.

[56] These include the *International Public Sector Accounting Standards*, the *Government Finance Statistics Manual* (2001), the OECD's *Best Practices for Budget Transparency* (2001) and the IMF's *Code and Manual of Good Practices on Fiscal Transparency* (2001 and 2007).

Table 2.17. The Fiscal Risk Cycle

Goal	Options
Risk awareness	• Risks and long-term fiscal cost as part of decision-making; • Employ useful analytical model; Collect and centralize information on fiscal risks; and • Discuss frameworks and valuation of risks and obligations.
Disclosure	• Disclose past fiscal cost of contingent liabilities and other sources of risk; • Disclose outstanding risk exposures; • Disclose government analysis the possible fiscal cost of its risk exposures; • Disclose draft contracts and government analysis of possible fiscal cost; • Disclose long-term fiscal scenarios reflecting the future fiscal effect of risks; and • Enhance the system of financial reporting standards to require disclosure of fiscal risk.
Accounting, budgeting, and fiscal planning	• Reflect the net present value of expected fiscal cost of fiscal risks in government deficit and debt when government obligation originates; • Reflect the future possible fiscal effect of fiscal risks in fiscal planning; • Set overall limits on government risk exposure—either as simple ceilings on the face value of government guarantees or as part of joint ceilings. Consider reducing deficit/debt ceilings by risk-adjusted values of contingent liabilities issued/outstanding; and • Enhance the accounting & budgeting standards to address fiscal risk.
Risk management	• Centralize government risk-taking authority; • Separately, analyze and monitor government risk exposures and obligations; • Audit government risk analysis and risk management; • Build capacity to evaluate and manage risk; and • Develop extended assets and liabilities management framework.

Source: Brixi (2006).

121. The lessons emerging from countries' varied experiences with fiscal risk assessments, disclosure and management are the following (IMF, 2008):

- *Effective identification of all fiscal risks is paramount.* Only through a comprehensive identification of risks can risk management be successful and policy decisions be taken under an adequate information set.
- *Comprehensive disclosure of fiscal risks helps facilitate identification and management of risks, and reduce borrowing costs in the long run.* However, disclosure practices should be designed in ways that avoid engendering moral hazard from the perception of an implicit guarantee (e.g., in the banking system) or harming the state's economic interests (e.g., legal claims), which in some cases might imply that quantification of risks may not be feasible or desirable.
- *Fiscal risk mitigation includes practices that require justification for taking on fiscal risks and risk-sharing with the private sector.* It may also involve use of insurance and hedging instruments. Key to reduce fiscal risks is sound macroeconomic and public financial management policies.

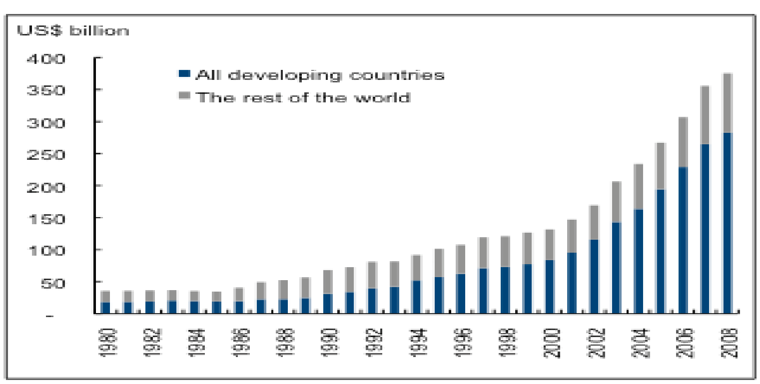
122. *Effective risk management is facilitated by a legal and administrative framework that clarifies key entities' role*, in particular the relationship between different levels of government and vis-à-vis the private sector (e.g., clearly identifying who can authorize government borrowing and guarantees). However, for fiscal risks to be properly incorporated in fiscal policy decision-making, contingent obligation proposals would need to be integrated with the budget cycle and considered alongside competing instruments.

3. REMITTANCES AND THE GLOBAL RECESSION

123. *Can traditionally counter-cyclical remittance flows to the Philippines continue to buffer the economy during a global recession? This critical question is addressed in this chapter. Remittances, given their size, have a major impact on many parts of the Philippines economy. In previous crises, remittances have been counter-cyclical thanks to the country's extensive diversification—in terms of geography, skills, occupation, gender—of its overseas work-force. Diversification during the recent global crisis was expected by most analysts to be less effective than in the past given the global nature of the crisis. Contrary to consensus expectations, while remittance flows did decelerate sharply, they have been resilient both in relative terms (compared to other financing and income sources) and in absolute terms (especially in real peso terms). Given the vital role remittances play in the Philippines, the crisis highlighted the need to systematically track information on returning OFWs, and not just on departing ones, so as to have real time and accurate information for policymaking.*

124. **Flows of worker remittances in the world have grown steadily and rapidly over the past decade** (Figure 3.1). Data on the workers' remittances, compensation of employees and migrant transfers (credit)—a proxy for remittances—reveals that the level of world-wide remittances quadrupled over the past two decades, from USD 69 billion in 1990 to USD 355 billion in 2007 (USD 375 billion in 2008, an estimate). Developing countries have seen most increases: about three fourth of the remittances went to developing countries in 2007. Asia received USD 102 billion in 2007, the highest remittance inflow region in the world. For developing countries as a whole, workers' remittances constitute one of the largest sources of external financing, far exceeding official aid receipts, and in recent years, non-FDI private capital flows (World Bank, 2006b). Remittances are also far less volatile than official aid, FDI and non-FDI private capital flows, and exports. Remittances, aside from reducing vulnerabilities of receiving households from income shocks, also generate macroeconomic gains, such as reducing the volatility of aggregate output, consumption, and investment (IMF, 2005).

Figure 3.1. Global Remittance Flows (USD billion)



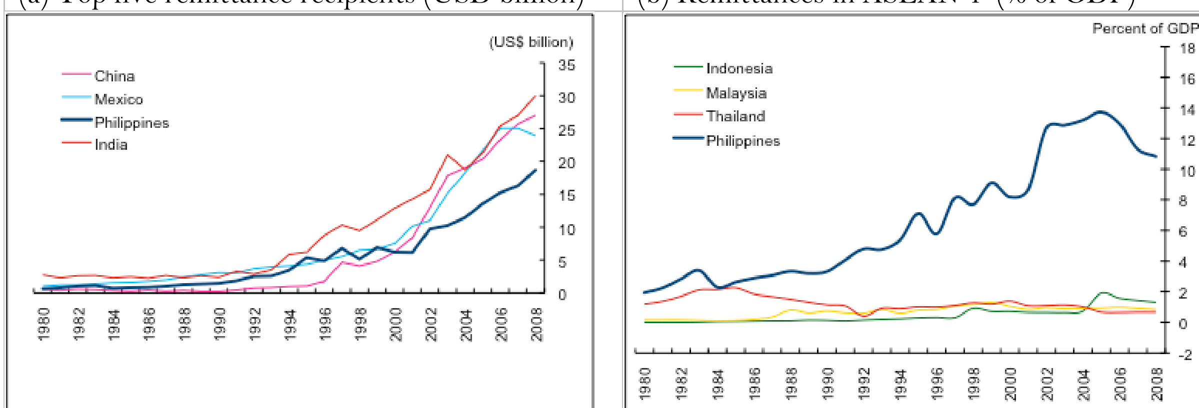
Source: World Bank

REMITTANCES AND THE PHILIPPINES ECONOMY

125. **Remittances are particularly important in the Philippines, accounting for over 10 percent of GDP annually over the past few years.** Such a large share of GDP makes the Philippines unique among large economies (Figure 3.2b). In 2008, workers' remittance flows reached a record high of close to USD20 billion (World Bank definition—Figure 3.2a). At the macroeconomic level, the size of remittance inflows enables Philippines to (1) post a current account surplus despite a large trade deficit (7 percent of GDP); (2) accumulate foreign exchange reserves that protect the country from destabilizing foreign exchange movements; (2) sustain domestic consumption and investment; and (3) have a cheap and relatively stable source of deposits. With over 8.2 million native Filipinos working or living abroad (22 percent of the labor force), overseas employment provides a significant relief to the structurally weak domestic labor market[57] (Chapter 4).[58] Overall, remittances play an important factor behind the country sovereign credit rating.

Figure 3.2. Remittances for Top Five Recipient Countries and for ASEAN 4, 1980-2008

(a) Top five remittance recipients (USD billion) | (b) Remittances in ASEAN 4 (% of GDP)



Source: The World Bank for remittance data and the IMF for GDP data.

126. **Foreign remittance flows in the Philippines play an important role in poverty reduction and social protection.**[59] Empirical evidence from cross-country

[57] It should be noted that the role that such a large Filipino emigration and their remittances have on the country's medium-term development prospects—though of crucial importance for the Philippines—is not addressed in this PDR since its focus is on the impact of the global recession and financial crisis for the country, and how to prepare for the recovery. From this short- to medium-term perspective, remittances are a positive factor for the Philippines as it clearly provides a major buffer for the country to absorb the global shocks. However, we should bear in mind that the literature on the impact of large emigration and remittance inflows is ambiguous as these could lead to Dutch diseases (an appreciated exchange rate that undermines export competitiveness), weaker institutions and governance. Box 3.2 develops briefly these important development issues.

[58] Ruiz (2008) provides a good overview of the (successful) institutional setup put in place by the Philippines authorities since 1974 so as to promote overseas foreign work.

[59] The economic literature, however, is ambivalent as to long-term desirability of remittances in the development process. Box 3.2 provides an overview of some of the long-term challenges that large-scale emigration and remittances impose on a country's development prospects, and especially its institutional strengthening.

studies does point to such a strong link between poverty, whether measured using the poverty headcount or the poverty gap, and remittances (IMF, 2005; World Bank, 2006b; Adams, 2007). In the Philippines, while foreign remittances are strongly positively correlated with household income, they nonetheless have an important bearing on the fight against poverty through several channels. First, to the extent that remittances received by low-income households are used mainly to finance and supplement basic consumption, they are expected to have an important alleviating effect on poverty (ADB, 2004). Second, they are expected to contribute to improved health and education participation of the poorest remittance-receiving households. Yang (2008) finds such supportive evidence: Philippines remittances enhance human capital accumulation (improved child schooling and higher educational spending) and entrepreneurship in origin households (e.g., increased probability of starting relatively capital-intensive household enterprises). Third, Martinez and Yang (2005) find evidence that remittances in the Philippines have important spillovers effects onto households without migrant members that lead to declines in poverty rates of non-remittance receiving households. Finally, Yang and Choi (2007) find that remittances in the Philippines act as an insurance against negative income shocks (with a 60 percent replacement ratio) that enable recipient households to smooth their consumption over time.

127. **Studies, mostly looking at developments during the 1997/98 Asian crisis, tend to find remittances to be counter-cyclical, including in the Philippines.** Ratha et al. (2008) observe that remittances rose during the financial crisis in 1995 in Mexico, and in 1998 in Indonesia and Thailand. In a cross-country study of Latin American countries, Fajnzylber and Lopez (2008) found that remittances move counter-cyclically with respect to recipient countries' GDP, reducing the volatility of economic growth; in particular, they increase significantly after natural disasters and financial crises. Regarding the Philippines, evidence also tends to indicate that remittances rise when the economy suffers an economic downturn following a financial crisis or natural disaster (Ratha, 2007; World Bank, 2006b). During the Asian crisis, remittances to the Philippines rose as a share of personal consumption expenditure (Yang, 2006). Some authors, however, find weak evidence of a short-term stabilizing effect on consumption of remittance flows.[60] Given the multiple potential motives for migrants and OFWs to remit money back to their country of origin, these findings need not be inconsistent as the time horizon under consideration might lead one motive to dominate others (e.g., portfolio investment versus altruism)—See Lucas and Stark (1985) on the various motives for remitting money.

128. **An important caveat with these results is that they considered crises that were isolated (as opposed to global) thereby potentially biasing the findings.** While some of the crises investigated were significant by many benchmarks, they remained localized, be it geographically (e.g., the Asian financial crisis of 1997/98; the SARS outbreak) or by sectors (e.g., the internet/.com bubble burst of 2001-2003). It has been well documented that OWs in general, and Filipino's OFWs in particular, have reacted to these downturns by re-deploying to countries or sectors that still had good

[60] For example, Tuaño-Amador et. al. (2007) show that overseas Filipinos' decisions to send remittances are affected by investment opportunities as much as altruistic considerations. Likewise, Dakila and Claveria (2007) find some evidence on the procyclical tendency of remittances. See also Burgess and Haksar (2005).

growth (and labor demand) prospects. The global financial crisis and ongoing global recession do not offer this escape route any more as all key countries and sectors that are large recruiters of OFWs are affected; most of the largest ones are suffering downturn unseen in generations. Hence, as noted by Ratha and Mohapatra (2008), while remittances have been noted to be stable or even counter-cyclical during an economic downturn in the recipient economy, and resilient in the face of a slowdown in the source country, this time the crisis has affected all countries, creating additional uncertainties.

Table 3.1. Philippines: OFWs and Remittances by Major Occupations, and Countries 1/

Major Occupations	Distribution		Source Country	Share
	OFWs	Remittances		
	(percent)			(percent)
All OFWs	100.0	100.0	USA	42.0
			Saudi Arabia	8.6
Laborers and unskilled workers	32.4	19.5	UAE	3.7
Service workers	14.3	14.0	Japan	4.6
Trade and related workers	15.7	18.1	Singapore	3.8
Plant and machine operators	13.0	15.5	Hong Kong	1.9
Professionals	9.6	13.2	Asia excl. above	1.8
Technicians and associate professionals	6.2	8.4	Americas excl. USA	11.4
Clerks	5.6	5.3	Europe	17.8
Officials, executives, managers and supervisors	2.7	5.2	Middle East excl. SA and UAE	3.1
Farmers, forestry workers and fishermen	0.5	0.8	Oceania	1.2
			Africa	0.1

Source: SOF 2008, NSO

Source: BSP (Jan. - Nov. 2009)

1/ Due to reporting considerations, source country shares are subject to a significant bias in favor of the USA and, for the most part, at the expense of the Middle East countries. The reporting bias stems from the fact that banks are required to report remittance flows to the BSP based on the country of the bank sending the money directly to them, not based on the country of bank that first sent the money. The largest Filipino banks, however, have a large network of partner institutions (foreign banks, Western Union, i-remit, etc.) and are therefore able to know the exact origin of these funds.

129. **While a global recession prevents OFWs from redeploying to non-affected countries/sectors, the net impact on remittances to the Philippines was uncertain.** Indeed, several opposite remitting behavior were seen to be possible (see Box 3.1 for further details). For example: (1) on the one hand, OFWs that lose their jobs might seek to stay in their host country hoping to find alternative jobs soon—and mindful of difficult job prospects in the Philippines given its relatively high unemployment; to do so they would tap into their savings nest and curtail their remittances to the Philippines. (2) on the other hand, they might decide to return to the Philippines and bring with them all of the accumulated savings they had maintained abroad—as opposed to previously sending home a share of their income; (3) they might also send a large share of their savings abroad to banking institutions in the Philippines if they perceive foreign banks as more at risk of failure due to the global financial crisis. These types of behavior would generate opposite remittance flows to the Philippines. Note that in the second example, while remittances flows would appear robust in the short-term (and even post record growth), once the OFW has returned, remittances abruptly stop. A global recession has also different implications for exchange rate movements. For 2009, the

Philippines peso has not and is not expected to fluctuate significantly against major OFWs' host countries' currencies, which differed from the Asian financial crisis.[61]

Box 3.1. The Resiliency of Remittance Flows During the Global Recession

Despite the prospect of a decline in remittance inflows for 2009, these flows remain more resilient compared to many other types of resource flows such as private debt and equity flows and foreign direct investment, which are expected to decline or, in the case of portfolio flows, perhaps become negative in 2009 (vis-à-vis their pre-crisis level in 2007) as foreign investors pull out of emerging markets. There are several reasons for the resilience of remittances in the face of economic downturns in host countries:

1. Remittances are sent by the cumulated flows of migrants over the years, not only by the new migrants of the last year or two. This makes remittances persistent over time. If new migration stops, then over a period of a decade or so, remittances may stop growing. But they will continue to increase as long as migration flows continue.
2. Remittances are a small part of migrants' incomes, and migrants continue to send remittances when hit by income shocks.
3. Because of a rise in rise in anti-immigration sentiments and tighter border controls, especially in the U.S and also in Europe, the duration of migration appears to have increased. Those staying back are likely to continue to send remittances.
4. If migrants do indeed return, they are likely to take back accumulated savings. This may have been the case in India during the Gulf war of 1990-91 which forced a large number of Indian workers in the Gulf to return home (Ratha 2003). Also the "safe haven" factor or "home-bias" can cause remittances for investment purposes to return home during an economic down turn in the host country. Anecdotal evidence point to some "safe haven" behavior from migrants that were banking with developed country banks whose financial strength were questionable.
5. Several high-income OECD remittance source countries are likely to undertake large fiscal stimulus packages in response to the financial crisis. This increase in public expenditure, if directed to public infrastructure projects, will increase demand for both native and migrant workers. Taylor (2000) found that public income transfer schemes in the United States resulted in increased remittances to Mexico–other things being equal, immigrant households that received Social Security or unemployment insurance were more likely to remit than other immigrant households. Also documented migrants are likely to send more remittances to their families, to make up for a fall in remittances by undocumented migrants.

Source: Ratha and Mohapatra (2009).

~~s to increase its investments in the Philippines as its dollar-purchasing power value increased.~~

Box 3.2. Remittances, Politics, and Economic Development 1/

Remittances may pose a moral hazard problem by reducing the political will to enact policy reform. Remittances that insure the public against adverse economic shocks, including those caused by poor economic policies and poorly performing institutions, may reduce households' incentives to pressure their governments to implement the reforms and improvements necessary to facilitate economic growth. At the same time, the receipt of remittances loosens fiscal constraints on governments, putting off any day of reckoning instigated by a faulty policy stance. In other words, remittance flows act as a buffer between households and the governments that serve them, creating the potential for a negative political economy effect. Remittances can therefore delay needed upgrades to public infrastructure by reducing both public demand for them and the likelihood of a crisis that will make such reforms necessary.

In the extreme case, remittance-dependent countries could become mired in a "remittances trap" of the following sort. The households in a particular country receive a significant quantity of remittances, which lifts most of them up to an acceptable standard of living. Private investment in the country is low because of poor investment opportunities due to low-quality physical infrastructure and missing or malfunctioning institutions, so economic growth in the country is also low. The country's government spends its revenues on nonproductive consumption (perhaps patronage) and maintains a high debt-to-GDP ratio, which is financed at a high interest rate, either domestically or through external debt. Individuals who are frustrated with the lack of opportunities at home migrate, rather than becoming politically active, and send remittances back to support those who stay behind. Those who remain also lack the incentive to put pressure on the government to reform, because remittances partly compensate them for the negative consequences of the government policy. Therefore, the country persists in a state characterized by low growth, poor economic policy, and high remittances.

1/ Chami et al. (2008). The authors specifically add that this description does not describe any particular country.

130. **This chapter investigates whether the unique portfolio-type diversification of the Filipino OFWs can shield the country from a sharp fall in remittances**—whose consequences for the country would be far reaching. As investors discovered to their dismay in 2008, portfolio diversification provides limited benefit when all asset classes plunge simultaneously due to a global shock. As studying the impact of a previous global recession on the Philippines's OFWs and remittances is not possible (data on OFWs and remittances go back to the early 1980s; the policy of actively encouraging OFWs dates back from the 1970s), the approach taken in this chapter is to investigate events when both the Philippines and a key migrant-host country were simultaneously in recession or severe downturn. While this approach has limitations—the main one being that the rapid re-location of OFWs from crisis affected countries to high growth ones would tend to bias the results; this bias would be to under-estimate the impact of a simultaneous economic slowdown on remittances—it nonetheless provides useful insights as to the projected behavior of remittances during a global downturn.

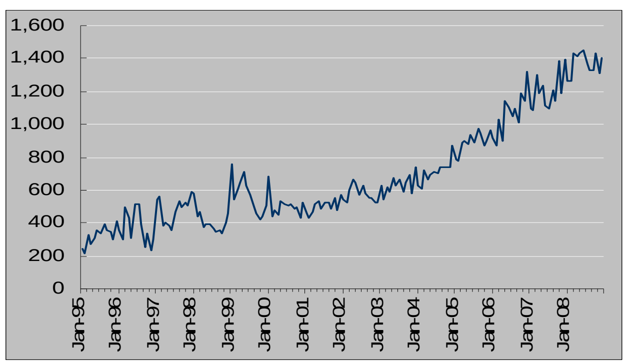
REMITTANCE FLOWS TO THE PHILIPPINES DURING SYNCHRONIZED SLOWDOWNS

131. How would remittances fare during a global recession? This section addresses this issue by analyzing episodes of simultaneous domestic and host-country recession or sharp slowdown. Particular attention is given to the 1997/98 Asian financial crisis, and, to a lower extent, the 2001/03 US recession. The contraction in economic activity observed by crisis-affected countries during the Asian financial crisis is of the closest magnitude to the global recession. That crisis was characterized by a V-shape path as the recovery was as sharp as the slowdown. The global recession is expected to differ from such a V-shape, notwithstanding the strong rebound since the lows of 2008/09.

The 1997/98 Asian Financial Crisis and Bilateral Remittances to the Philippines

132. **Monthly workers' remittance flows to the Philippines exhibit heightened volatility during times of economic crisis.** Despite their overall stability compared to other sources of foreign exchange, remittances have in the past exhibited large monthly swings (month-on-month changes of 30 to 40 percent were not unusual). While these are often smoothed out over a three to six month period, these sharp up and down swings complicate policy making in times of crisis. These swings were especially prevalent during the late 1990s at the time of the 1997/98 Asian Financial crisis (Figure 3.3). This high volatility explains the large change in remittance growth rates when looking at bilateral remittance flows to the Philippines (see below).

Figure 3.3. Philippines: Monthly remittances (USD million), 1995-2008



Source: Bangko Sentral ng Pilipinas

133. **During the Asian financial crisis, bilateral remittance flows between crisis affected countries and the Philippines dropped drastically.** Figure 3.4 reveals several consistent patterns across crisis-affected countries. First, the drop in remittances was substantial for all countries. Second, host country GDP growth seems to be a key remittance driver in times of crisis. Third, remittances behaved asymmetrically vis-à-vis GDP growth: while the drop was either concomitant or slightly lagged to the drop in economic activity, the increase in remittances lagged the economic recovery phase by several quarters (one to two years). Fourth, remittances bottomed out one to two quarters after GDP. Fifth, for some countries (e.g., Malaysia), the impact of the crisis had a protracted impact on remittances to the Philippines. A likely explanation is the large number of Filipino that left the country as the country favored domestic over foreign employees and as the exchange rate depreciation against the peso curtailed migrant workers incentive to work there.

134. **By contrast, remittances originating from countries not affected by the Asian financial crisis—the USA in particular—boomed during the crisis.** Transfers from the USA significantly increased during the crisis period, both in dollar and peso terms (by an impressive 149 and 169 percent respectively). As these account for about half of total remittance inflows to the country, they provided a major offset to the sharp fall emanating from neighboring Asian countries. Besides their counter-cyclical behavior, US-based Filipino senders might have remitted for investment purposes, taking advantage of the weak peso. Indeed, Yang (2008) finds that an appreciation of a migrant's currency against the peso increased households' remittance receipts during the Asian financial crisis, while Yang (2006) observes as a tendency for migrant workers to maximize the value of their remittances by leaving countries whose currencies depreciated in real terms against the peso.

The 2001 U.S. Recession and Bilateral Remittances to the Philippines

135. **The burst of dot-com bubble in the spring of 2000 offers insights into the impact of a global shock, though less severe than the global recession.** While the 1997/98 Asian financial crisis was geographically an isolated event, the recession that followed the dot-com bubble had a more global nature. The Philippine economy was impacted by the recession through exports. The National Bureau of Economic Research records March 2001 at a peak in business activity in the U.S. economy and a recession that lasted eight months began thereafter.

136. **During the U.S. recession in 2001, remittances from the U.S. declined in both dollar and peso terms.** Remittance inflows, however, increased from other economies, notably from Hong Kong and Singapore (increasing by 69.1 and 84.8 percent respectively in US dollar terms; overall remittances declined by 0.3 percent).

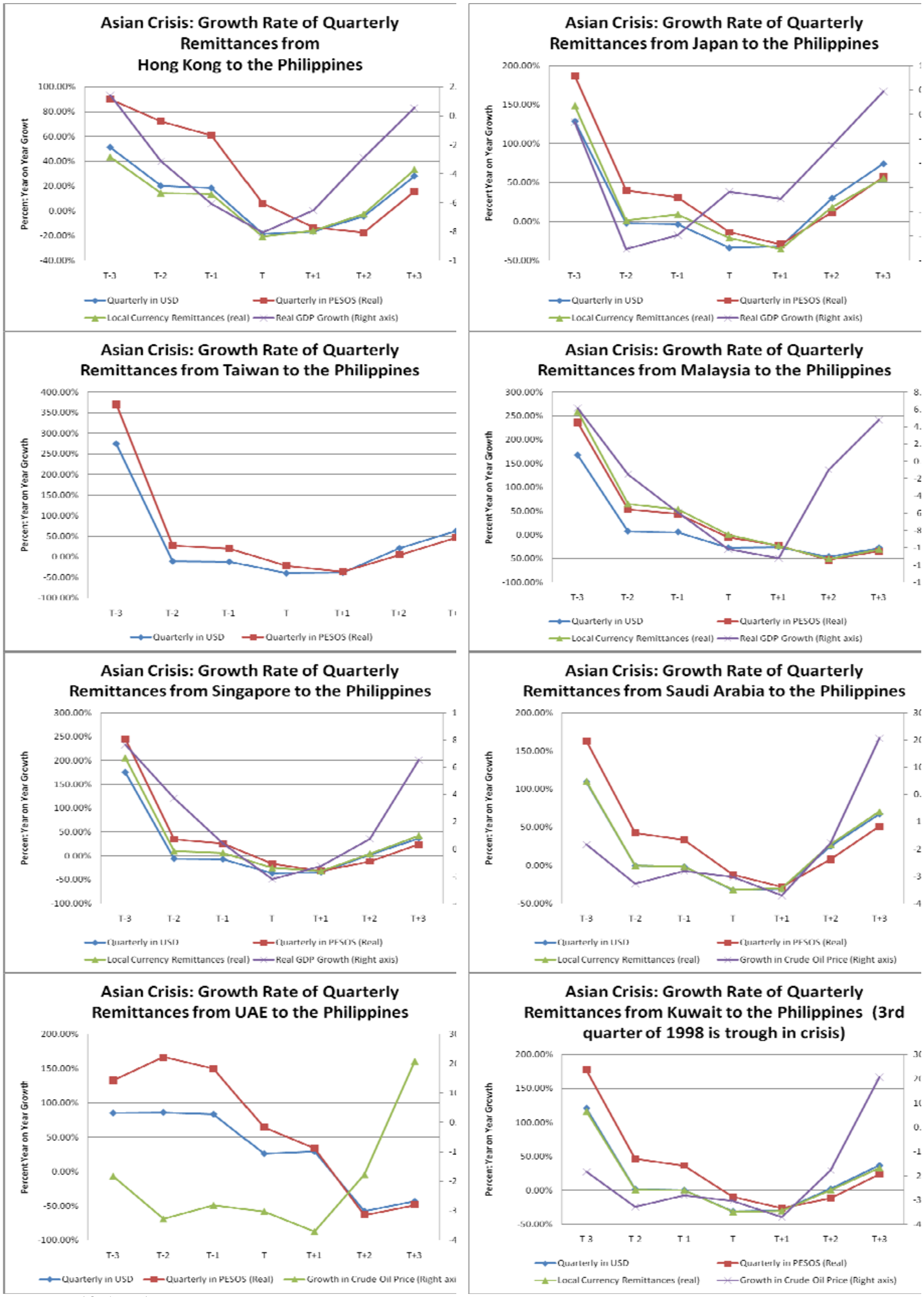
Econometric Study of Bilateral Remittance Flows When Host Country and the Philippines are Simultaneously in Sharp Slowdown

137. An econometric study (Reside, 2009) was commissioned as a background paper for this Chapter in order to assess whether a simultaneous recession of the host and recipient country alters the result found in the literature. In estimating the determinants of remittances to the Philippines, Reside (2009) finds that:[62]

- Remittances were positively affected by real GDP growth in the host country but also in the Philippines. These two results suggest that remittances are procyclical vis-à-vis the host country but also with respect to the Philippines (these findings are consistent with the bilateral patterns seen during the Asian financial crisis—Figure 5.6) but not with the literature consensus (though this consensus is not a strong one).

[62] The econometric study analyzes, with quarterly data from 1985 to 2008, remittance flows from the following countries to the Philippines: USA, Canada, Saudi Arabia, United Arab Emirates, Kuwait, Singapore, Hong Kong, Italy, United Kingdom, Japan, Malaysia. The results are not materially affected whether the flows are analyzed in peso or dollar terms

Figure 3.4. Growth of Remittances to the Philippines during the 1997/98 Asian Crisis1/



Source: Reside (2009).

1/ For the Asian financial crisis, the 3rd quarter of 1998 was designated as the trough (Time T in the charts), as most countries affected by the crisis saw real growth bottom out during this quarter (except Malaysia, whose trough occurred in 1998Q4, or T + 1).

- Remittance flows are also pro-cyclical when the economies of both the Philippines and the host country are simultaneously and substantially booming (slowing down).
- Remittances are negatively affected by a rise in oil prices, employment and immigration policy restrictions imposed by host countries, as well as the year of the SARS outbreak.
- A real depreciation (appreciation) of the host country currency versus the US dollar increases (decreases) remittances as OFWs compensate for the loss (gain) in domestic purchasing power by remitting more (less) units of local currency.
- Growth in world trade is positively associated with seafarers' remittances.
- Deployment of OFWs has a positive but lagged (about one year) impact on remittances.
- Remittance flows react to GDP growth, both at home and abroad, with a lag of about one year.

138. Reside (2009) concludes that with 2009 projected to be the trough for this global recession, then "2010-2011 should see some decline in remittances as contracts go unrenewed and deployment slows down. A conservative estimate of a 5 percent decline for 2010 -2011 would not be unreasonable".

Remittance Prospects and Risks

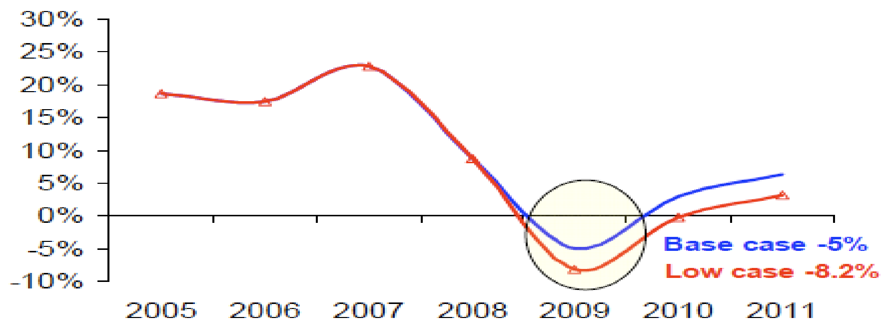
139. This section attempts to shed some light of the remittance prospects for 2009 and 2010, as projected at the beginning of the global recession (late 2008). To do so, a critical review of selected existing projections is undertaken. A few institutions and authors have provided remittance forecast for which the underlying methodology is detailed. Table 3.2 summarizes key forecasts for a wider range of institutions and authors.

140. **At the beginning of the crisis, the World Bank forecast that remittances to the Philippines would contract by 4 percent in 2009 but expand by 2 percent in 2010** (baseline scenario). Aggregate developing world remittances were projected to shrink by 5 to 8 percent in 2009 and to slowly recover thereafter—with growth of 0 to 3 percent in 2010, and of 3 to 6 in 2011[63] (Figure 3.5 and Ratha and Mohapatra, 2009). The World Bank's remittance forecast model is based on the sum of a recipient's remittance share in a remittance source country's GDP multiplied by projected GDP growth rate of the source country. The share of remittance outflows in a source country's GDP is based on a bilateral remittance matrix estimated by Ratha and Shaw (2007). GDP projections for host countries are from the World Bank's global macroeconomic forecasts. The model's other key variables are (1) remittance costs (the lower the costs the higher remittances); and (2) the number of years migrants lived in the destination country (the shorter the duration the higher remittances). An important assumption (that can easily be relaxed) is that the exchange rate is held constant so as to avoid attributing flows to dollar movements. The World Bank model is consistent with

[63] The World Bank's Migration and Remittances team releases two scenarios: a baseline and a low case.

the view that present and future remittances flows should be sensitive to present and future income growth in host countries. These were precisely the key remittance drivers during the Asian financial crisis (¶133).

Figure 3.5. Developing world Remittances Flows Contract in 2009 (YoY change)



Source: Ratha and Mohapatra, 2009

141. **Pineda (2009) from RGE Monitor predicted a 6 percent contraction in remittances for 2009** (baseline scenario). Her model is based on (1) the expected income of OFWs around the world, with adjustments made by industry and country regarding the employment outlook of OFWs; (2) the estimated share of income remitted; (3) the composition of deployment; and (3) the annual growth rate of deployment and wages. The best-case scenario for remittances is flat growth, assuming no net change in deployment and wages. She asserts that this is conceivable as a large share of OFWs have occupations that are less sensitive to economic downturns (nurses, domestic helpers and caregivers).

142. **Trinidad (2009) from Citibank predicted that under worst-case scenarios, remittances would fall by 21 to 30 percent.** He argued that the rising stock of OFWs is largely responsible for the strong remittance inflows in the past; the global stock of OFWs would not disappear but the rate of 'additions' (especially the newly hired category) would likely diminish. This would reduce the stock of temporary workers and ultimately remittances, as the temporary worker group is the largest recurring contributor. In one worst-case scenario—characterized by a 50 percent decrease in new hires and a 32 to 42 percent reduction in other categories—resulting in the fall of the stock to the 2001 level. This scenario estimates a drop of remittances by 21 percent. In another worst-case scenario, he further shocked his model by applying wage cuts in all labor markets and across skill categories: a 14-15 percent cut on top of the headcount cut. This results in a 30 percent decline in remittances. Trinidad stated the combination of headcount and wage cuts may be on the extreme side.

143. **Lim Su Sian (2009) from DBS forecast a drop of 7 to 13 percent in 2009 for remittances.** The projection is based on DBS growth forecasts for four key economies where Filipinos work: Hong Kong and Singapore are expected to shrink by an average of 6.5 percent (year-on-year), Japan to contract by 5.5 percent and the US to grow 1.5 percent. These four countries account for 57 percent of the total remittance inflow to the Philippines in 2008 and Lim finds that they yield significant predictive power. Lim

first ran a linear regression of remittance levels against the nominal GDPs of these four countries and finds that Japan matters little in the overall equation. Therefore excluding Japan yields to a 6.8 percent drop in remittances. The second estimate method was a more complex model capturing the long-term equilibrium between changes in remittances and changes in the total nominal GDP of these four economies. It points to a 13 percent contraction in remittances.

Table 3.2. Projected 2009 Growth Rate of Remittances to the Philippines 1/

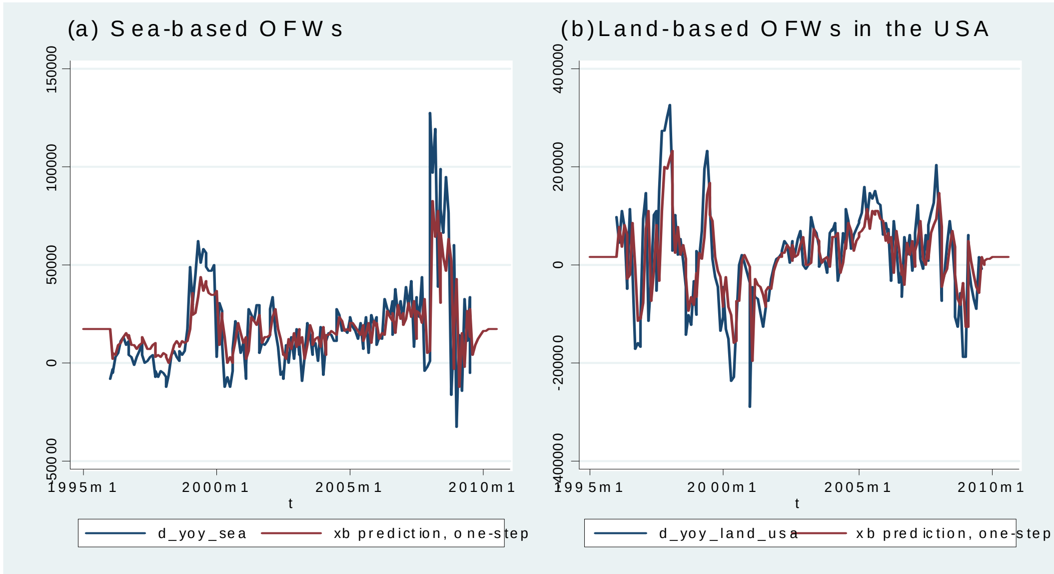
Author/Institution	Growth
	(percent)
BSP	0.0
World Bank	-4.0
Renato	-5.0
IMF	-8.0
RGE Monitor (Pineda)	-6.0
HSBC	-20.0
Citibank (Trinidad)	-21 to -30
DBS (Lim Su Sian)	-7 to -13
RBS	-8.0

Source: institutions/authors above mentioned.
1/ Projections as of the first quarter of 2009.

144. **On the contrary, Yi (2009) estimated a 3.8 percent increase in remittances for 2009.** Unlike the above studies, she employed a first-order autoregressive model (AR (1)) by remittance source: (1) sea-based OFWs; (2) land-based in the US; (3) land-based in Saudi Arabia; (4) land-based in the UK; and (5) all others. The reasoning behind using this autoregressive model is twofold. First, unlike migrants from other countries, Philippine OFWs engage in occupations less sensitive to economic downturns as argued by Pineda (2009) and therefore their remittances would be less sensitive to income growth in host countries. Second, the explanatory power of an income variable could be limited as remittances tend to be sensitive to exchange rate movements which exhibit random walk behavior. The choice of the five remittance sources rests on ordinary least square regression results indicating that remittances from the first four sources above have statistically significant explanatory power in the total remittances.[64] Yi's AR(1) model forecasts a year-on-year level change for each month (see Figure 3.7 for forecasts of changes in remittances from sea-based OFWs and from land-based OFWs in the US, the sources accounting for more than 50 percent of the total remittances). Additional tests with variables in log difference corroborate her baseline growth forecast, with remittances expected to grow by 2.9 percent for 2009.

[64] The data are at the monthly frequency for the 1995-2008 period. To deal with a decidedly upward trend and seasonality in the monthly remittance data series, the data are expressed in year-on-year differences at level.

Figure 3.6. Philippines: Changes in remittances by source 1/



Source: Yi (2009)
1/ Blue lines refer to actual changes and red to forecasts.

RECENT DEVELOPMENTS IN REMITTANCE FLOWS TO THE PHILIPPINES

145. **Remittances to the Philippines have remained relatively resilient since the onset of the global financial crisis and global recession** (Figure 3.7a). Remittances posted a solid performance in 2008 given the rapidly deteriorating global environment (growing by 13.7 percent in nominal US dollar terms compared to the 13.2 percent growth of 2007). With the collapse of the Lehman Brothers, a marked hump-shape is visible based on the three-months moving average (3mma) within 2008,: growth steadily accelerated in the first half of the year, peaked at about 20 percent in July, and steadily decelerated thereafter (to reach almost zero in March). A "boom-bust" pattern is present in remittances flows coming from the U.S. since the global financial crisis started—growth rates of remittances surged by over 30 percent annually through August 2008 and rapidly slumping after that (January 2009 posted a 25 percent annual decline). Remittances from Hong Kong—a major financial a trade center which was therefore quicker than other economies to be affected by the global financial and economic crisis—went sharply down during the peak of the crisis. However, the deceleration in aggregate remittance inflows bottomed out as early as the first half of 2009, refuting earlier projections of sharp decline. As the global economic recession softened and household needs increased due to the typhoon damages in September/October, remittance growth has been stronger in the latter part of 2009. For the whole of 2009, remittance grew by 5.6 percent, slower than the double digit growth posted during the boom period but much higher than consensus forecasts.

146. **The relative resilience of remittance flows to the Philippines owes mainly to its well-diversified OFW and migrant population** (Table 3.1). Although the impact of the global recession on migrants and OFWs is still ongoing, many large remittance-receiving countries have reported drastic contractions in remittance flows (e.g., Mexico for which a high share of migrants is low skilled and concentrated in a few

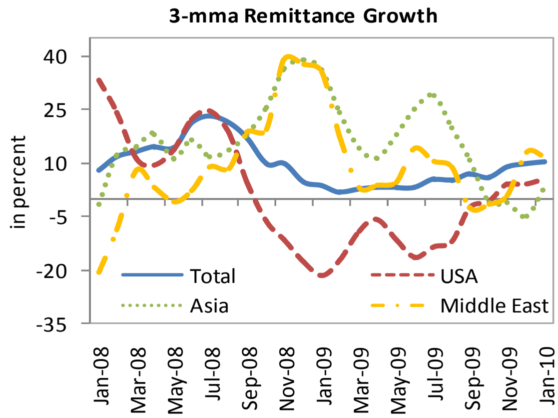
sectors, such as construction, farming, and low-value added services). No such collapse materialized to date in the Philippines. A key reason for such resiliency is that the Filipino overseas population is uniquely diversified in terms of its geography, occupation, skills, and gender. Such a diversified portfolio of migrants enables the country to weather geographically isolated or sector specific shocks—though the impact will be lessened for global ones. Moreover, the demand for Filipino workers overseas is shifting to more highly-skilled employment which yield more income and thus increases possibility of remitting more foreign exchange. In addition, the conduct of bilateral talks with host countries also continues to open up new employment opportunities abroad for Filipinos. Bank and non-bank service providers also continue to expand their international and domestic market coverage to capture a large share of the global remittance market and introduce new product and service.

147. **Remittance flows from sea-based OFWs are illustrative of the resiliency of remittances to the Philippines and the strong competitiveness of Filipino OFWs**. As global trade shrank by record amounts and speed in the latter part of 2008, all segments of the global shipping industry have been severely affected, including its labor force—with Filipinos accounting for 30 percent of all sea-based workers in the world (Ruiz, 2008). Yet, remittance flows from sea-based OFWs, which account for 20 percent of total remittances, has out-performed land-based remittances through 2009 although sea-based remittance has also considerably decelerated from its pre-crisis growth rates (Figure 3.7b). This good performance could be partly related to an acceleration of global staffing recruitment towards more cost efficient sources. For example, in the sea-faring industry—which has been, and continues to be, sharply affected by the global recession and the collapse in global trade and cruise ship tourism—the pressure to drastically reduce costs has led some companies to accelerate their staff sourcing from countries such as the Philippines which has a large pool of comparatively cheap, English-speaking, and well qualified sea-farers. There is also an observed change in saving pattern from seafarers: while most of these workers would have an arrangement with their employment agency and their Philippines bank whereby they would receive 30 percent of their salary for consumption and the remaining 70 percent would be sent directly to their bank in the Philippines. Since January 2009, it has been reported that seafarers have changed that ratio to 20/80 as their uncertain job prospects lead them to increase their rainy-day fund.

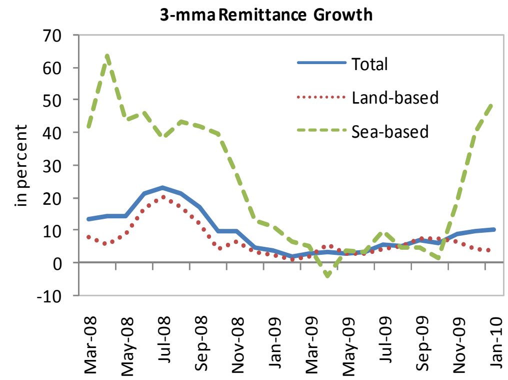
148. **Remittances to the Philippines could have benefited from a flight-to-safety away from large international bailed-out banks during late 2008 to early 2009.** Aggregate remittance flows could mask a one-off and possibly temporary portfolio reallocation from overseas Filipinos. Some evidence point to shifts of assets away from large foreign banks that have been at the forefront of the global financial crisis and towards Filipino banks perceived to be of higher quality (deposit growth of domestic banks increased at the peak of the global financial crisis while deposits actually contracted in foreign banks' branches in the Philippines). Should this flight-to-safety be significant, it would point to much weaker "traditional" remittance flows. Such a weakness could, in turn, explain the surprising weakness in domestic consumption in the first quarter of 2009.

Figure 3.7. Philippines: Remittances by countries of origin and type of senders

(a) Remittance growth declined fast as US inflows collapsed but recovery has set in



(b) Remittances from sea- and land-based migrants



Source: Bangko Sentral ng Pilipinas (BSP).

149. **Remittances to the Philippines could also benefit from a "sale effect" as the peso depreciated against the US dollar from late 2008 to the first half of 2009.** Exchange rate movements have an important bearing on many Filipino migrants decision to send remittances back home. In particular, an important share of remittances to the Philippines is used for asset purchases such as real estate (condominium). As the peso weakened from a 2008 high of 43 to a low of 50 due to the economic slowdown at home, there was a strong financial incentive to increase remittances sent for investment motives.

Conclusions and Policy Recommendations

150. **The following conclusions on remittances to the Philippines emerge from our analysis** of (1) the literature—and especially the significant body of Philippines-specific literature; (2) events when both the Philippines and a key OFW-host country are simultaneously in a sharp slowdown; (3) key institutions and analysts' projections for 2009 and 2010 and (4) actual outturn of remittances in 2009:

- *Remittances to the Philippines were projected to remain relatively resilient* (when compared to other sources of financing and income, and when expressed in real peso terms). While most analysts projected a contraction in the nominal US dollar value of remittances (a consensus range seems to hover from zero to minus 10 for 2009 with a slow rebound for 2010), such flows would, however, still represent positive real growth in peso terms, which would help sustain the all-important private consumption. One researcher, Yi (2009), projected small but positive remittance growth even in US dollar terms.

- *Actual remittance grew by 5.6 percent, slower than the double digit growth posted during the boom period but noticeably higher than forecasts.* Several explanations can explain the resiliency of dollar remittances. Structurally, this could be explained by the well-diversified OFW and migrant population, strong deployment due to continuous bilateral agreements as well as increasing preference for cost-competitive labor (e.g. seafarers). The strength, however, could also be cyclically explained by a flight-to-quality as well as returning OFWs.

- *Significant risk continue to undermine prospects of remittances* as the global nature of the recession and high unemployment (1) has a major bearing on OFWs migration options—escaping from a crisis affected country to one with still good growth prospects is less of an option; and (2) limits the largest source of historical resiliency of remittances to the Philippines, namely the unique portfolio-like diversification of its migrant workers (across geography, sectors, skills, gender, etc.).

- *The more protracted the weakness in the global labor market, the higher the downside risk to remittances become.* While most countries are emerging from the global recession in early 2010, the timing and strength of the recovery for the labor market is far less certain; most analysts are concerned about a jobless recovery. This would profoundly affect (1) global employment and migration prospects, and (2) the capacity of OFWs to keep sending remittances. Measures to favor domestic workers at the expense of migrant workers in many countries have already been introduced and they are expected to increase the longer the global labor market remains weak.

151. In light of the more challenging prospects for remittances, and the economy in general, and given the private/individual nature of remittances, the following policy recommendations would help improve remittances and their economic development impact:

- <u>R1. Migration policies</u>: the Philippines already have one of the most institutionalized programs for OFWs in the world (Ruiz, 2008); it provides many benefits for OFWs and the country as a whole. Policies that promote greater emigration of low-skilled workers make a significant contribution to poverty reduction (World Bank, 2006b). To further improve the resiliency of remittances, policies promoting programs targeted at non-cyclical jobs (such as nursing or teaching) should be encouraged. These are actively pursued by the authorities (e.g., the recent bilateral agreements with Japan regarding nurses[65]) but could be expanded further.

- <u>R2. Systematically monitor returning OFWs</u>. While government agencies in charge of helping and assisting OFWs have very detailed information on departing OFWs, information is, however, lacking in capturing and processing the number of returning OFWs. As a result, in times of economic crisis like the one experienced during the global recession, policy makers cannot know with a reasonable degree of accuracy whether OFWs are returning en masse or not. The availability of net deployment data would be critically important for the Government, not least in deciding of the scale and scope of assistance needed for OFWs.

[65] In the midst of the global financial crisis, the POEA and the Japan International Corporation for Welfare Services signed an agreement on January 12, 2009, under which Japan will hire initial 200 nurses and 200 caregivers with the target entry date of end April or early May 2009. The agreement was under the auspices of the Economic Partnership Agreement between Japan and the Philippines (entry into force on December 11, 2008), which offers a framework for the movement of natural persons—a mode of trade in services.

- R3. Remittance policies: while the BSP has an active program aimed at improving access to formal financial services, implemented measures to reduce remittance charges and improve remittance environment, [66] policies to further improve such access to poor migrants and their families would have an important impact on poverty reduction and on development (through increased use of remittance funds for entrepreneurship, and investment in human through health and education)—see World Bank (2006b for specific details).

- *Broader policy recommendation*: as remittances are person-to-person transfers, mostly (but not entirely) directed at family members, direct government involvement is limited. Remittances nonetheless have an important political economy aspect; one that is closely linked to economic and social development of the country. Box 3.2 illustrates these dimensions; many of which have a bearing on the medium-term growth prospects of the Philippines. Recommendations deriving from the political economy aspect of remittances are relatively straightforward and rejoin other key recommendations made in this report. These are related to structural reforms needed to:
    - Improve the investment climate (and governance in particular);
    - Tackle infrastructure bottlenecks; and
    - Improve access to finance for SMEs.

[66] In particular, to assist OFWs in their remittance concerns, a portal was created to provide information on remittance centers; banks and non-bank remittance companies, and their locations here and abroad; and fees, charges, product and services, among others. The BSP also initiates programs to make financial services accessible to OFWs. These include granting foreign currency deposit units to rural and cooperative banks, facilitating interconnectedness of ATMs, and approving alternative modes of sending remittances (e.g., Smart Padala). The BSP is also conducting regular financial literary campaigns for OFWs and their beneficiaries. This has been done both in the Philippines and overseas. In order to encourage OFWs to save and invest, the BSP and the national government agreed to offer retail treasury bonds. The BSP has also approved other saving schemes proposed by Land Bank and DBP.

II. ENSURING SOCIAL PROTECTION FOR THE POOREST AND MOST AFFECTED CITIZENS

4. THE GLOBAL RECESSION AND HOUSEHOLD VULNERABILITIES

152. *High levels of poverty and vulnerability in the Philippines allow the impacts of the global recession to easily permeate the socio-economic fabric. While the global recession translated only in an economic slowdown in the Philippines, it is nonetheless estimated to be responsible for pushing 1.4 million Filipinos into poverty (compared to the pre-crisis projections).*[67] *The main channels for this increase in poverty are reduced household earnings, increased joblessness among working household members, and a drop in remittances for less well-off households. Households in urban areas experienced harder blows than others. Workers who suffered the most were in the manufacturing and services sector in the National Capital Region and the surrounding highly urbanized regions (CALABARZON and Central Luzon). The government was quick to respond to mitigate the adverse impacts of the crisis by introducing a stimulus plan and prioritizing spending on social protection. However, further prioritization and enhancements could be introduced to enhance the Philippines' social safety net.*

PRE-EXISTING HOUSEHOLD VULNERABILITIES

153. **Over the past decades, the Philippines progressed in fighting poverty and in improving human development outcomes but lagged in some key non-income MDG targets.** While poverty incidence declined from nearly half of the population (45 percent) in 1991 to one-third in 2006, as of 2006 the country remained far from the MDG target of universal primary education (net enrollment rate for the elementary level was only 83.2 percent, and only 73.4 percent of those in school were able to complete Grade 6), and was unlikely to achieve key health targets by 2015.[68]

154. **In recent years, despite record economic growth, earlier progress in fighting poverty reversed so that over half of the population is poor or "near poor".** Between 2003 and 2006, when GDP grew by an average 5.4 percent, poverty incidence increased from 30 percent to 33 percent, back to its level in 2000. Similarly, the World Bank's $1.25-a-day poverty line increased from 22.0 percent to 22.6 percent and consumption-based poverty estimates increased from 26 percent to 28.1 percent during the same period (Chen and Ravallion, 2008; Balisacan, 2008). High rates of inequality explain some of the disconnect between growth and poverty reduction. Raising the poverty threshold to an international poverty line of $2 per day reveals a large proportion of "near poor" population—an additional 19.4 percent of the population

[67] Including the impact of the typhoons that caused massive flooding in Luzon in the last quarter of 2009.

[68] The decline in the number of maternal deaths per 100,000 live births has slowed down, reaching 162; and the infant mortality rate was 23 percent and the proportion of one-year old children immunized against measles was 83.2 percent, which are far from the 2015 targets of 19 percent and 100 percent, respectively (NSCB MDG Watch, July 2008).

in 2006 would be classified as poor. Poor and "near poor' households share almost the same characteristics—most of them are located in rural and economically lagging regions and are usually headed by a male, who has a lower educational attainment, or works as farmer or unskilled laborer.

155. **Access to basic services and income opportunities are highly uneven across the regions, leaving some households unable to participate and benefit from growth.** Income inequality in the Philippines (45.8 percent in 2006) remains high relative to its neighbors in East Asia and large variation in economic opportunities persists at the sub-national level (World Bank, 2009f). Regions with a high degree of economic activity have the lowest poverty rates. For example, the National Capital Region, which accounts for more than half of national GDP, has a per capita income about 11 times of the poorest region and also has the lowest poverty headcount ratio. The uneven progress in income poverty is also mirrored in the performance of non-income dimensions of welfare at the sub-national level. The least prosperous regions, mostly areas in Mindanao, have the least access to infrastructure and basic services while areas where economic activity is concentrated and poverty rates are lower have better access to services (Table 4.1).

Table 4.1. Philippines: Access to Basic Services, 2006

Region / Island Group	Proportion of the population Without access to		Proportion of Concrete & Asphalted Roads	Telephone Density [1/]
	Electricity	Water Source		
Region XIII – NCR	2.3	10.9	100.0	31.1
Region XIV – CAR	21.2	23.3	35.7	5.5
Region I - Ilocos Region	9.7	6.8	90.0	3.8
Region II - Cagayan Valley	19.1	16.4	69.5	1.4
Region III – Central Luzon	5.5	4.2	87.2	4.5
Region IVA – CALABARZON	7.7	14.5	85.8	10.2
Region IVB – MIMAROPA	38.0	19.9	46.1	10.2
Region V- Bicol	27.9	26.9	72.2	2.3
Region VI - Western Visayas	23.1	33.6	75.6	6.3
Region VII – Central Visayas	21.5	27.3	85.7	7.4
Region VIII – Eastern Visayas	26.2	19.3	81.3	3.7
Region IX – Zamboanga Peninsula	34.1	34.5	68.6	1.1
Region X - Northern Mindanao	23.8	18.1	69.5	3.8
Region XI – Davao	24.2	19.9	62.9	7.9
Region XII - SOCCSKSARGEN	30.8	19.5	62.4	2.1
Region XV – ARMM	50.1	64.9	46.3	5.4
Region XVI – Caraga	20.3	16.9	-	1.0
Average Philippines	18.0	19.4	71.5	8.3

Sources: 2006 FIES; NTC; DPWH.
[1/] Number of telephone lines installed per 100 persons.

156. **The global recession has highlighted vulnerabilities of Filipino households to economic shocks.** The global recession came immediately after the 2008 global food and fuel price shocks which had a profound impact on vulnerable households—see World Bank (2008b) for a detailed account of that crisis on household vulnerabilities and the poor. As in the case of the 1997/98 Asian financial crisis and the El Niño phenomenon in 1997, the succession of such shocks resulted in a further reduction of households' capacity to cope. A substantial proportion of the poor and the non-poor

households were unable to protect themselves and immediately succumbed to the effects of the crises (Reyes, 2002). The global recession, not only because of the magnitude of the shock itself, but also because it immediately followed a large negative shock for the poor—the 2008 food crisis—posed a serious threat to household welfare and likely further jeopardized the already slow progress towards achieving the MDGs.

157. **The Philippine labor market was structurally weak prior to the onset of the global recession.** Unemployment in the Philippines averaged 7.4 percent in 2008, significantly higher than most countries in East Asia (3.8 percent) and Southeast Asia (5.7 percent) (ILO, 2009a). One feature of the Philippine labor market is the high degree of unemployment even among the college-educated. New entrants to the labor market also have difficulty in getting a job. In fact, more than fifty percent of the unemployed belongs to the younger age group (Table 4.2). Meanwhile, both the underemployment and the visibly underemployed rates are high.[69] Half of the underemployed are found in agriculture. Informal sector workers represent about a third of total employment.[70] About half of the informal sector workers (48.4 percent) are engaged in agriculture while the other big share (44.9 percent) work in the service sector (NSO, 2008d). About one-fifth of informal workers attained college schooling.

Table 4.2. Philippines: Labor Market Structure, 2009 and 2008

	Apr-09	Apr-08	Jan-Oct 2009	Jan-Oct 2008
			Average	
Total Labor Force (million)	37.8	36.4	37.9	36.8
Labor Force Particpation Rate (%)	64.0	63.2	64.0	63.6
Total Unemployed (million)	2.8	2.9	2.8	2.7
Unemployment Rate	7.5	8.0	7.5	7.4
15-24 age group (% to total unemployed)	50.6	51.2	50.7	51.1
25-34 age group (% to total unemployed)	30.0	30.2	29.5	29.0
35-54 age group (% to total unemployed)	15.5	15.2	15.9	16.1
55 and over (% to total unemployed)	3.9	3.4	3.9	3.8
Total Underemployment (million)	6.6	6.6	6.7	6.8
Underemployment Rate (%)	18.9	19.8	17.7	18.4
Agriculture (% to total underemployed)	46.5	46.0	46.0	47.7
Industry (% to total underemployed)	14.5	15.5	15.1	15.1
Services (% to total underemployed)	38.9	38.4	38.9	37.1
Visibly Underemployed (% of employed)	11.8	11.4	11.3	11.4
Total Employment (million)	35.0	33.5	35.1	34.1
Employment Rate (%)				
Wage and Salary Workers (% of Total Employment)	51.9	52.9	53.3	52.3
Private household	4.9	4.7	5.4	5.1
Private establishment	38.5	39.8	39.4	38.9
Government/government corporation	8.2	8.0	8.2	8.0
With pay in family owned business	0.3	0.4	0.3	0.3
Own Account (% of Total Employment)	34.9	34.6	34.7	35.4
Self employed	31.1	30.0	30.6	31.3
Employer in own business	3.9	4.6	4.1	4.2
Unpaid Family Workers (% of Total Employment)	13.1	12.5	12.0	12.2
Employment by Industry (% of Total Employment)				
Agriculture	35.2	35.5	34.4	35.3
Industry	14.5	14.9	14.5	14.8
of which Manufacturing	8.1	8.6	8.3	8.6
of which Construction	5.6	5.5	5.4	5.4
Services	50.3	49.6	51.1	49.9
of which Wholesale and retail trade	19.1	18.9	19.2	18.9

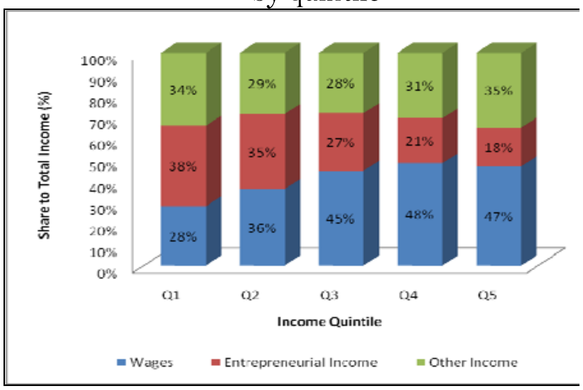
Source: NSO

[69] Visibly underemployed people are officially defined as those working less than forty hours a week.

[70] Informal sector workers are those who are either self-employed without any employee or employer in own family operated farm or business (also called own-account workers).

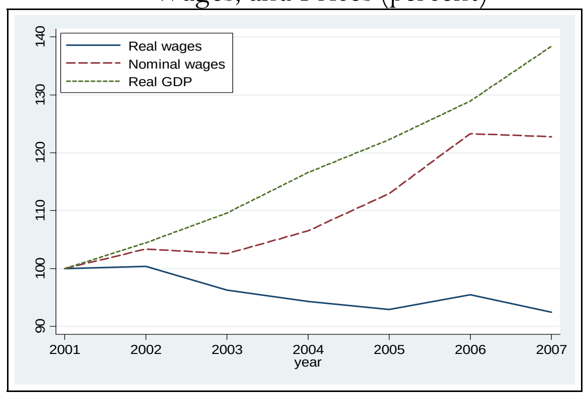
158. **The crisis has added further pressure on real wages; these have already been declining since 2001.** Filipino households are highly dependent on wage income. It accounts for almost half (45 percent) of an average household's pool of resources and an even higher share of a non-poor household's pool of resources (Figure 4.1). This reflects the extent of their vulnerability to falling incomes in the face of crisis. Labor Force Survey data on wages show a continuous decline in real wages in recent years despite the uptrend in economic growth (Figure 4.2). Between 2003 and 2006, average real family income declined by 3.7 percent contributing to the increase in poverty during this period. The 2008 food price shock led to a further decrease in real wages as nominal wages increased by 5.3 percent while CPI inflation rose by 9.3 percent between 2007 and 2008.

Figure 4.1. Composition of household income, by quintile



Source: FIES 2006

Figure 4.2. Philippines: Growth in GDP, Wages, and Prices (percent)

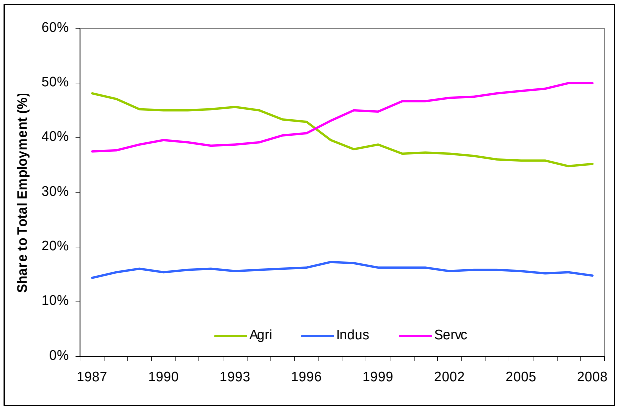


Source: LFS (various years), NSO

159. **Of the 35 million employed Filipinos, two-thirds work in the industry and services sectors and are particularly vulnerable to the global recession.** Agriculture used to have the largest share to total employment but now accounts for only 35 percent of employment. Employment in the industry sector has been stagnant at around 15 percent of total employment since the 1990s. Meanwhile, the share of the services sector to total employment has been increasing steadily since the mid-1990s and has been absorbing the surplus workers mainly from the agriculture sector (Figure 4.3). By 2008, services accounted for half of total employment.

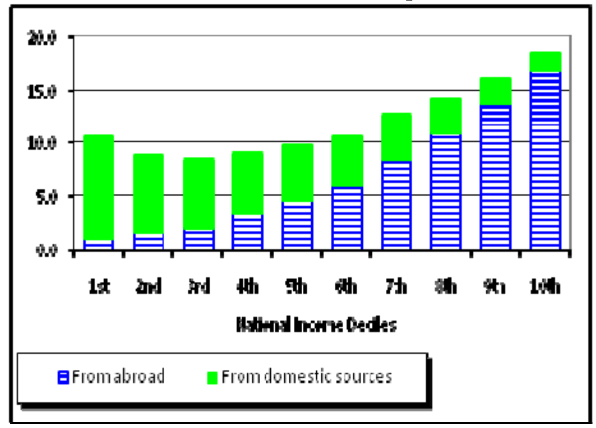
160. **Three out of five households in the Philippines receive remittances, and of those that receive remittances, a quarter live below the poverty line.** Remittances from abroad (which includes cash sent by OFWs) and from domestic sources (which includes cash sent by family members working elsewhere in the Philippines as well as government transfers) each account for 11.5 percent and 3.3 percent of total household income, respectively. This indicates that, for an average Filipino family, remittances from abroad are generally a more important source of financial support than remittances from domestic sources. Reliance on remittances differs among income groups, with wealthier households deriving 15.6 percent of their income from remittances while poorer ones derive only 7.1 percent. In terms of sources of remittances, wealthier households rely relatively more on overseas remittances than from domestic sources, while the opposite is true for poorer households (Figure 4.4).

Figure 4.3. Employment Shares by Industry, 1987-2008



Source: LFS (various years), NSO

Figure 4.4. Share of Remittances to Total Household Income, percent



Source: FIES 2006

TRANSMISSION CHANNELS OF THE GLOBAL RECESSION TO HOUSEHOLDS AND THE POOR

161. **The global recession is a negative shock that has directly affected household welfare.** The global recession has affected both aggregate demand and demand for labor, adding further downward pressure on wages and employment. Labor markets are expected to adjust to the shock through some combination of reduced employment and reduced earnings. For poor households whose incomes are already stretched and alternative sources of support are unavailable, a further reduction in income could push them deeper into poverty. The aggregate shock at the country level, however, does not tell the whole story as there would also be heterogeneous impacts across households (World Bank, 2008b). As discussed below, the largest proportionate income losses need not be amongst the poorest initially, as some of them would be protected by the same factors that have kept them poor, such as geographic isolation and consequently poor connectivity with national and global markets.

162. **There are several "transmission channels" through which the global recession are estimated to affect the socio-economic fabric in the Philippines.** To date, there is little hard evidence to indicate the degree to which each of these potential channels has contributed to real and long lasting welfare losses. However, understanding how the effects of such crises pass on to households is important in view of closely monitoring these areas. The key transmission channels are as follows (Figure 4.5):

- *A contraction in exports and foreign direct investment inflows.* The sharp reduction in demand for exports and the decline in FDI net inflows to the Philippines would result in lower industrial output and a general slowdown in business activity, particularly in the manufacturing sector. However, while the contraction in manufacturing production was sharp and significant at the peak of the crisis, the manufacturing sector employs a limited share of the labor force (9.1 percent). The aggregate impact of the global recession through this direct manufacturing channel is therefore estimated to be relatively limited. Poor and near poor households with members working in this sector would nonetheless be severely affected. One in every five workers currently in this sector was already poor prior to the global recession's shock.

Figure 4.5. Transmission Mechanism of the Global Recession on Households

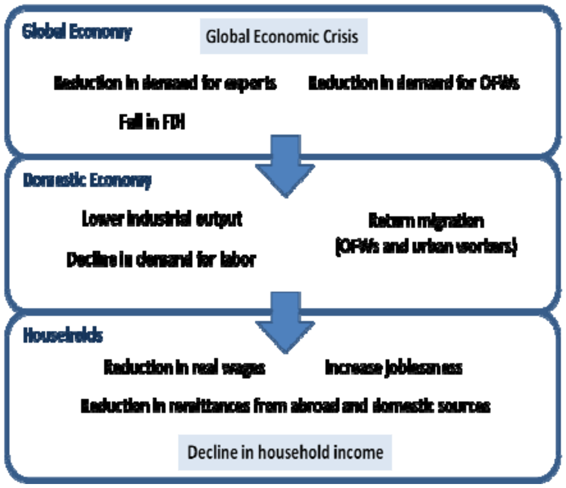
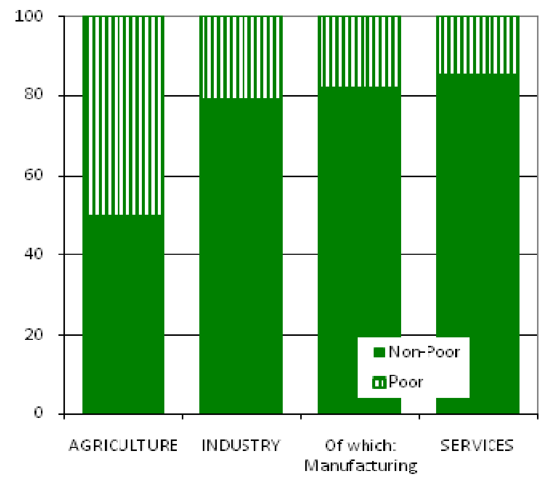


Figure 4.6. Sectoral Allocation of Labor by Income Group (percent)



Sources: LFS-FIES 2006, NSO

- *A reduction in net demand for overseas foreign workers (OFWs) and a slowdown in remittances from abroad* (see Chapter 3 for details). While remittances and overseas deployment have proved to be more resilient than projected at the onset of the global recession, the growth rates of both remittances and deployment are slower than they would have been absent the global recession. As 5 million Filipinos work on temporary and irregular contracts abroad (ILO, 2009a) and a quarter of Filipino households receive remittances from abroad, this reduction in remittance growth would hurt their incomes, particularly the households that depend heavily on remittances for consumption. Moreover, the return of displaced OFWs and slowdown in new deployments would add to an already weak labor market.[71]

- *Lower industrial output leads to a decline in demand for labor, and downward pressure on wages.* Sectors with extensive linkages to the global production chain such as electronics, textile, furniture and garments were the one of the first to get hit. Many of these industries are not only labor-intensive but also consist of a majority of low-skilled workers who have been disproportionately susceptible to job cuts. As employment worsened and new recruitments stalled, the excess supply of labor has placed downward pressure on wages. Displaced workers would be willing to take jobs even on a lower pay and those currently employed would be amenable to working more for the same amount of wage.

- *The reduction in wages and increased joblessness of urban workers and OFWs reduces income support to their rural families.* In general, more Filipino households rely on remittances from domestic sources (47 percent) than those that rely on

[71] From October 2008 to August 2009 the government reported that as much as 6,951 OFWs had been temporarily or permanently displaced due to the crisis, of which 4,495 returned to the Philippines.

remittances from abroad (24 percent). Specifically, poor households are more reliant on domestic remittances (31 percent) in contrast to non-poor households who are more reliant on remittances from abroad (9 percent). The reduction in earnings of urban-based family members that send money back home is likely to have a bigger effect to already poor households.

- *As export-oriented industries are mostly located in urban areas, the unemployment effects of the crisis will initially hit urban workers.* As the export-oriented manufacturing industries that are mostly located in urban areas are already hit by the global recession, urban workers, who are relatively less poor, would be the first to suffer from the contraction in the labor market (Figure 4.6).

- *Displaced workers from the formal sector may also seek employment in the informal sector as they could not afford to remain unemployed.* For workers in the formal sector who have lost their jobs or whose earnings have been reduced, an alternative option is to turn to the informal sector. In 2008, the informal sector accounted for 35.5 percent of the labor force. The Informal Sector Survey shows that there are about 10.5 million informal sector operators that are mostly self-employed without any paid employee (87 percent) and some employers in own-family operated farm or business (13 percent) (NSO, 2008d).

163. **For lack of timely and reliable data, a two-pronged approach to estimating the impact of the crisis on households and the poor is undertaken: simulations and rapid survey.** The first approach relies on a macro-micro simulation model applied to the Philippines economy. The second approach aims to check the validity of the results from the macro-micro simulations model through a specific workers survey. The next two sections present each of the approaches. It is found that the results of the macro-micro model and consistent with results from the workers survey.

POVERTY SIMULATIONS

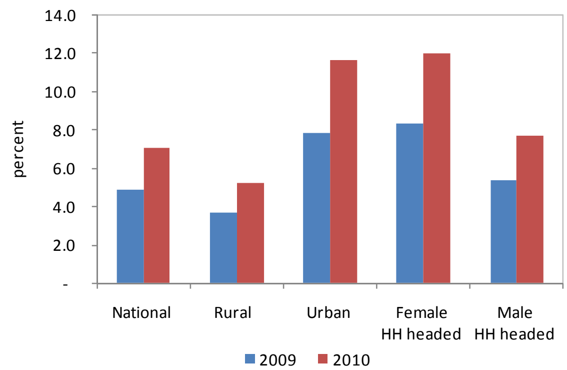
164. **The global recession is projected to have a notable impact on aggregate poverty in the Philippines but will particularly affect urban areas, certain sectors and types of households.** The results from a macro-micro simulation exercise for the Philippines[72] show that the poverty rate is projected to be 1.45 and 2.07 percentage points higher in 2009 and 2010 respectively as a result of the crisis, compared to what would have been without the crisis. This implies that the crisis would be responsible for an additional 1.4 million Filipinos living in poverty in 2010 (Figure 4.7).

165. **The impact of the global recession on poverty in the Philippines is primarily driven by a lower level of economic activity.** GDP growth was expected to be 3.3 and 1.9 percentage points lower due to the crisis in 2009 and 2010 respectively, which would be manifested in lower employment and labor earnings. The unemployment rate among adults is projected to be slightly higher in 2009 and 2010 respectively due to the crisis, compared to what would have occurred without the crisis.

[72] As in most countries, no household survey data during the global recession is yet available to directly measure the impact of the crisis on household welfare. In the absence of such data, estimating the welfare impact of the crisis requires linking macroeconomic projections with household data from a pre-crisis year to simulate impacts on households.

With most of the slowdown occurring in the manufacturing and services sectors, workers in these sectors are also expected to earn less. For example, average monthly earning per worker in manufacturing is projected to be 10.3 percent and 12.9 percent lower due to the crisis in 2009 and 2010 respectively, relative to earnings without the crisis.

Figure 4.7. Philippines: Increase in poverty rate due to the global recession 1/
(in percent of the poverty rate without the global recession)



Source: Habib, B. et. al, (2010)
1/ Based on FIES 2006

166. **The global recession is projected to adversely impact labor *and* non-labor income of households**, leading to a loss of 2.2 percent and 3.6 percent in average household income in 2009 and 2010 respectively, compared to the no-crisis scenario. Loss in labor income would account for a dominant share of the income loss for households who are in poverty due to the crisis. Loss in *non*-labor income for these households, which would be smaller than the loss in labor income, is primarily driven by a slowdown in remittances from abroad, both in terms of the number of households receiving and amounts received. That lower remittances has some impact on poverty is not surprising, considering that in 2006 around 9 percent of poor households were receiving transfers from abroad that amounted to nearly 17 percent of their family income.

167. **The poverty impact of the crisis is projected to be larger in urban areas than rural areas**, consistent with most of the impact being concentrated in sectors that are important for urban areas. In 2010, urban poverty rate is projected to rise by much more than the rural poverty rate relative to their corresponding benchmark poverty rates (11.5% and 5.2% rise for urban and rural poverty rates, respectively) due to the crisis. The relative impact also appears to be higher among female-headed households than among households headed by men (Figure 4.7).

EVIDENCE FROM RECENT SURVEYS

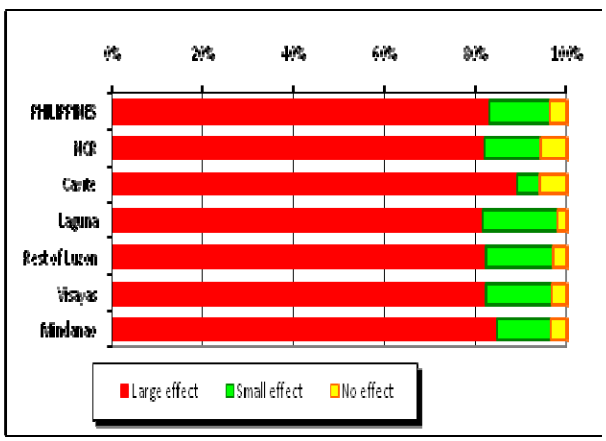
168. **As estimated above, the global crisis would be transmitted to households with negative repercussions to household welfare.** For lack of timely and reliable data, to check the robustness of the macro-micro simulation model, the World Bank commissioned an independent study to undertake a rapid assessment (described

hereafter as "rapid survey").[73] The survey confirms the findings of the simulation exercise, namely that households in the Philippines were negatively affected through several avenues including reduction in real household incomes, increased joblessness, and reduced remittance inflows. The following summarizes the findings from the rapid survey as well as other surveys that came out recently that confirm such impacts on households.

Deterioration of Overall Welfare

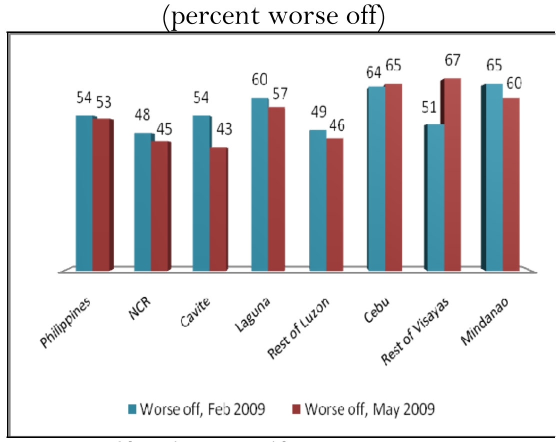
169. **Households perceive that the global economic crisis has a large effect on them and on their community as a whole.** The World Bank's rapid survey showed that households were aware of the potential impacts of the global economic crisis. As many as 83 percent of households perceived that the crisis had a large effect on them and their community while only 17 percent reported that the crisis had a small or no effect (Figure 4.9). In Cavite where several export processing zones and industrial parks are located, a relatively higher proportion of households think that the global economic crisis had a large effect on them and their community.

Figure 4.8. Households' Perception of the Effects of the Global Economic Crisis



Sources: LFS-FIES 2006, NSO

Figure 4.9. Personal Quality of Life Compared to Last year (percent worse off)



Source: World Bank 2009 Rapid Survey

170. **More specifically, one in every two Filipinos reported a worsening of their overall welfare this year compared to a year ago.** Results of the rapid survey show that 53 percent of Filipinos say that their personal quality of life is worse this year compared to a year ago. Visayas and Mindanao record higher incidences of deterioration in people's personal quality of life than on average (Figure 4.10). In Visayas, the proportion of those saying that their lives are worse off now increased markedly by 16 percentage points from that of last quarter. Visayas is home to the Mactan Economic Zone which houses about 200 firms in engaged in electronic manufacturing and

[73] The survey consisted of structured quantitative household interviews and focused group discussions. The surveys were carried out by an independent research group in May 2009 with February to April 2009 as reference period. The quantitative survey interviewed adults aged 18 years and over from 1,600 randomly selected households: 300 households were sampled in each of Luzon, Visayas, and Mindanao, and NCR and was supplemented by 200 samples each in the Laguna and Cavite economic zones. The quantitative interviews asked questions on quality of life, employment conditions, crisis impacts, and coping strategies.

exporting furnitures, housewares, and garments. Most of these firms have adopted the compressed work-week arrangement since January 2009. In Luzon, the proportion of individuals who reported deterioration in their quality of life is also higher in Laguna than on average or compared to NCR. In January 2009—the peak of the crisis for the electronics and semiconductors export section—some 35,000 workers were reported to have been laid off in Laguna Technopark alone (Senate Press Release, 26 January 2009), which more than 100 companies involved in precision/leading edge electronics including circuit assembly and packaging and hard drive manufacture, and assembly of automobiles and related parts.

171. **The number of Filipinos who consider themselves as poor and food-poor rose after the global crisis struck.** Self-rated poverty peaked to 53 percent in September 2009 from 47 percent or 8.7 million families in February 2009 (SWS, 2009b). However, the figures on self-rated poverty are lower than IN 2008 (59 percent) when the food crisis peaked. Despite a considerable increase in general prices in 2008, the poverty threshold for poor households remained at the same (nominal) level as a year ago. A reduction in self-assessed poverty conditions among households from 2008 may thus indicate that families had been lowering their living standards or doing some belt-tightening just to meet their needs (SWS, 2009b). Severe hunger was also reported to be highest among those who have been laid off from work (SWS, 2009c).

Reduced Earnings and Increased Joblessness

172. **Filipino households felt the impact of the global recession through a combination of reduced earnings and reduced employment.** Results of the rapid survey indicate that, next to higher commodity prices, reduction in income and loss of a job are the next main contributors to the perceived worsening of people's quality of life during the survey period (Table 4.3). As of the first half of 2009, about 6.8 million adult Filipinos said their situation was worse than a year ago because they lost a job or their incomes have been reduced.

Table 4.3. Shocks that Negatively Affect Household Welfare (percent)

Shocks	All Households	Households in Urban Areas	Households in Rural Areas
Higher prices	70.7	69.3	71.9
Reduced income	13.0	12.0	13.8
Job loss	11.2	13.4	9.4
Unforeseen household expenses	3.2	4.1	2.5
Reduced remittances	1.6	0.7	2.3
Death of household head	0.1	0.1	0.0
Natural disasters	0.1	0.1	0.0
Others	0.1	0.3	0.0
Base: All households that reported shocks	100.0	100.0	100.0

Source: World Bank 2009 Rapid Survey

173. **Reduction in earnings has been less a result of a downward adjustment in real wages…** Historically, labor market adjustment in developing countries during times of crisis occurred predominantly through real wage declines, often facilitated by sharply higher inflation during the crisis. For instance, decline in real wages was particularly dramatic in Indonesia during the 1997 Asian crisis where real wages fell by

an estimated 41 percent (Betcherman and Islam, 2001). However, the reduction in real earnings from this crisis does not result from high inflation, unlike the past crisis (in fact, contrary to most recent crises, inflation has not increased but decreased during this crisis). Full year inflation rose to 9.3 percent in 2008 due to the fuel and food price shocks thereby well exceeding the 2007 inflation rate of 2.8 percent. However, CPI inflation has steadily decelerated since reaching a peak of 12.4 percent in August 2008, registering a full year inflation of 3.2 percent in 2009. The exchange rate also remained relatively stable during the global recession, again in contrast to most other severe crises experienced by the Philippines.

174. **... than a result of a reduction in workers' supply of labor.** The Philippines is characterized as having an inflexible labor market—at least on paper—because it is highly regulated and geared towards protecting the employed rather than promoting overall employment of the labor force (Sicat, 2004).[74] Despite this, the experience of the Philippines during the Asian financial crisis is that, during times of crisis, both firms and workers would find flexible means of keeping firms from shutting down altogether and laying off more workers. Workers adjusted by reducing days and hours of work while others were put on job rotation (de Dios, 1999). This resulted in increased underemployment rates, from 19.4 percent in October 1996 prior to the crisis to 23.7 percent in October 1998. In the context of the current crisis, some 40,000 local workers were left jobless from company shutdowns and downsizing as early as January 2009. The Philippine government quickly offered contractual jobs and temporarily issued flexible working arrangements to avoid further job loss (DOLE, 2009a). Firms and employees were given several options, which include reduction of workdays, employee rotation, and forced leave, among others.

- **More jobs were lost than found between February and April 2009.** Reported cases of permanent and temporary job losses between October 2008 and May 2009 due to the crisis are only at 85,846 (DOLE and PEZA, May 2009).[75] However, results of the rapid survey show that 11 percent or close to 2.2 million adults were laid off between February and April 2009. In comparison, 4 percent of the currently employed, whose number is equivalent to about half of those who were laid off, found jobs around the same time. This indicates that an estimated 1.1 million adults remain jobless at the time of the survey. Moreover,

[74] The Philippines rigidity employment index in 2008 is at 35, higher than all countries in the region with the exception of Indonesia (World Bank, 2009a). The cost of employing regular workers and firing them are high. The unit cost of regularly employed workers has been made artificially expensive by mandated labor policies, such as the minimum wage law, provision of 13th month pay and cost of living allowances, night differential pay, and security of tenure after 6 months of continuous work, among others. The cost of dismissing or firing workers also comes at a higher price (equivalent to 91 weeks of salary) compared to neighboring countries and East Asia as a whole (38.6 weeks). Firms need to interact with labor bureaucracy on matters of dismissal or removal of regular workers.

[75] The Department of Labor and Employment (DOLE) monitors the number of displaced workers due to the crisis and other various reasons through establishment employment reports submitted by employers to DOLE regional offices. Submission of such reports, however, does not include establishments in the special economic zones, which fall under the ambit of the Philippine Economic Zone Authority (PEZA). Meanwhile, PEZA only has records of workers who asked for assistance through the PEZA One-stop Workers' Assistance Centers (POSWACS). The government reported that as many as 208,128 domestic workers and 6,951 overseas Filipino workers (OFWs) have been temporarily or permanently displaced between October 2008 and August 2009 due to the global recession, of which about 120,000 workers have been placed under flexible working arrangements.

of the 2.2 million jobs lost, the survey found that 866,000 were due to company shutdowns and layoffs because of the crisis.

- **Underemployment became a more serious issue than outright unemployment.** As in the case of the Asian financial crisis, a trade-off occurred between job preservation/generation and increased underemployment. Resorting to more flexible working arrangements and informality worked, before and again now, to mitigate large scale unemployment. While overall unemployment went down to 7.5 percent in April 2009 from 8.0 a year ago and 7.7 in January 2009, underemployment rose to 11.8 percent from 11.4 percent. This meant an increase of 336,000 individuals working less than 40 hours a week. Underemployment continued to be on the rise as of January 2010. Data from the rapid survey also show that of those who experienced a reduction in income or hours of work, 43 percent is looking for additional work augment their current income. The April 2009 LFS reports close to 1.5 million jobs created from a year ago. However, of this number, about 70 percent either work in the informal sector or as unpaid family workers. In addition, those who worked less than 40 hours a week increased by 2.4 million during the same period and mean hours worked for the week dropped from 41.6 to 39.8. All these point to the temporary nature of jobs that have been generated during the period.

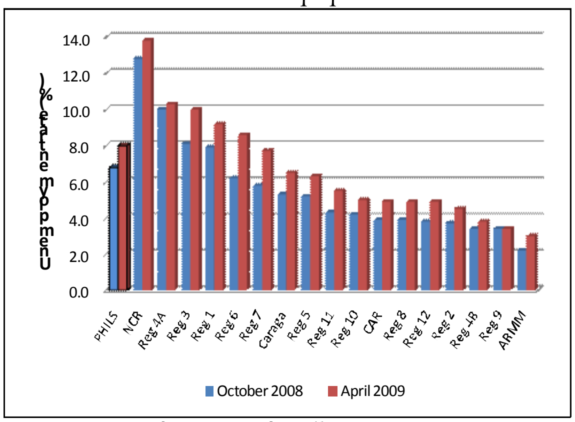
175. **There were also indications that employee benefits have been reduced.** Among those who were laid off, the rapid survey showed that only 10 percent received their expected severance pay, while a large majority (83 percent) did not receive any form of compensation from their employers. The Focus Group Discussions (FGDs) undertaken alongside the World Bank's Rapid Survey further reveal that those who retained their jobs have to put up with harsher working conditions, fewer benefits, and experience greater job insecurity at work. These come in the form of delayed salaries, reduced health insurance coverage, employer's contributions to social security and health care being deducted from employee's salary, unpaid overtime work, and delays in converting contractual employees to regular workers.

176. **Workers who suffered the most because of the global recession were in the manufacturing and services sector.** Data from the rapid assessment indicate that more than half of those employed in manufacturing, retail and wholesale trade, private services, and construction suffered a reduction in income or hours of work. In comparison, workers in agriculture and government services who experienced the same situation were less. Workers in the most affected sectors cited declining company income and lower demand for products as the main reason for such conditions. In the January 2009 LFS, manufacturing recorded a reduction in employment of about 120,000 sustaining the net job losses registered since January 2008. The loss seemed to have bottomed down in July 2009 but job creation still remained weak through 2009.

177. **Urban areas reported higher increases in unemployment and job losses.** Sectors under the direct hit of the current financial crisis are highly concentrated in urban areas. Industry and services are concentrated in three highly urbanized regions, namely, NCR, CALABARZON and Central Luzon. Together, these three region account for about 60 percent of GDP and about 46 percent of employment in the industry and services sectors. However, unemployment rates are also highest in these regions (Figure 4.10). In October 2008, unemployment in these three regions averaged

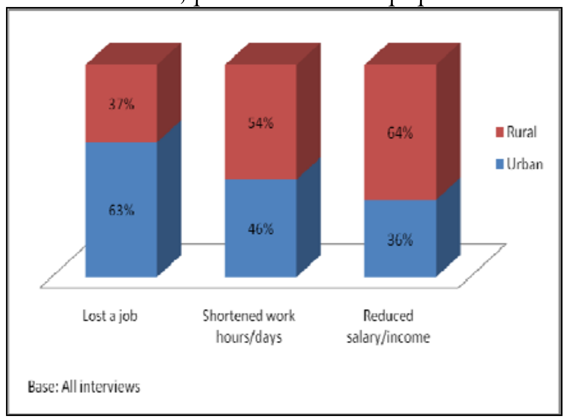
10.3 percent versus a national rate of 6.8 percent. By April 2009, this swelled even further to 11.4 percent against a national rate of 8.0 percent as the crisis crept into the economy. These 3 regions alone already account for 78 percent of reported cases of permanently displaced workers to the DOLE. Further, data from the rapid survey indicate that 63 percent of the adult population who lost their job was from urban areas (Figure 4.11). NCR, Laguna and Cavite contributed nearly 36 percent to total job loss. In contrast, higher proportions of the adult population who experienced reduction in incomes and work hours were found in rural areas.

Figure 4.10. Regional unemployment, percent of adult population



Source: LFS, October 2008 and April 2009

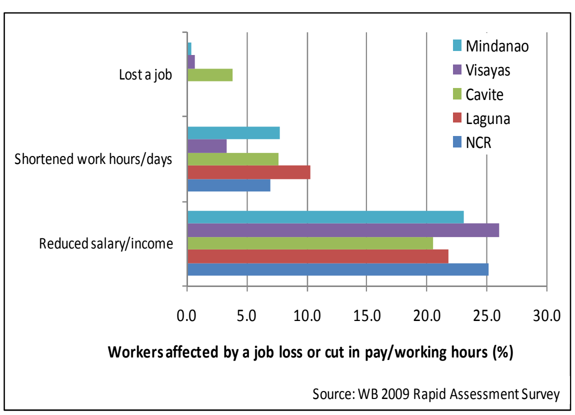
Figure 4.11. Crisis impacts in urban and rural areas, percent of adult population

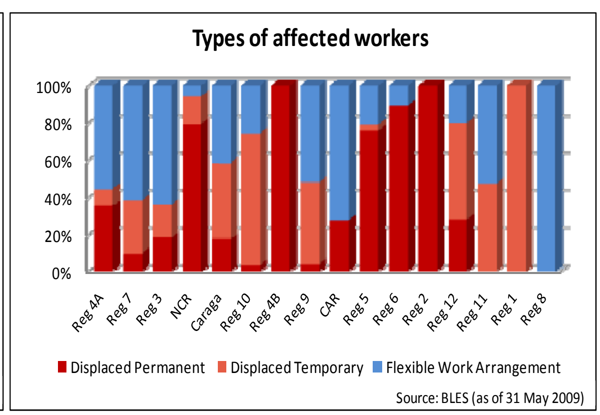


Source: World Bank 2009 Rapid Survey

178. **Although some areas were affected more intensely than others, the impact of the global recession on employment and household incomes is widespread.** Although job losses were highly concentrated in a few regions, the impact of the global recesion is, however, felt all across the country. Based on establishment reports collected by BLES, CALABARZON (Region 4A), Central Visayas (Region 7), Central Luzon (Region 3), and NCR posted the highest number of workers affected by the global economic crisis. Reported cases of permanent and temporary worker displacements were highest in CALABARZON at 68,614 as of May 2009. These numbers do not yet include workers affected by company downsizing and closures in the economic zones which are not being monitored by BLES. Based on these figures, reported cases from other regions account for only 10 percent of the total. The rapid assessment, however, shows that the share of employed workers who took cuts in pay or hours of work in other parts of the country are also high (Figure 4.12).

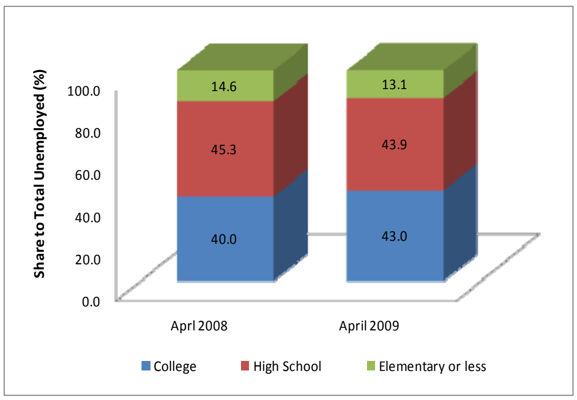
Figure 4.12. Affected workers by area/region





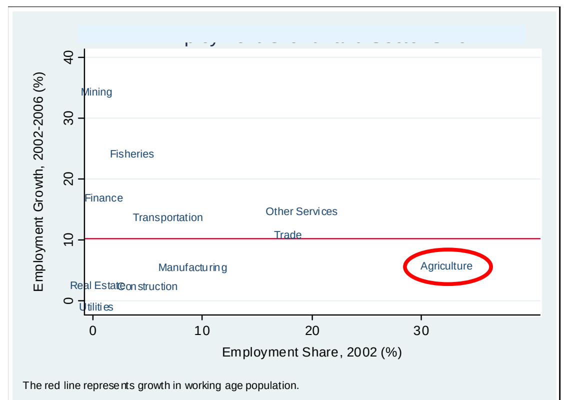
179. **Across income groups, evidence points to a higher increase in unemployment among the non-poor, better educated workers.** While it remains that more than half of those who are underemployed have attained no more than secondary schooling, data from the latest LFS show that the share of workers who have reached college schooling among the unemployed increased in 2009 (Figure 4.13). As of April 2009 (the peak of the crisis), there were 51,000 more unemployed workers who have at least attained college education. This indicates that workers from higher-income households who are better educated may have suffered more job losses than workers from poorer households.

Figure 4.13. Education profile of the unemployed



Sources: LFS April 2009

Figure 4.14. Growth in sectoral employment, 2000-2006



Source: LFS (various years), NSO

180. **Meanwhile, the poor are also getting hit by the effects of reverse migration of displaced urban workers.** Two-thirds of the poor in the Philippines live in rural areas. In general, displaced workers from urban non-agricultural sectors find it unattractive to go back to rural agriculture because labor productivity in agriculture is already low.[76] In fact, the rapid survey showed that most workers still hoped to find jobs in wholesale and retail (28 percent of those looking for work) and in private services (22 percent). Moreover, the agriculture sector has not been a source of major job creation in the past (Figure 4.14). Data reveal that workers who went to find jobs in agriculture were unable to find enough opportunities to offset their lost income. They find themselves competing with other workers who probably may have already saturated work in the sector. Indeed, the April 2009 LFS show that the number of underemployed workers in agriculture increased by about 33,000 over last year. Such is also the experience in other affected countries like China, India, and Vietnam (ILO, 2009a).

181. **Rural households that are dependent on incomes from certain export commodity crops were affected by the decline in real commodity prices.** Households in rural areas who are engaged in exporting agricultural products also felt the impact of reduced demand for their agricultural products. Eastern Visayas and the Mindanao regions are main contributors to agricultural employment and some of the

[76] In 2006, gross value added per worker in the agriculture sector is only a quarter of the industry sector and half of the service sector (National Accounts, NSCB; LFS, NSO).

country's top export products, which leaves them highly vulnerable to income losses as a result of the crisis. Farmers in these regions are already getting hit by the decline in copra prices since the last quarter of 2008. Copra prices were reported to have declined by as much as P15 per kilo in November 2008 as a result of falling demand (NEDA Region 8), and this went on up to the first quarter of 2009 when coconut oil and copra prices were reported to have declined by as much as 20 percent from the previous quarter (NSCB, 2009c).

182. **In summary, the adverse impact of the global recession on employment and earnings cuts across geographic areas and income classes.** As mentioned earlier, an average Filipino household derives about 45 percent of its total income from wages. Without existing income support programs for the unemployed, this leaves households highly vulnerable to sudden changes in their employment status. All else remaining unchanged, it is estimated that a general 10 percent reduction in total wage income could increase the proportion of people living below the poverty line by 2.4 percentage points, equivalent to an additional 2 million people, and increase the income gap of the poor by 0.7 percentage points (Table 4.4). This would increase the number of poor people in urban areas, where a disproportionate share of the wage-earners are concentrated, by 12.1 percent more than twice the rate in rural areas (5.1 percent).

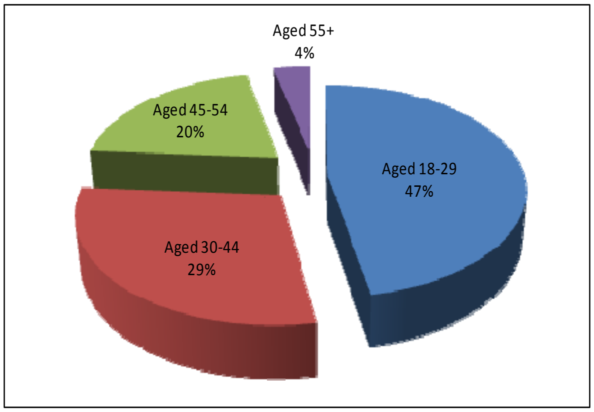
Table 4.4. Philippines: Simulated impact of a 10 percent reduction in wages on poverty[1/]

	Base rates	Impact of a 10% reduction in	
	(2006)	Non-agricultural wages	Total wage income
Poverty Incidence (% of population)			
Urban	19.5	19.7	21.9
Rural	45.9	46.8	48.3
All Philippines	32.9	33.4	35.3
Income gap of the poor (% of poverty line)			
Urban	27.6	27.9	28.3
Rural	31.7	32.2	32.5
All Philippines	30.5	31.0	31.2

Source: WB staff estimates using FIES 2006.
1/ Partial equilibrium analysis of the direct impact of a wage reduction.

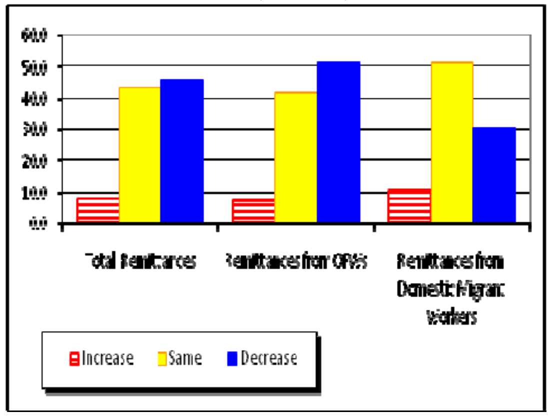
183. **In the short-term, however, unemployment may be less of an issue for the poor than for the urban youth who belong to non-poor families.** There are three main reasons for this. First, poor households have more diversified sources of income than the non-poor. The ratio of wage to non-wage income among poor households is lower than the non-poor, indicating that they are less dependent on formal wage income. Second, majority of the non-poor live in cities and urban areas and employed in the industry and service sectors. This suggests that unemployment in sectors hardest hit by the crisis will affect the (previously) non-poor living in urban areas more severely than the poor. Third, unemployment rates in the highly urbanized regions are already about twice as high as the national average—10 percent in CALABARZON and about 13 percent in the NCR. The largest proportion of the unemployed comprises young workers who have the least experience. As much as 50.6 percent of the unemployed are in the 15-24 age group (Table 4.2). The rapid survey finds that a big share of those who lost a job during the reference period is indeed from the younger age group. Interviewees below 30 years old share 47 percent of reported job losses (Figure 4.15).

Figure 4.15. Share of workers who lost a job by age



Source: World Bank 2009 Rapid Survey

Figure 4.16. Percent of Households that Reported Change in Cash Remittances (percent)



Source: World Bank 2009 Rapid Survey

Table 4.5. OFWs and Remittances by Major Occupations (percent)

Major Occupations	% distribution	
	OFWs	Remittances
All OFWs	100.0	100.0
Laborers and unskilled workers	32.4	19.5
Service workers and shop and market sales work	14.3	14.0
Trades and related workers	15.7	18.1
Plant and machine operators and assemblers	13.0	15.5
Professionals	9.6	13.2
Technicians and associate professionals	6.2	8.4
Clerks	5.6	5.3
Officials, corporate executives, managers, and supervisors	2.7	5.2
Farmers, forestry workers, and fishermen	0.5	0.8

Source: SOF 2008, NSO

184. **Another important facet of unemployment would be the slow-down in the net deployment of Overseas Filipino Workers (OFWs).** The Survey on Overseas Filipinos (SOF) shows that one-third of OFWs are laborers and unskilled workers, which include domestic helpers, cleaners, and manufacturing laborers, many of whom are on temporary contracts and may be more vulnerable to discontinuation of employment overseas (Table 4.5). The return of displaced OFWs who are low-skilled would contribute to higher unemployment as they compete in an already slackening domestic labor market. Data from the BLES show that of the 4,495 expatriated OFWs as of May 2009, only 56 percent were referred to various employment agencies for redeployment abroad. However, the impact on deployment seems to be small. Overall deployment has remained resilient through 2009, growing by 15.1 percent from 12.1 percent. This good performance could be partly related to an acceleration of global staffing recruitment towards more cost efficient sources.

Slowdown/Contraction in Remittances

185. **A reduced demand for OFWs and the increase in unemployment in the domestic labor market hurt families that rely on remittances.** The World Bank's rapid survey showed that 46 percent of households that receive cash remittances from their family members working abroad and elsewhere in the Philippines (domestic migrant workers) reported a decrease in remittances in May 2009 compared to what they received three months ago. A smaller proportion of households (44 percent) reported that remittances remained the same while only 8 percent reported that the remittances that they received increased (Figure 4.16). For households that receive remittances from OFWs alone, almost half reported that remittances decreased while 30 percent of households that receive remittances from domestic migrant workers reported similar case. This trend was supported by the results of the focused group discussion conducted by the World Bank in May 2009 in parallel with the rapid assessment survey, which indicated that remittances that households receive declined as overseas workers have experienced reductions in work hours and work days due to decreased productions.

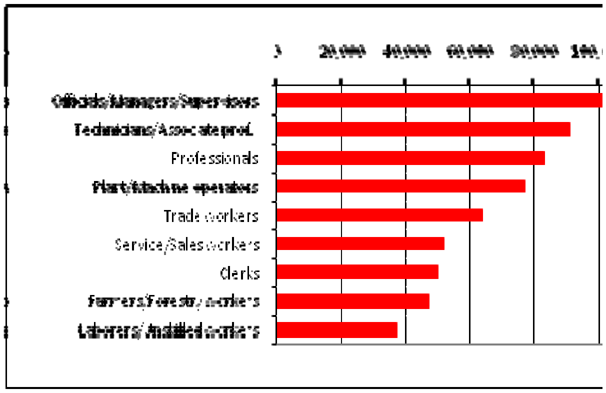
186. **So far, urban areas in Luzon suffered the most reduction in cash remittances.** The results of the rapid assessment survey show that more than half (54 percent) of households that reported that a decrease in cash remittances from OFWs and domestic migrant workers are located in the urban areas of Luzon, which covers the National Capital Region and its neighboring cities Laguna and Cavite as well as the rest of Luzon (Table 4.6). Households that reported decrease in remittances in Visayas and Mindanao, on the other hand, are mostly located in rural areas.

187. **Although poorer households have a much lower share of remittances to their income compared to the wealthier ones, they face risks in experiencing reductions in remittances.** As previously discussed, the larger proportion of total remittances from abroad are from low-skilled workers because of the higher number of OFWs that belong to this category. However, in terms of average remittances, low-skilled workers send a much lower amount compared to their high-skilled counter-parts (Figure 4.17). Laborers and unskilled workers, which account for 35 percent of all OFWs, send only about P37,000 per year. Low-skilled workers usually belong to the poorer households while high-skilled workers typically belong to wealthier households. In addition to the risk of termination or non-renewal of these contracts, FGDs from the rapid survey reveal that OFWs also were also subjected to reduced pay, reduced work hours and no overtime pay due because of company downsizing or lower production. Retained OFWs also feel increased job insecurity as retention policies of companies in some host countries give preference to their own nationals.

188. **While aggregate remittances have been resilient, a large share of households has experienced a decline in overseas remittances; this could push near poor households into poverty and poor households deeper into poverty.** While aggregate remittance inflows to the Philippines have been remarkably resilient, in US dollar terms, and strongly counter-cyclical in real peso terms, the Rapid Survey points to significant heterogeneity and inequity in the receipt of remittances during the crisis: some households were not or not significantly affected (these would receiving large amounts of remittances, hence driving the aggregate remittances numbers) while 30 percent of low-income households experienced a contraction in their (already small) remittances. The income per capita of poor households is already so low such that a

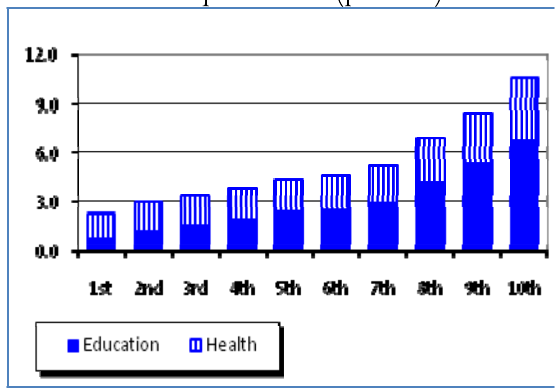
reduction in household income stretches their budgets even more. Even without a reduction in remittances, the per capita income of poor households on average is already 30.5 percent short of the poverty line (i.e., the income gap of the poor).

Figure 4.17. Average Remittances of OFWs, by Major Occupation (Pesos)



Source: SOF 2007

Figure 4.18. Share of Education and Health Spending to Total Household Expenditures (percent)



Source: FIES 2006

Table 4.6. Distribution of Households that Reported Decrease in Cash Remittances (percent)

	All Households	Households in Urban Areas	Households in Rural Areas
National Capital Region	20.9	33.8	0.0
Laguna	3.7	6.0	0.0
Cavite	2.3	2.9	1.2
Rest of Luzon	47.2	44.8	51.2
Visayas	18.7	12.5	28.8
Mindanao	7.2	0.0	18.8
Households that reported decrease in	100.0	100.0	100.0

Source: World Bank 2009 Rapid Survey

Table 4.7. Simulated Impact of Decline in Remittances on Poverty (percent) [1/]

	No reduction in remittances (base rates)	10% reduction in remittances from abroad	10% reduction in remittances from domestic sources	10% reduction in all remittances
Poverty Incidence (% of population)				
Urban	19.5	19.7	19.7	19.8
Rural	45.9	46.1	46.3	46.5
Philippines	32.9	33.1	33.2	33.4
Income Gap of the poor (% of poverty line)				
Urban	27.6	27.7	28.0	28.1
Rural	31.7	31.8	32.1	32.2
Philippines	30.5	30.6	30.9	31.0

Source: World Bank staff estimates using FIES 2006

[1/] In the FIES, remittances from abroad include cash received from family members who are contract workers or working abroad; pensions, retirement, workmen's compensation and other benefits; cash gifts, support, relief, etc. from abroad; or dividends from investment abroad. Remittances from domestic sources include cash, any gift, support, assistance or relief from other families, government institutions, or private institutions. Unfortunately, the figures for remittances from abroad and domestic sources in the FIES are not disaggregated into these components.

Differential Impacts

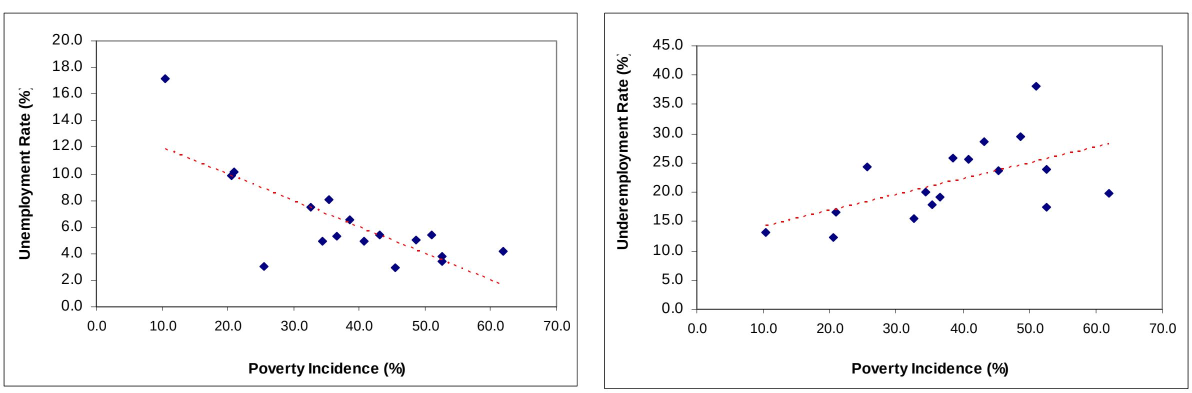
189. **Based on the above discussion, the global recession affected households in different ways**. In summary:

- **The initial impact of the crisis is felt by urban workers as sectors that are most immediately affected are concentrated in urban areas.** In urban areas, employment is concentrated in manufacturing and services so that more families depend on non-agricultural wages and salaries as their main source of income. Rural households were affected more through reduction in incomes as laid off family members in urban areas return to their rural roots and prices of their main agricultural produce decline because of lower demand.

- **Affected workers were highly concentrated in CALABARZON, Central Luzon, NCR, and to a lesser extent in Central Visayas.** These regions alone hold half of the Philippines' employment in manufacturing and services. Export processing zones in Central Luzon (Bataan), Central Visayas (Mactan) are also at high risk as export growth is expected to contract. Manufacture of electronic products, which remains the Philippines' top export commodity, also concentrate within these regions. Remittance inflows also accrue mainly to these households.

- **The non-poor were the first and hardest hit as they tend to work in the industry and service sectors most directly affected by the crisis.** The non-poor rely highly on wage income formal employment and diversify less their domestic sources of income compared to the poor. Non-poor families have more members working in the most affected sectors. In fact, even prior to current crisis unemployment is already higher among the non-poor (Figure 4.19). Evidence from the 1997 financial crisis points to a more severe impact of job loss among higher income groups (World Bank, 2001). So far, available data point to higher job losses among the non-poor in highly urbanized areas.

Figure 4.19. Poverty Incidence, Unemployment, and Underemployment, 2006



Sources: FIES 2006, NSO; Philippine Statistical Yearbook 2008, NSCB

- **As the poor cannot afford to stay jobless, the crisis impacts them more through lower paid wages, increased underemployment, and informality.** In contrast to unemployment, poverty appears to be more positively correlated to underemployment because the poor cannot afford to stay out of work (Figure 4.19). The poor will find means to find or create employment no matter how low the income from such activities. Compared to the non-poor, the poor also have more diversified sources of income. This makes them less exposed to formal sector unemployment. The LFS show that the contribution of agriculture to underemployment has increased and jobs generated were mostly in the informal sector, especially in April 2009 when the impact of the crisis was the greatest (Table 4.2). These are sectors where the poor are concentrated.

- **A large number of less well off households reported a decline in foreign remittances, notwithstanding the aggregate increase in remittances.** While wealthier households depend more on foreign remittances than poor households, making them (unconditionally) more at-risk to a fall in remittances from retrenched family members abroad, the data to date suggest that their source of remittance is more resilient—presumably higher skilled workers with more stable positions and more secure labor contracts. The rapid survey revealed significant inequality in the face of a global recession, with the less well off households reporting a contraction while the better off experienced continued increase in remittance inflows. The poor and near-poor would also be affected by the fall in domestic remittances from family workers in urban areas who either lost their jobs or subjected to reduced working hours.

190. **While the immediate impacts of the crisis were disproportionately borne the non-poor, the long-term impact will fall more severely to the poor.** To the extent that the poor have low endowments to begin with, they can only afford very little adjustment in their consumption baskets during times of crises. Even a small reduction in their income can have lasting effects to their overall welfare as this affects household decisions to invest less in the education and health of family members, as discussed in the following section.

HOW DO HOUSEHOLDS COPE?

191. **Faced with shrinking income, households take a variety of actions to cope.** The World Bank's rapid survey showed that more than half of sample households find ways to cope with the economic crisis. Among the households that undertake coping strategies, a majority choose to reduce household expenditures by (1) reducing the amount of food consumption and by (2) replacing consumption of food items with cheaper alternatives (Table 4.8). Other households cope by seeking additional jobs or finding other sources of income to meet their basic needs. Households in urban and rural areas undertake almost similar coping strategies, but reduction in expenses on transportation, gas, light, and water is more prevalent among urban dwellers. As an immediate step to augment falling household incomes, poorer households tend to sell or pawn productive assets while higher income households tend to use up savings. Other ways to cope include borrowing money from informal (friends and relatives) and formal institutions and reducing household expenditures on health and medical care as well as on children's education.

Table 4.8. Households' Coping Strategies (percent)

Strategies	All Households	Households in Urban Areas	Households in Rural Areas
Reduce amount of food consumption	28.0	28.1	28.0
Replace consumption of food items with cheaper alternative	23.2	23.8	22.7
Seek additional jobs or other sources of income	11.8	11.2	12.4
Reduce expenses on transportation, gas, light, and water	11.6	16.6	7.5
Borrow money from relative and friends	6.5	5.9	7.0
Reduce expenses on health and medical care	4.1	3.3	4.8
Borrow money from financial institutions	3.9	2.8	4.9
Sell or pawn assets	2.7	1.7	3.5
Withdraw children from school or postpone enrollment	2.6	1.3	3.6
Transfer children to another school with lower fees	2.2	0.9	3.4
Send non-working family member to work	1.9	2.2	1.6
Reduce or use up savings	1.4	2.2	0.7
All households that reported coping strategies	100.0	100.0	100.0

Source: World Bank 2009 Rapid Survey

192. **Displaced workers or those that experienced reduction in income undertake various measures to sustain individual and family needs.** The FGDs showed that displaced younger workers or those that experienced reduction in income look for irregular odd jobs to gain extra income, such as driving pedicabs (unmotorized three-wheel vehicle), repairing appliances, selling health and beauty products, selling prepaid phone cards, among others. Taking out loans, often from individual lenders who charge high interest rates, is the most frequently cited coping strategies undertaken by older workers. Some urban-based workers with families decided to send their families to the province to cut down expenditures while others relocated to other areas where jobs are available.

193. **Food is one of the top items that households spend less on in times of economic crisis.** The rapid survey showed that 94 percent of households reported that they spent less on household expenditures between February and April 2009 compared to previous period. Among these households, 64 percent spent less on utilities and communications while 23 percent cut down expenditures on food. A relatively smaller proportion of households spent less on health and medical care needs of the family while others cut down expenditures on recreation (Table 4.9). Cutting down expenditures on utilities and communications is more prevalent for urban households than for rural households, which could be attributed to the higher need for mobility and connectivity in urban areas. However, a higher proportion of households spends less on food items in rural areas than in urban areas.

Table 4.9. Items that Household Spent Less on in the Past 3 Months (percent)

Items	All Households	Households in Urban Areas	Households in Rural Areas
Utilities and communications	64.5	66.8	62.4
Food including rice	23.3	21.4	25.0
Health and medical needs	6.7	5.6	7.8
Recreation	5.3	5.9	4.7
Housing maintenance and repair	0.1	0.2	0.0
Livelihood	0.1	0.0	0.2
All households that reported spending less	100.0	100.0	100.0

Source: World Bank 2009 Rapid Survey

194. **While some of households' coping strategies may help them in the short-term, some may produce negative long-term consequences.** To mitigate negative income shocks, households tend to resort to coping strategies that may help them in the short-term but at the expense of long-term well-being, thereby not eliminating their vulnerability to shocks and deepening poverty (World Bank, 2001). The FIES shows that for the poor households food accounts for as high as 90 percent of the total household expenditures (NSO, 2006). Reduction of food intake and unhealthy changes in food consumption patterns could result in high prevalence of malnutrition and weight loss, illness from weak resistance, which in turn comes from poor nutrition. The most susceptible are children under 24 months, pregnant and lactating women, and those already suffering from malnourishment. For example, although the causal effect has not been thoroughly studied, the prevalence of underweight children increased as a result of the Asian financial crisis.[77]

195. **In times of crises, households tend to invest less in health and nutrition or resort to lower quality health services, which may be detrimental to their long-term well-being.** Results of the rapid survey show that 23 percent of households resort to reducing spending on health and medical needs to cope with the reduced earnings because of the crisis. The survey also found that this coping strategy appears more prevalent among lower income households than higher income households. In addition, households tend to prefer health facilities that offer lower quality health services if it means paying less. It is estimated that a reduction in household income due to a crisis increases dependence on home care and public/charity clinics rather than outpatient care from private clinics (Orbeta and Alba, 1999).

196. **When reducing expenditure, poor households tend to de-prioritize education, pull children out of school or settle for lower quality of education.** Poorer households are unable to prioritize education as much as wealthier households as evident in the share of education to their total household expenditures (Figure 4.18). As household income shrinks, it reduces the ability of poor households to either contribute to their children's education or reduce their motivation/ability to send their children to school and increase the likelihood of child labor from poor families. The financial crisis in 1997 is believed to have caused decline in enrollment, higher dropout, increased absenteeism, and decreases in student participation in special school activities as it meant additional expenses.[78] Meanwhile, results of the rapid survey indeed point to higher prevalence among poorer households who withdrew children from school or delayed enrolment of children to school as well as transferred children to schools with lower fees.

[77] From 34.5 percent in 1990, the prevalence of underweight children declined to 30.8 percent in 1996, but it went up to 32 percent in 1998 and decreased again to 20.7 percent in 2007. It can be argued that the increase in 1998 may have been due to the change of eating pattern in response to the crisis.

[78] Between the school year 1997-98 and 1998-99, enrollment in Grade 1 declined by 3.4 percent indicating that families postponed the entrance of their children to school. Enrollment at secondary level also declined by 7.9 percent, but a much larger decline was observed in the first year high school. Moreover, enrollment in private secondary schools declined much larger than in public schools indicating a shift of preference from private to public schools (Reyes, et al, 1999).

RESPONDING TO THE GLOBAL RECESSION

197. **The Government's Economic Resiliency Plan (ERP) aimed, among others, to prioritize spending for social protection.** As discussed is Chapter 1, the ERP has been the Government's main vehicle to counter the impacts of the global crisis. One of the Plan's main objectives is the expansion of social protection programs. Specifically, it realigned the budget to increase social welfare allocation (e.g., scale up the conditional cash transfer program, or 4Ps), provided the full national government contribution to National Health Insurance program (i.e., PhilHealth Indigent Program), realigned the budget to increase scholarship/training allocation, increased allocation for primary and secondary hospitals, provided matching grants to local government units, and allocated more funds for student loans. Of the P330 billion allocations to implement the ERP, at least P10 billion had been set aside for these specific interventions.

198. **Much of the increase in the budget for social protection was given to expand the coverage of direct cash transfers to provide income support to poor families.** Direct cash transfers have low administrative costs and do not distort prices (Box 4.1). Making them conditional, for example on school attendance, will also address long-term human development outcomes of the vulnerable segments of the population. In particular, in a crisis situation, they could mitigate the long-term negative consequences of households cutting back on these important human development expenditures. As the Philippines already has, since 2008, a carefully designed and effective CCT program, the *Pantawid Pamilyang Pilipino Program* (4Ps), the government was quick to scale it up. In late 2008, the government allocated an additional P5 billion through the ERP to expand the coverage of the CCT program, from 321,000 poor households in 2008 to 720,000 in 2009. Moving into 2010, the Government announced that it will provide another P5 billion for the 4Ps to increase coverage to 1 million poor households. Spending for the 4Ps not only provides income support to poor families affected by the crisis, it also serves as a very effective fiscal stimulus since the poor consume—i.e., re-inject in the economy—*all* of the cash transfer they receive.

199. **With a view to saving jobs, the Philippines took steps to make working hours more flexible.** In January 2009, the Government through the Department of Labor and Employment (DOLE) issued Department Advisory No. 2 (2009) on 30 January 2009 to provide options for flexible working arrangements that can be implemented temporarily to avoid further job loss. Options for flexible working arrangement include compressed workweek, reduction of workdays, rotation of workers, forced leave, broken-time schedules, and flexi-holidays. The choice of flexible working arrangement should be made voluntarily and with conditions mutually acceptable/agreed upon by employers and employees. The plan suggests the reduction of working time (and salary) without any compensation but the guarantee to stay employed and return to normal employment in the future. Although such arrangements can be helpful if the difficulties of the firms are short-lived, they may simply delay firings and are not very different from temporary layoffs. A rapid survey of the corporate and business sectors conducted for the World Bank in September 2009 reveals that, as the economy recovered from the trough experienced in the first quarter of 2009, firms in most sectors have been able to re-hire on a full time basis a large number of their work-force. The survey also reveals that employers were very positive

in assessing the impact that labor flexibility had in helping their company whether the sharp and sudden contraction in sales and production (World Bank, 2009i, Box 2).

200. **A number of policies aimed at creating new jobs and easing job search were also initiated or re-activated.** Public works programs are a good instrument to temporarily alleviate the financial loss associated with unemployment. In addition to providing income to the unemployed, they can improve infrastructures and other public goods in poorer communities, thereby improving long-term growth prospects. In October 2008, the government put in place the Comprehensive Livelihood and Emergency Employment Program (CLEEP) to assist local and overseas Filipino workers who had been affected by the crisis. The government reports that as of August 2009 about 151,000 jobs have been created through the CLEEP, which indicate that the program has helped in providing assistance and income support to workers. Moreover, the Philippines trainings were made available to workers both abroad and domestically. For domestically affected workers, the TESDA and DTI (under the CLEEP) provided skills and entrepreneurship trainings. The "Nurses Aligned in Rural Service" (NARS) of the DOLE and DOH fills the dual role of providing relevant training to nurses and improving health services in rural areas. For displaced overseas workers, skills upgrading and retooling were undertaken by the DOLE and Overseas Workers Welfare Administration (OWWA).

201. **The Government took an important step to improve institutional capacity and coordination to undertake social protection programs.** Currently, several government agencies undertake different programs to address various aspects of social protection. For example, important programs include food subsidies through the National Food Authority (NFA), a school feeding program through the Department of Education (DepEd), and a subsidization of poor households through Philippine Health Insurance, as well as an assortment of other subsidy programs that range from fertilizers to drugs to shops and public transport. Consolidating government programs into a single, national social welfare strategy is a key first step towards improving the ability of the government to respond to the impact of the present and future crises. In July 2008, this key step was taken by the government with the creation of an inter-agency "National Social Welfare and Protection Program" cluster. The cluster is currently undertaking an assessment of the existing social protection programs in the country with a view to scale up and reallocate resources to the most effective and efficient ones.

202. **Effort is also underway to adopt an objective and unified targeting system to enhance the Government's ability to support vulnerable households and increase cost-effectiveness of transfer programs.** Many of the past and existing programs use varying criteria for geographical and household targeting that are neither transparent nor standardized. Assessments of such programs show high under-coverage of the poor and high leakage to the non-poor. This has tended to weaken the general credibility of Government programs aimed at targeting the poor. The NFA rice subsidy program, which comprised about 70 percent of the Government's transfer programs in 2007, was found to have 40 percent leakage rate to the non-poor. Improving the distribution of this program using an objective system of targeting poor households can significantly reduce the national poverty incidence and the income gap of the poor (Box 4.1). An effort is currently underway at the Department of Social Welfare and Development (DSWD) to roll-out an objective household targeting system

that can be applied to existing programs such as the NFA rice subsidy as well as future programs to increase the benefits of intended beneficiaries and minimize program leakage. Such a system is aimed to build a national poverty database that is based on an objective, credible, and standard criteria of identifying poor households.

CONCLUSIONS AND POLICY RECOMMENDATIONS

203. **While the Government's policy response to the crisis is commendable, some areas could still benefit from enhanced prioritization.** While it may be tempting to target sectors most directly hit especially by the global financial crisis, historical evidence suggest that it will permeate quickly to other sectors and affect the wider economy. Actions from the government thus need to be designed to provide targeted assistance to Filipino households that are most vulnerable and would be further affected by an economic slowdown. For the government to be able to provide such targeted assistance cost-effectively, it first needs to (1) enhance its capacity to monitor, with limited time lag, socio-economic developments; (2) enhance social protection measures to support vulnerable households; (3) support employment and earnings; and (iv) support investment in human capital. The following set of recommendations would help improve some of the current shortcomings in these areas:

Quick socio-economic monitoring of the crisis

- R1. Monitor closely and quickly the socio-economic impacts of the crisis. This is important to understand the magnitude of impacts and the transmission channels through which households are affected, as well as how households are responding. A comprehensive monitoring of key indicators in "real time" is needed.

  (i) The emphasis given by the ERP to DOLE in monitoring employment is useful, and DOLE may wish to make public this information on a regular basis. Since DOLE does not monitor developments within export processing zones, this information should also be monitored and consolidated to give the complete and timely picture of labor market developments.

  (ii) Prompter analysis and release of (1) the NSO's quarterly *Labor Force Survey* and (2) the 2009 *Family Income and Expenditure Survey* (FIES) is desirable. The 2009 FIES should include rider questions that could focus on crisis impacts in a nationally representative fashion.

  (iii) While the nationally representative NSO surveys is an important form of monitoring, given the inevitable time lags in its release, these could be supplemented by faster (non-representative) monitoring of socio-economic effects. Either qualitative methods (such as focus group discussions) or small quantitative methods (such as small, quick surveys) could help.

Box 4.1. Philippines: NFA and the Social Safety Net One Year After the Food Crisis 1/

One year after the food and fuel crisis hit the Philippines, we review progress made in the social protection system. The 2008 food and fuel crisis pushed an estimated 3 million Filipinos into poverty and widened the poverty gap and poverty severity (World Bank Quarterly Update, November 2008). During the crisis, in order to protect the poor, the government deepened and broadened the National Food Authority's (NFA) rice subsidy program as this was the only available, though not ideal, social protection system with enough scale to reach a large number of poor (other, smaller, measures included cash transfers to electricity lifeline users, cash subsidies to the elderly who have no regular income or access to social security, fertilizers and seed subsidies, and school feeding programs).

As a subsidy program for the poor, NFA rice subsidy program suffers from serious deficiencies, not least: (1) limited assistance reaching the poor (the poor only get 16 percent of their rice consumption from the NFA; based on a subsidy per kilo of rice of 25.4 peso in 2008 (the difference between the shadow[1/] market price and the NFA subsidized selling price), this is equivalent to a cash transfer of P1,599 per year per household or to 36.6 kilos of rice bought at the (shadow) market price of P43.7/kg); (2) high leakage to the non poor (about half of NFA rice is consumed by the 66 percent of the population which is not poor); (3) a very expensive program due to limited operational efficiency of NFA. In 2008, the NFA delivered between P8.4 and P25.1 billion worth of consumer subsidy to the poor[2/] and a total rice subsidy of between P17.6 and P52.8 billion. Yet, the total cost for public finances, on an accrual basis, of the NFA for 2008 reached P72 billion (1 percent of GDP)—Table 3. Hence, assuming NFA did distribute all the rice it reportedly distributed—which is three times higher than what recipients are reporting receiving—the fiscal cost of the NFA would still exceed the cost of subsidizing rice by P21.8 billion. These P21.8 billion ($470 million) in annual cost can be taken as the administrative cost of the NFA to operate the subsidy program. Thus, for every peso-equivalent given to the poor through the rice subsidy program, the Philippine taxpayers spend between 3 to 8.6 pesos.

In the aftermath of the food crisis the government decided to better target the poor and to do so more efficiently; one key measure was to target NFA rice subsidies to the poor. To better target the poor, NFA started limiting, in early 2009, the sale of subsidized non-commercial rice grain to holders of Family Access Cards (FACs) issued by the Department of Social Welfare and Development (DSWD) in Metro Manila, or/and to those listed in Rice Allocation Ledgers (RALs) in the field offices of the NFA. The success of this improved targeting is yet to be seen as NFA is reporting an increase in rice sales of 54 percent in the first five months of 2009 against the same period of 2008. While the international purchase price of rice by the NFA has decreased noticeably, it remains much higher than in 2006 (prior to the food price shock). As a result, the 2009 budget points to a limited decrease in the fiscal cost of NFA in both 2009 (P63.1 billion) and 2010 (P51 billion) compared to 2008 (P74.6 billion)—Table 4.10.

A second set of measures to improve the targeting, coverage, and cost efficiency of social protection was the development of a National Household Targeting System for Poverty Reduction and a conditional cash transfer (NHTS-PR and CCT, respectively). The government, through the DSWD, developed an efficient and functional NHTS-PR and used this system to launch a large scale CCT program (called *Pantawid Pamilyang Pilipino Program*, or 4Ps), first aimed at reaching 376,000 households by end 2008, and now planned to reach 1 million households as a response to the global recession's impact on the poor. CCT beneficiaries can receive a maximum annual cash payment of P15,000 ($320)[3/] per year. 2008 data reveal that the average household received an annual transfer of P10,630. In light of the total administrative budget allocated to DSWD to set up and administer the program for the first 376,000 households, every peso given to the poor through the CCT cost taxpayers 0.5 pesos.[4/] This cost is expected to decrease sharply over time as (1) the 2008 administrative cost include a large one-off program start up cost and (2) the administrative running costs include an important fixed cost element which is being spread up as the CCT is being scaled up from 376,000 to 1 million households. The 4Ps is expected to increase the recipients' total incomes, on average, by 23 percent, to reduce poverty incidence in targeted areas by 6.1 percentage points, the income gap by 7.6 percentage points and poverty severity by about 5 percentage points.

1/ World Bank (2009i).

Box 4.1 (continued). Philippines: NFA and the Social Safety Net One Year After the Food Crisis

Reallocating NFA's fiscal support to the CCT would enable the government to cover 100 percent of the country's poor (25 percent with NFA[5/]), with each poor household receiving 7 times the NFA subsidy. While during the 2008 food and fuel crisis, options available to protect the poor on a large scale basis were mostly limited to the NFA rice subsidy program, this is no longer the case in 2009 thanks to the successful launch of the CCT. Given the high cost of reaching the poor through the NFA rice subsidy program both compared to the CCT and in absolute terms, refocusing the NFA outside of its rice subsidy operations and reallocating the NFA fiscal support to the CCT would generate major social protection gains for the Philippines and a drastic improvement of the welfare of the poor. Reallocating the P63.1 billion in public support NFA is receiving in 2009 to the CCT, and assuming that, due to the CCT scale up, the cost of sending P1 to the poor falls by half the 2008 level of 0.5 peso (a realistic estimate as discussed above), this could cover about 4.7 million poor households (100 percent of the poor in the Philippines), with each receiving on average P10,630 per year (the current yearly average for the first set of 376,000 CCT households). Given that the CCT is already budgeted to cover 1 million poor households, should the government decide to limit the CCT coverage to the poor, then savings of P11.5 billion would arise. It should be noted that the NHTS-PR can also be used to improve the efficiency, targeting, and coverage of the poor from other social protection programs, such as the Food-for-School Program (applying NHTS-PR would, for instance, reduce FSP's leakage to the non-poor from 62 to 24 percent).

Table 4.10. NFA: Financial Accounts, Fiscal Cost, and Benefits to the Poor, 2006--2010

	2006 Act.	2007 Act.	2008 Act.	2009 Budget	2010 Budget
			(in billion peso)		
Total Assets	35.8	26.4	58.2	54.5	60.8
Total Liabilities	82.6	68.6	133.3	162.6	194.2
Net Worth	(46.9)	(42.2)	(75.1)	(108.1)	(133.4)
Budgetary Support	0.9	16.1	41.7	30.1	25.7
Total NG Support	0.9	16.1	39.2	30.1	25.7
National Government subsidies	0.9	16.1	2.0	4.0	8.0
Net Lending	-	-	2.5	-	-
Others 1/	-	-	37.2	26.1	17.7
Memorandum items					
Total public support to NFA 2/	19.3	11.4	74.6	63.1	51.0
Breakdown based on rice reported to be consumed					
Subsidy for rice consumed by the poor	3.0	3.2	8.4	7.5	5.0
Subsidy for rice consumed by the non-poor	3.3	3.5	9.2	8.3	5.5
NFA operational costs	13.0	4.8	57.0	47.3	40.5
Breakdown based on rice reported sold by NFA					
Subsidy for rice consumed by the poor	9.0	9.5	25.1	22.5	14.9
Subsidy for rice consumed by the non-poor	10.0	10.5	27.7	24.9	16.5
NFA operational costs	0.3	(8.5)	21.8	15.8	19.5
Public cost of sending P1 to the poor through NFA:			(in peso)		
Upper bound 3/	6.3	3.5	8.6	7.9	9.5
Lower bound 4/	2.2	1.2	3.0	2.7	3.3
Public cost of sending P1 to the poor through CCT: 5/	…	…	0.5	n/a	n/a
Consumer subsidy per kilo of NFA rice 6/	11.5	11.4	25.4	22.8	15.2

Source: DBM, Budget of Expenditures and Sources of Financing (fiscal years 2009 and 2010).
1/ Other NG support refers to Non-cash support (mainly tax expenditures related to import tariff on rice.
2/ Total public support is the sum of budgetary support and the change in the net worth of the NFA. Indeed, the large annual deterioration of the NFA's net worth will eventually give rise to a large recapitalization from the national government.
3/ Based on the consumption of NFA rice reported by the poor in the 2006 FIES survey.
4/ Based on scaling up the share of NFA rice reportedly received by the poor in the 2006 FIES to the sales volume that NFA is reporting.
5/ Based on data covering the first set of the CCT program (covering 376,000 poor). The total budget for that program was P5 billion, of which P3.2 billion was spent in cash transfer, and P1.8 billion in administrative costs. It should be noted that the administrative cost is expected to sharply decrease as 2008 included start up costs of the CCT program. A 15 percent leakage to the non-poor is assumed, in line with international experience with CCTs.
6/ Calculated as the difference between the import price of rice (including customs tariff) and the NFA selling price for subsidized rice.

1/ The price of an imported kilo of rice after clearing customs. It exceeds the domestic "market" retail price as the domestic price market is regulated (the average retail price of regular milled rice in 2008 was P29.4 per kilo).
2/ The large range of estimated benefit accruing to the poor are obtained as follows: the lower value is based on the consumption of NFA rice reported by the poor in the 2006 FIES survey (only 34 percent of the total quantity of rice NFA reported selling); the higher value is obtained by scaling up the share of NFA rice reportedly received by the poor in the 2006 FIES to the sales volume that NFA is reporting. The first number is clearly a lower bound as it includes some under-reporting from households (a common problem is household surveys), while the second number is an upper bound as it assumes there is rice loss in NFA operations. Yet, pilferage, damage in storage, loss in transit, and possible diversion of NFA stocks into the private commercial market are possible leakages.
3/ The 4Ps provides a monthly education grant of P300 per child for 10 months up to a maximum of 3 children conditional on school attendance and a monthly health and nutrition grant of P500 to those with children 0 to 14 years old or pregnant women conditional on their compliance to agreed health conditions.
4/ Assuming a leakage of 15 percent to the non-poor which is in line with international experiences—however the true leakage rate is expected to be lower since the 376,000 households were selected exclusively from the poorest barangays of the 20 poorest provinces of the country.
5/ Jra, S. and A. Mehta, 2008, "Effectiveness of Public Spending: The Case of Rice and Subsidies in the Philippines," ADB Working Paper No. 138.

Emphasis here should be on regular surveys (say every quarter or semi-annually) with very fast turn-around on data analysis and reporting for policy making purposes. The type of group or sample to be selected, as well as the questions to be asked, could be tailored based on the expected transmissions channels discussed above, including a special focus on the vulnerable groups and regions identified ex-ante.

Enhance social protection policies to support household income

- R2. Develop an operational social protection strategy and work-plan for the National Social Welfare Program cluster. The expected results entail a more rational allocation of responsibilities and resources among agencies implementing social protection programs, such that efforts are not duplicated and resources are allocated to programs that best address the actual risks and vulnerabilities of the Filipino population.

- R3. Enhance the capacity of agencies to efficiently implement the unified targeting system. The government has decided to roll out the targeting system used by the 4Ps nationwide and is planning to assess about 9.4 million households by the first half of 2010. As of February 2010, the government, through the DSWD, has already completed assessment of about 8.4 million households. To complete the survey by end of 2009 while ensuring that the assessment of the remaining 5.7 million households is undertaken at the same level of quality, administrative and technical skills within DSWD needs to be developed to undertake surveys more efficiently and resources (budget and additional manpower) to flow speedily.

- R4. Carefully expand the CCT in urban areas to increase coverage of groups affected by the global crisis. The current coverage of the CCT is predominantly in rural areas. However, as the impact of the global recession is significantly impacting urban areas and the urban poor and near poor, expanding the CCT program towards urban areas would be desirable. Existing programs that have a particular urban focus may also need to be temporarily prioritized. It should be noted that poverty targeting is more challenging in urban than in poor areas; international experience reveals, for instance, higher leakage rate of CCT in urban compared to rural areas. The government should also consider expanding the coverage to specific vulnerable groups beyond those poor households with children (i.e., poor households not currently covered by the CCT program).

Support employment and earnings

- R5. To be cost-effective public work programs (PWP) should follow best practices.[79] First, to ensure self-targeting of the poor, the program wage should be set below the relevant local market wage. Because the Philippines has a minimum wage, setting a wage below this level may be difficult, but it is not impossible, especially as there is already a provision for exempting firms that

[79] See Grosh et al. (2008) for a detailed explanation of how to adapt public works programs to specific countries.

face difficulties.[80] Second, programs should be limited in time and contain provisions for exit strategies for participants. Third, infrastructure projects should be chosen for their benefits to communities but also be located in areas most affected by the crisis. In particular, given that the crisis affects urban areas more severely, it would be important to look into ways of reaching poor urban areas.

- R6. Consider scaling up existing programs as public work generating programs. Some programs already exist and could be built upon to improve effectiveness of employment programs. For example, a community driven program of infrastructure work (KALAHI-CIDSS) currently operates similarly to a PWP. The program currently covers poor rural municipalities. Given the likely urban impacts of the current crisis, as discussed in this note, the Government should consider expanding such a program to poorer urban localities.

- R7. Improving the training content of PWPs would help increase employment prospects. The Philippines has demonstrated a strong commitment to improving their workers skills for working both domestically and abroad through trainings. However, the success of such programs depends on the ability of the government to ensure the quality of the training content. In financing further training programs (for example through increasing funding to TESDA), it is useful to note that recent evidence suggests that demand-driven training that combines classroom and on-the-job training has the best performance. Training programs, especially those that emphasize on-the-job training, can also help increase the employability of groups that are most vulnerable to the global crisis such as the youth.[81]

- R8. Strengthen the regional network of DOLE and other public employment offices that can help deliver services and information to job seekers. Plans to strengthen the regional offices teams are in place to help workers in the export sector but other sectors are receiving less assistance. As in many developing countries, public employment services (PESO) have suffered from lack of funding and limited administrative capacity. However, they have fairly good placement rates for registered applicants, although, as in many countries, they tend to serve lower-skilled workers. Such services are an excellent base to coordinate and publicize active labor market policies (for example training programs) as well as income support programs (for example livelihoods programs)—(Gaelle Pierre, 1999). Making them more attractive to employers (through the provision of specific recruiting services) can increase their performance.

[80] For example, in Argentina, the salary paid as part of the Trabajar program was considered a social transfer. This was well-understood and it was therefore not difficult for the government to set it at the appropriate level.

[81] Evaluations of such programs in Latin America suggest that they improve participants' chances of getting a job and the quality of the job found (Puerto, 2007).

Support investments to human capital

- R9. Increase priority in delivering social services that support household investments in human capital to reduce the vulnerability of households to future income shocks. National government spending on social services (education, health, social welfare, housing, other services and transfers to local governments) is only at 4.9 percent of GDP, far less than countries with a similar income per capita level. This has been compounded by fiscal compression, which contributed to a fall in real per capita spending on social services by as much as 28 percent between 1997 and 2006. The budget of the DSWD, which has the primary role in delivering social welfare services, accounted for only 0.32 percent of the national budget (equivalently, 0.05 percent of GDP) in 2007. Increased priority and spending on providing health care and subsidizing health care insurance, as well as abolition of auxiliary school fees to keep children in school, can potentially mitigate the long-run impacts of sudden income declines at times of crisis.

- R10. Given the low levels of spending on education, health, and social protection, particular emphasis should be aimed to increase expenditure in these sectors. In addition to capital expenditures, it is critical to maintain operating expenditures in these sectors. As discussed above, the public sector needs to stand ready to address any switch from private to public sector service delivery. Meanwhile, the lack of adequate human resources, health supplies, and critical education inputs (such as quality teaching and learning materials) could lead to deterioration in health conditions and longer-term educational outcomes. Interventions that expand health human resources, such as the *NARS* and the *Midwives to the Barrios* programs, and subsidized drugs and medicines such as the *Botika ng Barangay* and *p100* programs should be sustained.

- R11. It is also critical to ensure that funding is available for health and educational service delivery on a timely basis. It is important to see health and education programs as a key component of the macro-economic fiscal stimulus package.

III. PREPARING THE ECONOMY FOR THE RECOVERY

5. PREPARING FOR THE RECOVERY: SELECTED ISSUES

204. *The Philippine economy is suffering from a long term decline in its investment ratio. The low level of investment reached and the rapidly diminishing stock of capital undermine the country's medium-term growth prospects. Investors report that a weak investment climate, and in particular weak governance and business enabling environments account for a large part of this structural problem, as is the poor quality of infrastructure. The recent push for upgrading infrastructure as part of the fiscal stimulus package is welcome. Effective and efficient implementation of the additional resources as well as sustaining the efforts over time (including with private sector participation) will be critical to overcoming the existing infrastructure bottlenecks and boost the growth potential of the Philippine economy. Also key to the quality of the recovery from the global recession, its inclusiveness and job content, is improving access to credit for micro, small, and medium enterprises—which is both structurally and cyclically challenging.*

STRENGTHENING THE INVESTMENT CLIMATE

205. *The Philippines' structural deficiency in attracting significant investment undermines its medium-term growth prospects. A weak investment climate, and in particular weak governance and business enabling environments account for a large part of this structural problem.*

206. **Through 2007, the Philippines achieved high rates of economic growth despite falling investment**. As growth accelerated, investment as a share of GDP fell to about half of its share in 1980. Bocchi (2008) attributes this "puzzle"—high growth with shrinking investment in an economy opens to trade and capital—to three reasons. First, the public sector has limited fiscal space. Second, the capital-intensive private sector, which is mostly shielded from competition, does not find it convenient to raise investment at the economy's pace. Third, fast-growing businesses in the services sector do not need to rapidly increase investment to enjoy rising profits. The economy, therefore, finds itself at a sub-optimal equilibrium with a low level of capital stock. As a result, while the Philippine economy grew rapidly over the past few years by its own historical standards, its growth performance has been weaker than that of its peers in the region, sometimes significantly worse (World Bank's Global Development Finance, June 2009).

207. **A weak investment climate is one of the major constraints to accelerating investment, growth, and employment.** In particular, investors cite weak governance and the lack of infrastructure as leading factors for the low level of investments. Firms, in particular small and medium-size enterprises (SMEs), also identify complex and tedious business regulations and difficulty in getting credit as major hindrances to doing business and expanding operations. SMEs concerns are particularly resonant during a global recession for two reasons. First, SMEs are the largest source of

employment in the country. Second, SMEs are historically the one most at risk in economic downturns as access to finance dries up disproportionately for them. Addressing these investment climate concerns, especially SMEs' concerns, would therefore go a long way towards tackling the potentially severe labor market challenges stemming from the global recession (as detailed in Chapter 4).

208. **Thanks to recent measures introduced by the BSP, progress is being made to improve access to finance of SMEs.** These include: (1) Credit Surety Fund program was conceptualized by the BSP in August 2008 to increase the flow of credit in the countryside and to micro, small and medium enterprises (MSMEs);[82] (2) in February 2009, the BSP started conducting financial learning seminars for banks catering to microfinance clients;[83] and (3) in October 2009, the Monetary Board made financial services more accessible and less costly to microfinance clients by allowing Loan Collection and Disbursement Points of microfinance-oriented banks and microfinance / Barangay Microbusiness Enterprise (BMBE)-oriented branches of banks, not only to accept deposits from, but also to service withdrawals of existing microfinance/BMBE borrowers.

209. **To improve growth prospects, further improving the investment climate is crucial**. Key reforms could include accelerating ongoing governance reforms and easing various aspects of doing business, in particular access of SMEs to credit. Public investment in infrastructure, guided by increased transparency and accountability, could be ramped up and given its large multiplier effect on growth and employment, public investments could be used as a catalyst for more private sector investment (though, in the Philippines, the private sector already accounts for a large share of total investment). Strengthening the investment climate would help buoy growth and increase employment in the short-term, enabling the country to better weather the impact of the global recession and providing the foundation needed to sustain higher levels of growth over the medium-term and accelerate poverty reduction.

Falling investment has limited the Philippines' growth potential

210. **The lack of sustained investment has been a major constraint to growth in the last three decades.** From close to 30 percent of GDP in 1981, the share of investment to GDP has been on a general downtrend in the last three decades and reached 14.6 percent of GDP in 2005, with a small uptick in 2007 and 2008 to 15.3 percent of GDP (Figure 5.1a). The decline in total capital formation has been driven by the sharp fall in private investment, both construction and purchase of durable equipment (about 50 percent in real term). The decline in public investment in

[82] The CSF will serve as credit enhancement mechanism for MSMEs who are members of cooperatives to be able to access formal credit sources. The CSF is a fund created from contributions by well-capitalized and well-managed cooperatives with counterpart contribution from the provincial government and donors. The fund will provide surety cover, in place of acceptable collateral, to guarantee loans of MSMEs from banks.

[83] This series of seminars is part of BSP's comprehensive financial learning agenda aimed to educate and empower more Filipinos to benefit from the opportunities presented by economic development. The other financial learning programs cover young students through the integration of savings and money management in the elementary curriculum in cooperation with the Department of Education; OFWs and their families on growing their money through investments or entrepreneurship; and the general public through an economic and financial learning center that the BSP has recently established.

infrastructure though slightly less severe (at 40 percent) has been a major impediment to private sector investment due to its large complementary nature to private investment (Figure 5.1b)—as later developed.

Box 5.1. The Rise of the Business Process Outsourcing (BPO) Industry

The BPO industry is a prime example of a dynamic industry which has benefited tremendously from the liberalization of the telecommunications industry. Prior to this deregulation in the mid 1990s, the industry was virtually a monopoly with one major player controlling 90 percent of the market and owning the country's only transmission line. Telephone lines were hard to obtain (waiting time reached 10 years) and service quality was low. At the same time, macroeconomic instability and unreliable power supply were hindrances in attracting foreign direct investments. This changed in 1993 when the government liberalized key industries such as water, oil and telecommunications and embarked on a plan to restore continuous power supply and improve the fiscal position of the country. As a result, investments flowed in at a higher rate and led to the birth of new non-traditional and non-captured industries such as the BPO which benefited from the much lower telephone call and internet rates.

In the last decade, the BPO industry has grown at impressive rates averaging 30 percent annually and now directly contributes 5.3 percent of gross value-added and employs nearly 371,965 people. The industry has also generated significant positive externalities for the country, such as an important contribution to the rapid growth of the property sector in recent years and, to some extent, retail trade and private services. To date the BPO industry is dominated by the contact centers, which account for 70 percent of total BPO revenues and 60 percent of total employment. However, in recent years, BPO growth has shifted from contact centers to more knowledge-based businesses such as back office systems development and accounting. Growth in these non-voice BPOs ranged from 40 to over 100 percent.

The growth potential of the industry is outstanding, especially in light of prospects of other sectors in the global recession (and even the recovery period). The sector is still poised to achieve high double digit growth, especially in the back-office segment as multinational firms still opt to outsource to the Philippines and other destinations to save costs. However, recent supply bottlenecks—mainly the availability of qualified BPO workers—are slowing down growth in the industry, albeit still high relative to other sectors of the economy. Nevertheless, provided the overall investment climate improves, input costs such as communications and labor costs remain competitive, and most importnantly, an abundant supply of qualified workers is available, the industry is expected to grow and contribute significantly to the economy over the medium-term.

The success of the BPO industry highlights the large dividends that can be earned from improving the investment climate. Going forward, non-traditional and non-captured industries with very large growth contribution such as tourism and outsourcing of manufacturing (especially electronics) could become key growth and employment drivers if supported by the requisite infrastructure and governance reforms.

Figure 5.1. Capital Intensity of the Philippines Economy

(a) The great decoupling…or the economy adapting to a weak investment climate

(b) Declining investment drives down overall capital intensity

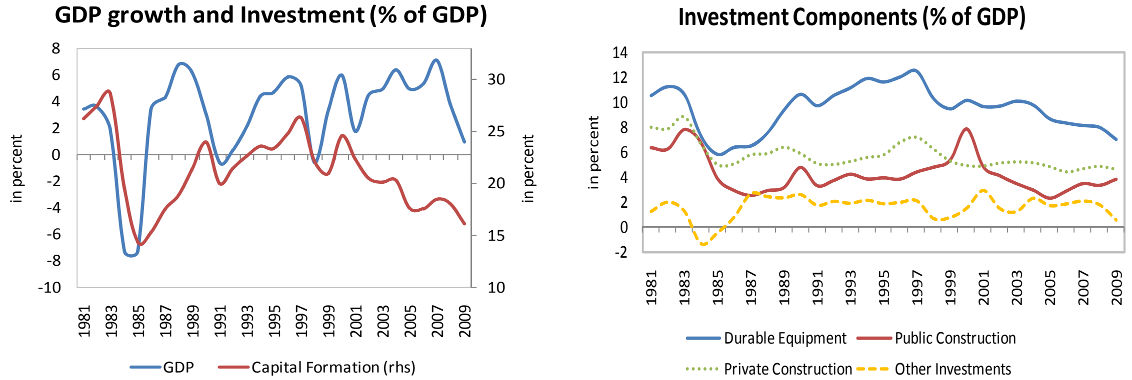
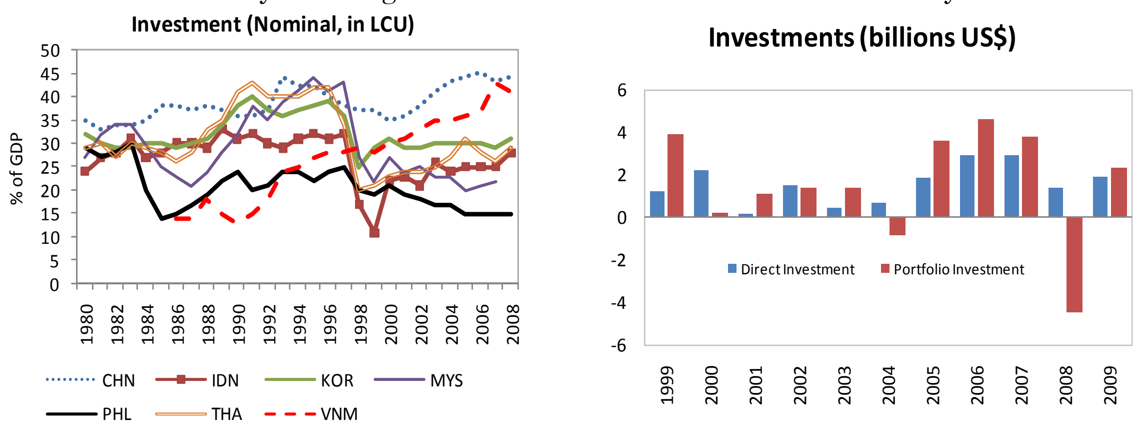


Figure 5.2. Regional capital intensity and capital inflows

(a) The Philippines has the lowest capital intensity in the region

(b) Investment remains patchy and moderate, even in boom years



211. **Weak contestability of markets and a weak investment climate can also explain the shift away from capital intensive sectors.** While historically, major shocks were at the root of steep declines (and subsequent sharp rebounds) in investment,[84] no such shocks can account for the significant decrease in the investment-to-GDP ratio since the Asian financial crisis—where economic growth has taken place amid a sustained decrease in the capital intensity of the economy. This is in stark contrast to previous periods and to the experience of other countries in the region (Figure 5.2a). The decline in public investment is largely explained by expenditure contraction since the onset of the fiscal consolidation in 2003. The weak investment climate and the negative impact that a fall in public infrastructure spending have on capital-intensive industries, progressively led to a sectoral shift in the economy—away

[84] These are (1) the 1983-85 economic crisis in which the economy contracted by 7.3 percent in 1984 and 1985; and (2) the 1997-98 Asian financial crisis in which the economy fell by 0.6 percent.

from capital-intensive manufacturing to capital-light services (a prominent example is the rise of the BPO sector as detailed in Box 5.1[85]). Lack of contestability of capital intensive and non-tradable sectors as well as large rent-capturing regulation and inadequate infrastructure could explain such a shift (Bocchi, 2008).

Limited attraction of the Philippines to foreign direct investment

212. **Foreign direct investment—a major source of growth in the region—has been patchy and moderate in the Philippines.** In 2007, prior to the financial crisis and global recession, foreign direct investment (FDI) inflows to the Philippines reached $2.9 billion, a 25 percent increase over 2006 (UNCTAD, 2008); though significant, these growth rates and levels lag behind the Philippines' ASEAN neighbors' (e.g., Indonesia's 41 percent, Malaysia's 39 percent, Cambodia and Lao PDR's over 70 percent, and Vietnam's close to 200 percent). Moreover, although intra-ASEAN investments rose by 19.8 percent to $9.5 billion, inflows to the Philippines was minimal. Despite a surge in global FDI (to $500 billion) and a strong bias towards investing in Asia (64 percent of total FDI), the Philippines were only a small recipient of these flows (Table 5.1).[86]

Table 5.1. Foreign Direct Investment Flows to ASEAN Countries, 2003-08

[redacted]

Source: ASEAN FDI Statistics Data base (ASEAN Statistical Yearbook 2008)
UNCTAD FDIStats (World Investment Report 2010)

213. **Limited attractiveness points to weak prospects for FDI inflows.** Recent surveys reveal that commercial expansion plans in the Philippines are the lowest in the region (Figure 5.3). The overall attractiveness of the Philippines also fell short within East Asia (Figure 5.4a) and although Philippine attractiveness has been improving in

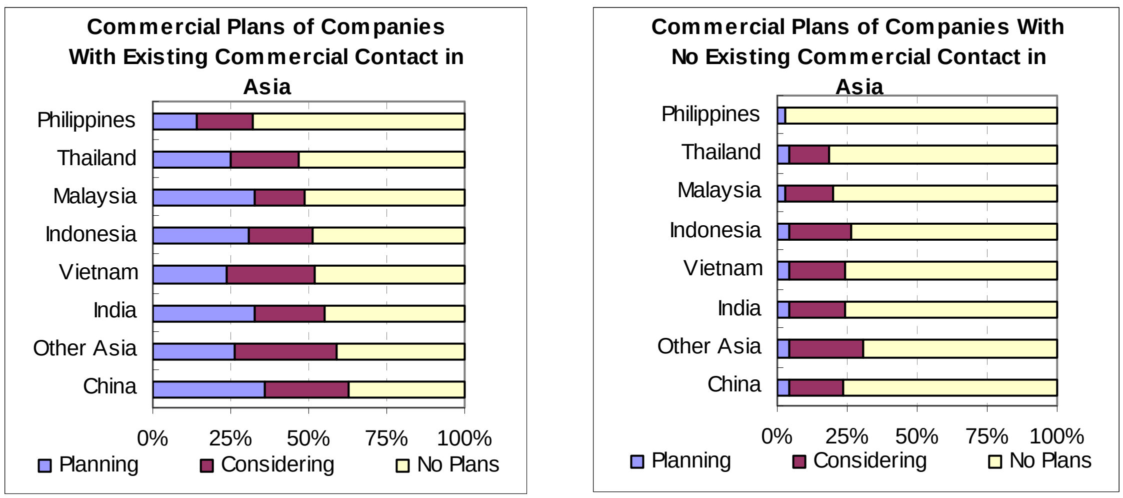
[85] Another key factor for the development of the BPO was the telecom sector liberalization.

[86] Less than 5 percent of total inflows in 2007 and only 3.6 percent on average in the last five years.

the last 3 years, albeit marginally, it lags when compared to the rest of the region (Figure 5.4b).

Figure 5.3. Regional commercial expansion plans

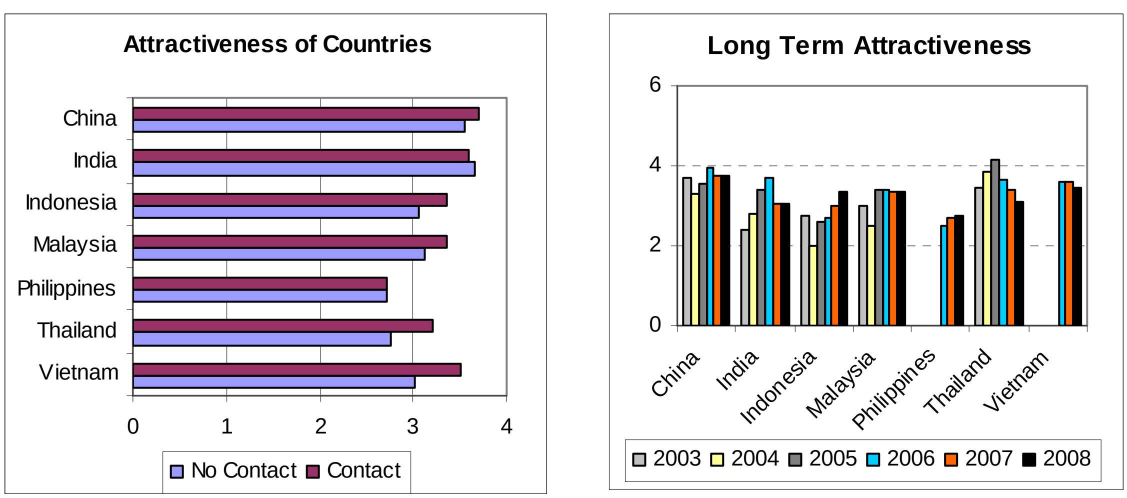
(a) The Philippines clearly trail the region both with established companies.... (b) ...and companies with no Asia base as far as expansion plans is concerned



Source Asean Focus Group, 2009

Figure 5.4. Regional attractiveness of countries

(a) Attractiveness of the Philippines is the lowest in the region... (b)...with limited improvement over time



Source Asean Focus Group, 2009

Key constraints to attracting investment into the Philippines

Weak governance environment

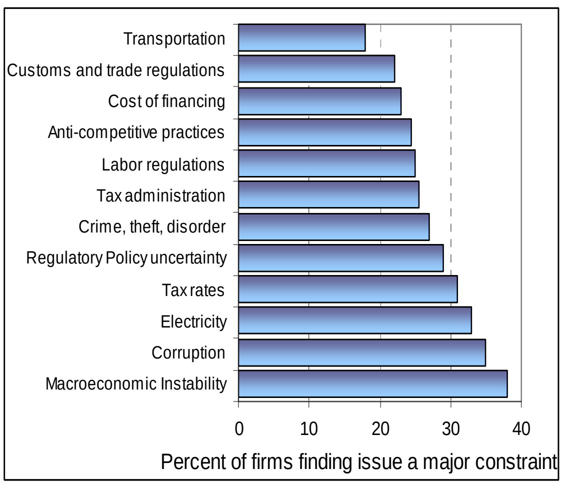
214. **Surveys report that corruption is one of the most pressing constraints to investment and doing business in the Philippines.** In a landmark ADB-WB

investment climate survey in 2004, firms identified corruption as the second most pressing constraint to a sound investment climate, next to macroeconomic instability (Figure 5.5a). In 2007, a similar survey by the Makati Business Club and the World Economic Forum identified corruption as the most pressing constraint to doing business (Figure 5.5b).[87]

215. **The Philippines is one of few countries in the region where governance indicators have become substantially worse since 1998.** Despite efforts by the government to tackle governance issues,[88] the most recent World Bank worldwide governance indicators reveal deteriorating scores for the Philippines in a number of governance dimension most notably in the control of corruption and political stability (Figure 5.6).[89] The substantial worsening control of corruption in the Philippines over time contrasts with most countries in the region so that the country now ranks as the weakest in controlling corruption against one of the top three performers in 1996. By contrast, "Voice and Accountability" indicators remain comparatively strong in the Philippines.

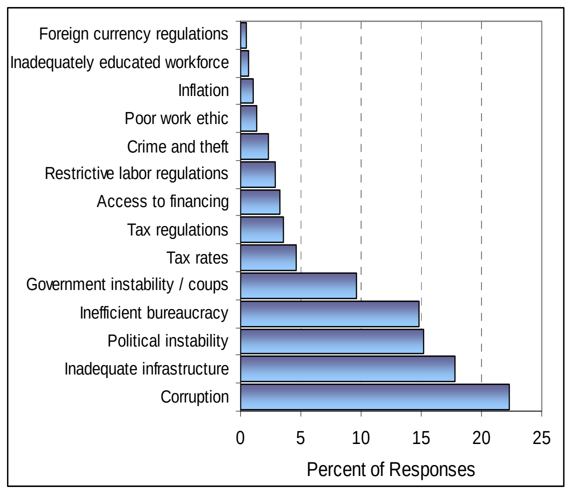
Figure 5.5. Philippines: constraints to doing business

(a) Firm Perceptions of Severe Constraints, 2004



Source: WB-ADB Investment Climate Survey 2004.

(b) Most Problematic Factors, 2007



Source: World Economic Forum & Makati Business Club

Weak business enabling environment

216. **Businesses find regulations and procedures increasingly complicated and taxing, especially against other countries in the region.** In the 2010 *Doing Business*

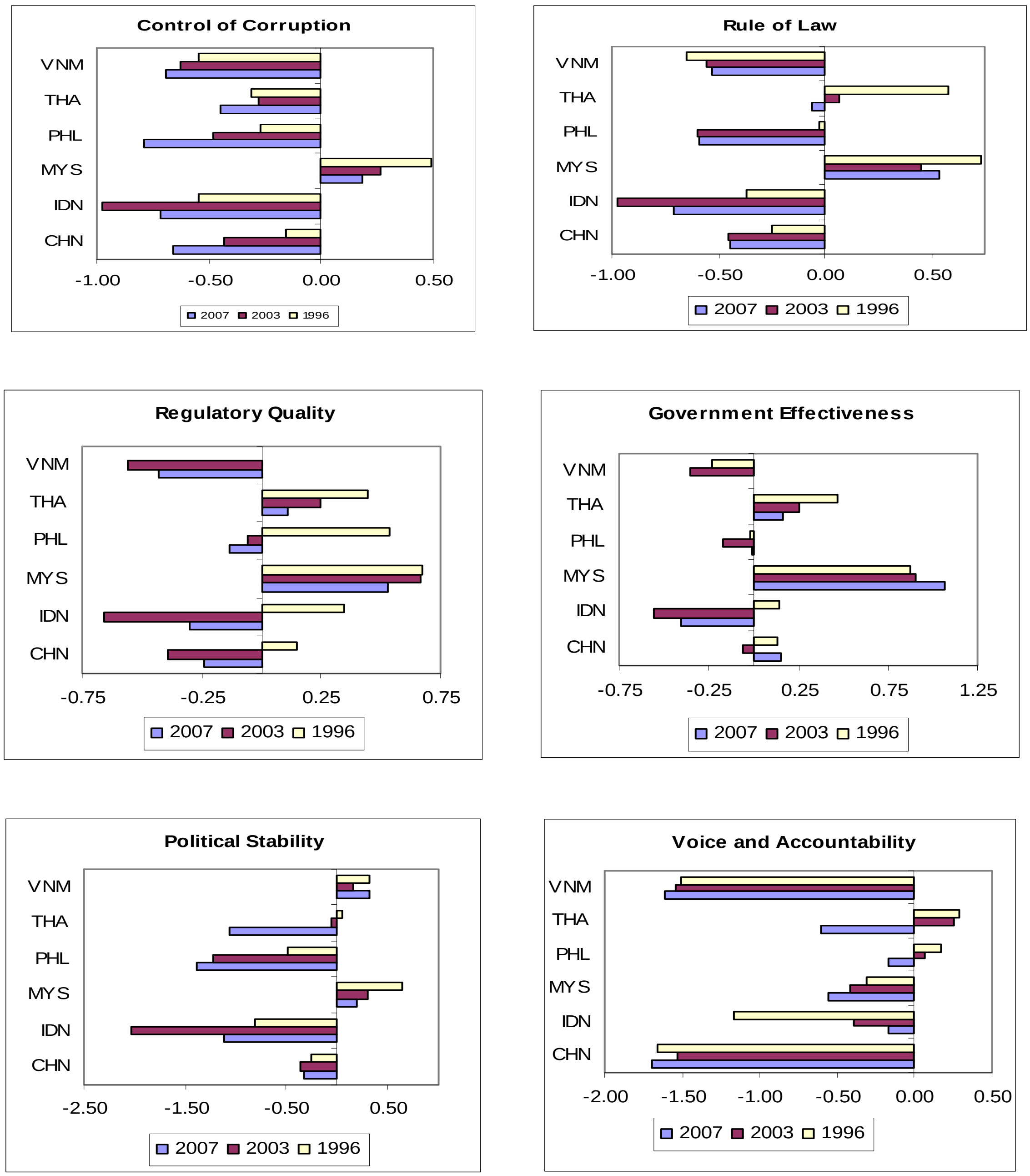
[87] Although the two sets of survey results are not strictly comparable as they involve different sample and methodology, one can glean positive relationships between the two surveys.

[88] These include increased lifestyle checks on public officials, enhanced controls in procurement and expenditure management, and higher conviction rate in the Sandiganbayan (i.e., the court for public officials charged with corruption) involving high ranking officials.

[89] These findings validate the 2007 Doing Business survey which ranks corruption and political instability among the top constraints.

survey, the Philippines continued to rank near the bottom of the region in terms of ease of doing business, just above Lao PDR and Timor-Leste. Relative to its peers, in parti-

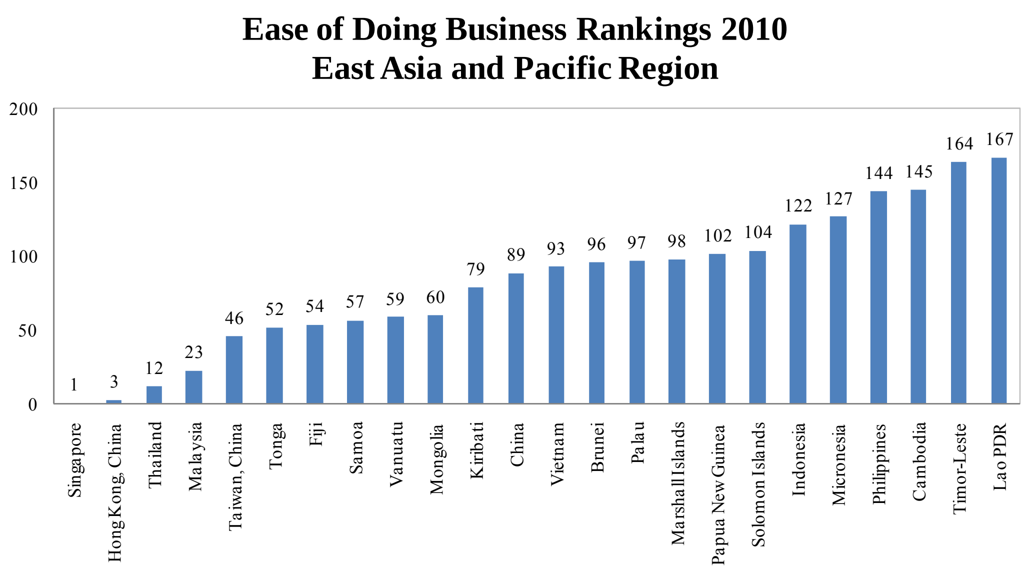
Figure 5.6. Worldwide Governance Indicators



Source: World Bank Institute
Note: A negative (positive) score indicates worsening (improving) level of governance.

-cular Thailand, Indonesia, and Vietnam, the country scores poorly in terms of starting a business, paying taxes, and employing workers, and remains uncompetitive in most other dimensions of doing business (Figure 5.7). Moreover, surveys show that the country's performance worsened over time (Table 5.2). In particular, the ranking for registering a property and getting credit fell by 1 and 2 points respectively. Starting a business in the Philippines remains complex and expensive.[90] Although the fall in ranking can be attributed to faster speed of reform in other countries relative to the Philippines or to lags in the implementation of identified reforms, the falling ranking—now below the 25th percentile globally and below the 10th percentile in the region—points to serious concerns about enhancing productivity and competitiveness, attracting investments, and creating jobs especially during the economic slowdown and slow global recovery prospects.

Figure 5.7. Ease of Doing Business Around the East Asia and Pacific Region, 2010



Source: The World Bank

217. **Of particular concern is the indicator for *Getting Credit* which has fallen by more than 20 points in the last two years.** The indicator, which measures the legal rights of borrowers and lenders and the scope and quality of credit information systems, is of particular importance to the economy given the low levels of private credit as a share of GDP (at less than 30 percent in 2008 compared to 60 percent ten years ago), the limited access to finance by micro-, small- and medium-size enterprises (MSMEs), and the large impact that access to credit (or lack of) has on firms resiliency, let alone expansion plans. MSMEs success has also a significant bearing on the strength of the labor market as they are the largest employers (Chapter 4).

218. Building on the 2007 Philippines Development Report recommendations to improve the business climate, the global financial crisis and economic recession call for pressing attention to (1) increasing credit to MSMEs, and (2) increasing expenditure and improving outcome of public investments. The next section provides an assessment of constraints to MSME financing and provides recommendation to increase their access to credit while the last section explores ways to improve infrastructure expenditure and quality in the Philippines.

[90] The Doing Business survey reveals it takes 15 steps, 52 days and 30 percent of average gross national income per capita to set up a business. The national average, however, does not do justice to several cities and municipalities which have substantially improved their processes in starting a business.

- R1. Implement the recommendation of the 2007 Philippines Development Report entitled Invigorating Growth, Enhancing its Impact and aimed at improving the business climate.

Table 5.2. Philippines: Ease of Doing Business Ranking 1/ 2/

	2006	2007	2008	2009	2010	Change in 2009-2010
Ease of Doing Business	126	136	140	141	144	-3
Of which:						
Starting a Business	108	151	155	155	162	-7
Dealing with Construction Permits	113	102	105	106	111	-5
Employing Workers	118	123	126	114	115	-1
Registering Property	98	88	97	101	102	-1
Getting Credit	101	116	123	125	127	-2
Protecting Investors	151	125	126	127	132	-5
Paying Taxes	106	132	129	126	135	-9
Trading Across Borders	63	58	58	66	68	-2
Enforcing Contracts	59	113	114	116	118	-2
Closing a Business	147	150	151	153	153	0

Source: World Bank Doing Business Survey 2006-2010
1/ 2008 ranking is out of a total of 178 countries; 2009 ranking includes 181 countries. A ranking of one indicates the best performer in the world.
2/ It should be noted that the League of Cities of the Philippines (LCP) has already started some efforts to streamline business procedures within their respective localities. These include: (1) Cities in Metro Manila already agreed to standardize and harmonize the procedures in obtaining business permits; (2) Metro Manila cities agreed to cut the steps of processing from 19 to 7; and a maximum timeframe of 10 days; (3) Synchronization of local regulations with national laws to eliminate conflict and confusion in the interpretation of laws; and (4) Implementation of the one-time assessment by the Bureau of Fire Protection, Department of Environment and Natural Resources, Department of Health and Engineering's Office and the one-time payment of registration costs and assessment fees to the Municipal Treasurer's Office.

IMPROVING ACCESS TO CREDIT BY MICRO-, SMALL- AND MEDIUM-SIZE ENTERPRISES[91]

219. SMEs and MSMEs are particularly exposed to an economic downturn as they have limited financial strength and access to credit is particularly challenging for them in the Philippines. Structural institutional weaknesses explain a large share of the difficulty in accessing credit. These companies are, however, crucial to a smooth weathering of the downturn and in limiting risks of a "jobless recovery" as they are important drivers of job creation and poverty reduction. The government and the BSP have introduced specific measures to assist SMEs and MSMEs in accessing credit but supplementary actions are needed to relieve market failures and unleash small entrepreneurs' potential.

220. Globally, SMEs are particularly exposed to the global recession and disruption of the financial system. A major fall out of the global crisis is likely to be the crowding out/shrinking of private financial institution/commercial bank resources to the private sector, especially MSMEs. Several compounding factors are simultaneously at play: (1) commercial banks/financial institutions curtail their overall

[91] See World Bank (2009b) for details. See Aldaba (2008) for definition of what constitutes SMEs, MSMEs in the Philippines.

lending as they deleverage and reassess their capacity to bear risk (deleveraging); (2) large firms that were previously financed from international capital markets are now retrenching towards domestic capital markets and/or bank lending (re-intermediation); (3) a collapse in the supply of trade finance as financial intermediaries re-assess credit risk which has resulted in an across the board rise in cost of trade finance (IMF, 2009); and (4) increased regulatory requirements for Philippines banks due to the move to Basel II capital adequacy standards.

221. **As in most countries, MSMEs play a crucial role in the economic and social development of the Philippines.** MSMEs account for 99.6 percent of registered enterprises, they employ 70 percent of the total workforce, and contribute to around 32 percent of GDP.[92] About half of MSMEs operate in the retail and wholesale trade industry but a sizable 15 percent of SMEs operate in the manufacturing sector. About 30 percent of the total sales and value added in the manufacturing sector comes from MSMEs (Leano, 2004). Similarly, MSMEs account for 25 percent of the country's total export revenue as they contribute to exports through subcontracting arrangement with large firms or as suppliers to exporting companies.

222. **While MSMEs are largely concentrated in National Capital Region, a large share is scattered in less banked areas.** An analysis of the geographic distribution of enterprises throughout the country shows a high concentration of MSMEs in Metro Manila and the two adjacent regions (slightly more than 50 percent of total MSMEs). The remaining MSMEs are dispersed in the other 14 regions of the country (Table 5.3).[93] The wide distribution of 50 percent of MSMEs, some in far-flung areas of the country, has increased the difficulty of accessing credit as about 95 percent of banks are located in major urban areas.

Table 5.3. Philippines: Distribution of MSMEs in top regions

Distribution of MSMEs (2004) *		Population (2004)**
National Capital Region (NCR)	198,140	10.628 Million (1.86%)
CALABARZON (Region IV-A)	113,792	10.407 Million (1.09%)
Central Luzon (Region III)	83,963	9.005 Million (0.93%)
Western Visayas (Region VI)	45,454	6.743 Million (0.67%)
Central Visayas (Region VII)	44,098	6.230 Million (0.71%)

Sources: * SME Statistics from DTI; ** – National Statistics Office, September 2007

[92] The total number of registered companies is 784,000. Of these, 91 percent (713,566) are micro enterprises, 8.2 percent (64,501) are small enterprises while 0.4 percent (2,980) are medium enterprises. MSMEs generated a total of 3,906,529 jobs in 2004 versus 1,736,658 for the large enterprises. Of these, 36.8 percent or 2,075,005 jobs were generated by micro enterprises; 25.3 percent or 1,428,455 by small enterprises; and 7.1 percent or 403,069 by medium enterprises.

[93] The top five regions account for about 62.2 percent of the total number of MSME establishments in the country. The Central Visayas region where the second largest City of Cebu is located has 7 percent of all MSMEs, while the Davao region has fewer than 5 percent of MSMEs. The entire Mindanao region carries only 15 percent of the MSME distribution.

223. **Philippines SMEs appear to be less productive than SMEs in neighboring countries.** While the number of SMEs as a share of total enterprises in the Philippines is comparable to countries in region (Table 5.4), Philippines SMEs contribute less to GDP, suggesting that their productivity is lower and integration of SMEs to the rest of the economy and the world is not that strong, leaving out SMEs from sharing in economic growth in recent years.

224. **Policy measures are needed to prevent the global financial crisis and recession from becoming a Philippines' employment and poverty crisis.** Chapter 4 highlights the challenges the global recession is posing for the labor market in the Philippines. Timely and appropriate measures are needed to specifically address the likely shortage of credit/funds availability to MSMEs because of their key role in generating employment and reducing poverty.

Table 5.4. Comparison of SMEs in selected Asian Countries

	Malaysia	Thailand	Philippines	South Korea	Japan	China	Indonesia
				(In percent)			
SME Establishments	94.40	98.00	99.60	99.00	99.00	99.70	99.99
Employment	40.40	55.80	69.10	69.00	88.00	74.00	99.04
Value Added	26.00	n.a.	32.00	46.00	56.00	60.00	63.11

Source: Japan International Cooperation Agency (JICA)

225. **The government, cognizant of the role MSMEs play in growth and job creation, has given high priority to MSME development.** Key measures introduced recently include additional structures and programs such as the Bureau of Small and Medium Enterprise Development (BSMED)[94] and the passage of a magna carta for SMEs to guide policy formulation and implementation.[95] The law is guided by three principles in setting the pace for SMEs development: (1) minimal set of rules and simplification of procedures and requirements; (2) participation of the private sector in the implementation of SME policies and programs; and (3) coordination of government efforts. The SME Development Plan (SMEDP) of 2004-2010 sets the framework for current strategies for the development of the SMEs and is geared towards building the capabilities of both SMEs and SME support organizations. The plan adopted a three-pronged strategic approach, focused at providing support to individual enterprises, identifying growth or priority industries and evolving an operational and regulatory environment that is more conducive for SMEs to set up, operate, and succeed.

[94] BSMED is mandated to develop and promote MSMEs in the country by advocating policies, programs, and projects addressing the specific needs of MSMEs in the areas of market access, human resource development, and technology upgrading. Being the Secretariat to the SMED Council, the Bureau is also tasked to review policies and strategies geared towards MSME development.

[95] Currently, the Magna Carta for Small Enterprises (RA 6977 as amended by RA 8289, and recently amended by RA 9501) now known as the Magna Carta for Micro, Small and Medium Enterprises is the landmark legislation which reflects the current policy to foster a dynamic SME sector, particularly rural and agri-based manufacturing ventures.

226. **The BSP (central bank) has also continued to work on improving the policy and regulatory environment for MSMEs.** In particular, the BSP issued microfinance regulations and supported the establishment of the Credit Surety Fund (CSF), a credit enhancement scheme that allows MSMEs that are members of cooperatives to have access to financing. The electronic rediscounting (eRediscounting) system, an online, internet-based rediscounting facility that is available to all active and qualified banks nationwide, was also introduced to provide immediate availability and fast delivery of credit to banks, especially those in the countryside. While much has yet to be done, several indicators show that the BSP has improved its microfinance program. The number of banks engaged in sustainable microfinance increased from 184 in 2004 to 214 in 2009. The microfinance loan portfolio of the banking system rose by 93 percent from its level in 2004 to reach a total of P3.3 billion in September 2009 albeit this is still small (only 0.04 percent of GDP). This was accompanied by a 63 percent rise in the number of micro-borrowers in the same period. With the efforts of the National Government and the central bank, the Philippines ranked third in the world out of 55 countries in terms of microfinance policy and regulation.[96]

227. **The national government has also adopted several programs to increase lending to MSMEs based on policy-driven targeted interventions.** These programs include the SME Unified Lending Opportunities for National Growth (SULONG), and the One Town One Product One Million Pesos Program (OTOP). Aside from these programs, GFIs and GOCCs have their own lending programs focused on MSMEs. In addition, private banks are mandated to allot a certain portion of their credit to SMEs and the banking system has been divided into four categories (universal, commercial, thrift, and rural banks) and given corresponding quotas and incentives by the BSP to encourage lending to MSMEs.

228. **Access to credit for MSMEs, nonetheless, remains challenging despite the high liquidity currently in the banking system.** Funding obtained by MSMEs from formal institutions accounts for only 11 to 21 percent of their total current funding with start-up enterprises receiving much less. Most firms rely heavily on internally generated funds or personal resources and loans from friends and relatives, which may have limited their growth. Even after operating for many years, many MSMEs continue to depend on internal funds and borrowings from relatives, friends and informal lenders for most of their credit needs. Nangia and Vaillancourt (2006) show that despite various bank lending programs beyond the minimum requirement of directed credit programs set by the BSP (Table 5.5), the total amount of funds provided to SMEs was still insufficient.[97]

229. **Export-oriented SMEs experienced a reduction or even cancellation of trade credit lines because of the global crisis.** According to a recent World Bank survey[98] while large exporters have maintained their trade credit lines during the crisis, smaller exporters faced a tougher financing environment. Particularly affected are small firms operating in the garments, furniture (mostly located in Cebu), electronics, and

[96] Economic Intelligence Unit (2009) "Global Microscope on the Microfinance Business Environment".

[97] The study reveals that as of 2005, the total volume of SME lending was at most P250 billion, of which P226 billion were sourced from banks. The unmet demand was in the range of P67 to P180 billion (or between 28 to 72 percent of current levels) which reflects SMEs lack of access to formal sector financing.

[98] "Trade Finance Situation in the Philippines," World Bank Trade Group, June 2009.

automotive parts. The financial standing of many export-oriented SMEs was already weakened by the appreciation of the peso in 2007.

Table 5.5. Philippines: Bank lending to SMEs and Compliance with Lending Requirements 1/

	Universal / Commercial banks	Other Commercial Banks	Thrift Banks	Rural and Cooperative Banks	Total Banking System
			(Million Pesos)		
Assistance to Small Enterprises	112,412	8,401	40,184	32,356	193,353
Direct Compliance	99,475	5,290	39,970	32,041	176,776
Indirect Compliance and Funds Set Aside	12,937	3,111	214	315	16,577
Required Allocation @ 6% of Net Loan Portfolio	54,812	11,407	13,077	3,737	83,033
Actual Allocation (%)	12.31%	4.42%	18.44%	51.94%	13.97%
Assistance to Medium Enterprises	112,808	7,232	21,856	8,433	150,329
Direct Compliance	104,325	6,379	21,780	7,668	140,152
Indirect Compliance and Funds Set Aside	8,483	853	76	765	10,177
Required Allocation @ 2% of Net Loan Portfolio	18,271	3,802	4,359	1,246	27,678
Actual Allocation (%)	12.35%	3.80%	10.03%	13.54%	10.86%
Total Assistance to SMEs	225,220	15,633	62,040	40,789	343,682
Direct Compliance	203,800	11,669	61,750	39,709	316,928
Indirect Compliance and Funds Set Aside	21,420	3,964	290	1,080	26,754
Net Loan Portfolio	913,537	190,113	217,943	62,291	1,383,884
Required Allocation @8% of Net Loan Portfolio	73,083	15,209	17.435	4,983	110,711
Actual Allocation (%)	24.65%	8.22%	28.47%	65.48%	24.83%

Source: Data from Supervisory Data Center, Supervision and Examination Sector, BSP 1/ 1/ As of December 2007

230. **Obtaining medium to large size loans from banks is challenging for MSMEs.**[99] Some of the difficulties are brought about by the absence of adequate infrastructure and appropriate tools that enable proper risk evaluation and monitoring of the SME borrowers. Also, a number of existing business practices immediately raise a "red flag" on the side of lenders such that they are hesitant to even consider assessing the needed resources of SMEs in their initial contact with them. Furthermore, some SME borrowers have a perceived notion that the lenders would not be interested in them, and that it is a waste of time on their part to even go to a bank, hence, their dependence on informal or other alternative sources of funding (World Bank, 2009b).

231. **Several factors explain the low supply of credit to MSMEs relative to demand.** These barriers to lending include (1) inadequate credit risk assessment skills in banks; (2) legal, regulatory, supervisory issues; (3) physical access and affordability; and (4) financial infrastructure deficiencies. In particular:

- *Inadequacy of banks to do risk-based credit scoring of SMEs.* Previously, prudential requirements require prospective borrowers to submit income tax returns to the bank but the BSP has issued a circular exempting SMEs from the requirement as this is of limited use in helping banks ascertain the credit risk of prospective borrowers. Ascertaining the risks involved through credit scoring models or tools will help banks to move away from strict prudential requirements and hard

[99] These are loans ranging from P150,000 to P5 million.

collaterals, thus increasing the banking sector's portfolio for SMEs. This is currently being addressed by the central bank by promoting cash-flow based lending to MSMEs. There are also efforts to increase the capacity of bank examiners to evaluate risk-based lending technology for SME lending. The enactment of the Credit Information System Act or CISA in 2008 and the subsequent issuance of the rules that will enforce the CISA in January 2010 is an important milestone in the establishment of a comprehensive and centralized credit information system for the collection and dissemination of fair and accurate information relevant to, or arising from, credit and credit-related activities in the financial system.

- *Bureaucratic constraints to starting a business affect MSMEs compliance with loan requirements.* The tedious processes and procedures involved in registering new businesses—as captured in the *Doing Business* surveys—as well as securing permits for existing ones has hindered MSMEs development and has pushed many MSMEs to the informal sector. However, the submission of business license and permits from the local government unit is a requirement for loan application and MSMEs in the informal sector are effectively barred or face great difficulty borrowing from formal institutions.

- *Inconsistent regulations and policies over time.* For instance, microfinance lenders worry about policy reversals insofar as the microfinance program is concerned (i.e., various changes in microfinance policy from EO 138 to 558, and to 558-A). Such policy inconsistencies significantly increase the cost of doing business for small operators. Key players have organized and approached Congress to pass a law imbedding the key principles of doing credit and microfinance programs in a sustainable manner.

- *Lack of or limited physical access and affordability.* Many SMEs, especially those in rural areas, are beyond the geographic reach of most banks. These SMEs find the cost of financial services is high. Because of the geographical spread of SMEs, banks often need to charge considerably higher interest rate to these customers, which often render these services unaffordable to SMEs which find themselves credit constrained from formal lending channels.

- *Deficient financial infrastructure.* These have hindered the flow of credit to the MSMEs. Specifically, the absence of data or insufficient relevant data both at the macro and individual levels pose a challenge to SME lending. Banks have experienced difficulties in obtaining specific and timely data on commodities and industries to help them assess a prospective client's business via-à-vis the industry performance.[100] In addition, when data are available, the cost of obtaining it is high. Likewise, the limited scope of financial products available to support the peculiar needs of SMEs is another form of barrier as most banks supporting SMEs employ

[100] However, some banks have overcome these challenges. Planters Development Bank, for example, tailored its lending program to SMEs—such as through a simplified loan documentation and loans matching borrowers' cash flows—and also by providing services to strengthen their operations. These include assistance in preparing accounting records, business advice, and networking (Aldaba, 2008).

straight forward credit lines and loans most of the time and are of short to medium term in horizon (less than 3 years).[101]

232. **Improving access to finance for MSMEs would help protect both growth and jobs, contributing to the resiliency of the economy.** With the crisis, MSMEs face increasing risk of shutting down and displacing a significant number of workers. Targeting MSMEs by improving access to credit is therefore an integral part of the policy toolkit to manage the economic slowdown and the recovery—especially to minimize the risk of a "jobless recovery"—by protecting jobs and buoying growth. Access to finance in the agricultural sector, given its large share of total employment and acute poverty incidence, is particularly important. Beyond the large number of existing programs and assistance provided to MSMEs—as detailed in Aldaba (2008)—the following recommendations would contribute to that goal (see World Bank, 2009b for details):

- R2. Prudential requirements should shift to a more risk-based assessment of borrower's credit. Currently, prudential requirements focus criteria that have a limited bearing in assessing SMEs' credit-worthiness. Related to this is the recommendation towards increased risk-based supervision and monitoring of banks which would involve a possible area for future collaboration of the BSP with other institutions in the institutionalization of SME portfolio monitoring and supervision, using some of the "best" and sound tools, experiences, and practices in other jurisdictions. Continued efforts initially made towards risk-based assessment is welcome;

- R3. Streamline the business regulatory process in local governments. In order to lessen the bureaucratic red tape in registering or in renewing licenses of business enterprises, scaling up pilot-tests in streamlining the business regulatory process in local governments could generate significant gains for SMEs. Pursuant to this, support should be given to establish a Business Profile Management System as part of the Philippine Business Registry Portal. The system will provide the needed just in time information and monitor various types of assistance such as trade fair missions, market/business matching, consultancy, training, and financing that will facilitate a more efficient and effective conduct of business and marketing in the country;

- R4. Develop electronic banking to reduce financial services costs to SMEs. The BSP, alongside with the industry associations and chambers may want to consider conducting regular workshops, fora and conferences to popularize electronic banking and other evolving IT-based developments. As practitioners and MSME clients become aware of the recent developments on web-based and internet facilities, as well as mobile phone banking, their acceptance and usage become a day-to-day routine, hence, access to financial services, including releases and payments of loans and other services becomes wider, inclusive and efficient;

[101] On the other hand, SMEs often have difficulty in preparing credible business plans and realistic cash-flow estimates, and have sub-standard financial record keeping. This situation points to the low level of managerial skills and capability of the clients as well their low level of financial literacy.

- R5. Explore expanding the supply of financial services by non-traditional actors. To further widen the scope of providing banking services to the "underserved" and "unbanked" areas, including MSME clients, a special study could be conducted to focus on further expanding the access of non-bank operators to banking institutions. The BSP's efforts to develop mobile banking targeted to the underserved and unserved are welcome;

- R6. Promptly implement the credit information system. There needs to be a stronger advocacy in the MSME sector to push for the establishment of a comprehensive credit information system as soon as possible. Likewise, the "Risk-Based Lending Movement" launched in the Philippines in July 2008 as well as the "Borrower Risk Rating System" need to be supported by key stakeholders to popularize the use of risk-based technologies in assessing the financial needs of the SME clients; and

- R7. Improve SMEs' managerial and financial acumen. For example, the SBC or the MSMED Council may undertake joint activities with other industry partners to adequately address the various needs of the SME clients. One model is for providers of financial services to SMEs to partner with institutions who are offering business development services, including training of clients.

INFRASTRUCTURE INVESTMENT PROSPECTS[102]

233. *The Philippines suffers from poor quality of infrastructure compared to emerging markets with a similar level of development. Effectively and efficiently boosting spending on infrastructure during an economic downturn not only helps stimulate the economy thanks to a strong multiplier effect, but also, and most importantly, helps relieve the structural bottlenecks to growth that the country is facing. This section highlights key pitfalls arising in rapidly scaling up infrastructure spending and offers recommendations to efficiently improve the quality of infrastructure in the Philippines.*

234. **Infrastructure spending is a key measure advocated as part of the global fiscal stimulus aimed at tackling the global recession.** The IMF (2009) advocates that a global stimulus package of about 2 percent of global GDP—undertaken by countries with appropriate fiscal space—is needed to offset some of the output gap created by the global recession. Infrastructure spending has been flagged as a key measure that would not only help pump-prime economies in the midst of a significant recession, but would also help improve these economies medium-term growth prospects as long as the specific spending addresses existing infrastructure bottlenecks.[103]

[102] See World Bank (2008d) for an in-depth analysis of the transport infrastructure sector, issues, and recommendations. This chapter draws heavily on that recent Public Expenditure Review report.

[103] Infrastructure is critical to investment generation. Efficient and effective infrastructure links firms to their customers and suppliers and lessens the overall cost of the supply chain. This in turn further drives firms to invest and create productive jobs and expand their operations.

Box 5.2. Philippines: Access to Finance in Agriculture—Bottlenecks and Recommendations

Agriculture in the Philippines accounts for over one third of total employment (Table 4.1) and is severely affected by poverty. For example, World Bank estimates based on the 2006 Family Income and Expenditures Survey reveals that, out of 100 poor Filipinos, 71 leave in rural areas, and 59 belong to families whose head works in agriculture (World Bank, 2009f). The sector, consisting of mostly small family businesses and plagued with longstanding lack of pledgeable collateral (e.g., ongoing CARP reforms), is particularly constrained in its access to finance. In particular, access to finance in the sector suffers from:

- High transaction cost of access to finance by small farmers and fisherfolks, agri-enterprises and SMEs. Loan application costs are in the range of P2,000 to P5,000 (compared to monthly GDP per capita of about P8,000). Due to limited information on borrowers available to financing institutions, these institutions will normally require significant collateral as a condition to their loans; and
- Limited technical expertise at financial institutions, in particular regarding innovative financing schemes (e.g., financing with limited or no collateral). These issues lead to limited flow of credit to the sector relative to demand.

In light of the importance of agriculture as far as employment and poverty is concerned, tackling the above issues should be considered a high priority. The ongoing economic slowdown further reinforces the urgency of the issue. The following recommendations should be considered (see World Bank, 2009h, for details):

- R8. Improve the absorptive capacity of the small farmers and fisherfolks, agri-enterprises and SMEs by increasing their productivity, thereby minimizing the lending risks of financial institutions;
- R9. Establish effective loan administration mechanisms, and minimize loan appraisal costs as well as transaction costs through the strengthening of linkages between financial institutions, intermediaries, and end-users;
- R10. Introduce programs to enhance capability of financial institutions to produce innovative financing schemes; and
- R11. Increase investments in infrastructure such as farm-to-market roads, irrigation facilities, logistical infrastructures (e.g., cold chain facilities).

235. **The Philippines have had limited success in improving critical infrastructure necessary to attract investments and spur economic growth**. Various studies all point to a weak and deteriorating infrastructure in the Philippines. In a 2005 investment climate survey, electricity and telecommunication were the cited by firms as two of the top constraints in doing business in the Philippines. In the 2010 Logistics Performance Index, the Philippines made significant headway in addressing these problems, moving 21 notches from its rank in 2007 with country's improvement in terms of ease of arranging competitively-priced shipments. However, the quality of

transportation and information technologies, remain particularly weak (Table 5.6).[104] A closer look of the operational aspects of logistics reveals that the crux of the problem is the quality of the transport infrastructure—roads and ports.[105] While other contributing factors (including governance and customs procedures) have a bearing on the low performance of the logistics network in the Philippines, the shortcomings of the transport network are markedly evident and a major reason to the high logistics costs overall (more respondents indicated that costs are high for transport compared to responses to overall logistics costs). As a result, the country fell 16 places to rank 86 in the World Economic Forum Global Competitiveness Report 2009-2010, lower than Indonesia (54), Thailand (36), China (29) and even Vietnam (75).

236. **To address both the impact of the global recession and the infrastructure bottlenecks to doing business, the ERP has a strong infrastructure component** (the Economic Resiliency Plan is reviewed in Chapter 1). In light of the current policy push towards boosting infrastructure spending in the Philippines, this section (1) discusses the key reasons behind the relatively poor state of infrastructure in the country; and (2) provides some recommendations for successfully implementing the infrastructure component of the ERP, and in particular, flags some pitfalls that countries have experienced when rapidly scaling up large infrastructure programs.

Table 5.6. Logistics Performance Index (LPI), 2010 [1/]

	Int. LPI Rank	LPI	Customs	Infrastructure	International shipments	Logistics competence	Tracking & tracing	Timeliness
Singapore	2	4.09	4.02	4.22	3.86	4.12	4.15	4.23
China	27	3.49	3.16	3.54	3.31	3.49	3.55	3.91
Malaysia	29	3.44	3.11	3.5	3.5	3.34	3.32	3.86
Thailand	35	3.29	3.02	3.16	3.27	3.16	3.41	3.73
Philippines	44	3.14	2.67	2.57	3.4	2.95	3.29	3.83
Vietnam	53	2.96	2.68	2.56	3.04	2.89	3.1	3.44
Indonesia	75	2.76	2.43	2.54	2.82	2.47	2.77	3.46

Source: World Bank Logistics Performance Index 2007.
[1/] Scale of one to five, with five being the highest.

Reasons behind poor infrastructure development

237. **In the Philippines, access to infrastructure compares favorably in the region, but the quality of infrastructure remains poor and the user cost is high**. In particular: (1) assessments of transport infrastructure network indicate quality is low and costs high (while road density is comparable with countries in region, road quality compares less well, leading to higher land transport costs and high accident rate; ports and airports are plentiful but capacity is under pressure, resulting in congestion and high costs); (2) electrification rates are above middle income country average, but major parts of the islands (especially outside Luzon) suffer frequent electricity supply

[104] The 2007 Logistics Performance Survey is the first report presenting the Logistics Performance Index (LPI) and indicators. The survey will be conducted each year to improve the reliability of the indicators and to build a dataset comparable across countries and over time.

[105] Around 67 percent of survey respondents indicated that transport infrastructure quality is low or very low. When asked about the operational aspects of logistics, 67 percent of the respondents indicated that port/airport charges are high/very high; for rail transport rates, all responded that they are very expensive.

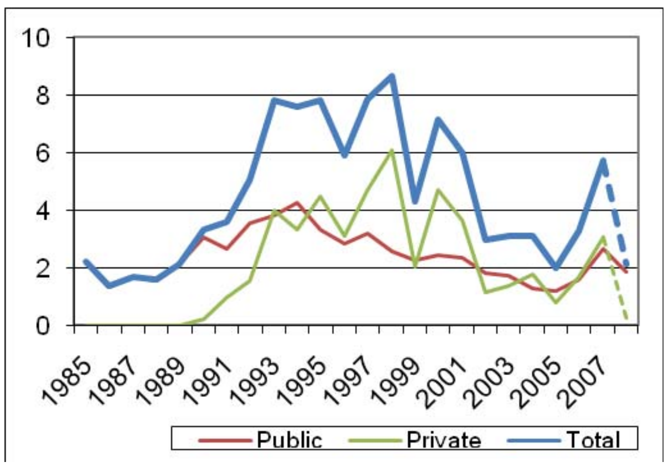
interruptions; electricity tariffs are some of the highest in East Asia; and (3) outside Metro Manila, water supply systems suffer interrupted supply and significant pressure fluctuations.

238. **The following factors explain, to a large extent, the current weak state of infrastructure in the Philippines**:

Inadequate new spending

239. *Low infrastructure spending levels.* Middle-income countries in East Asia will need to spend at least 5 percent of GDP on infrastructure to meet infrastructure needs in the next 10 years (World Bank, 2005). The Philippines has spent less than this benchmark level and lower than most countries in the region. For example, in 2002, Philippines spent around 3 percent of its GDP on infrastructure, compared to 8-10 percent of GDP spending in China, Thailand and Vietnam.[106] As a result, overall infrastructure investment levels, be they from the public or private sector, have not recovered since the Asian Financial Crisis (Figure 5.8).

Figure 5.8. Total expenditure on infrastructure (percent of GDP) 1/ 2/



1/ Sources: Data from the Department of Finance, Department of Budget and Management, National Statistics Coordination Board, Manila Water Company, Inc., Maynilad Water Services, Inc, Optel, Ltd., and the PPIAF-World Bank Private Infrastructure Investment Database.
2/ 2008 data (dotted line) reflects preliminary estimates on water, transport and energy private investments; data on telecom still unavailable at the time of writing. Total infrastructure investments include capital outlays expenditure in transport, water supply, energy, telecommunications and other works.

Inadequate planning, coordination and institutional capacity

240. **Planning, coordination and institutional capacity constraints are a major bottleneck to infrastructure development in the Philippines.** Irrespective of whether an infrastructure will be built or provided through purely public or with some from of private participation, identification, assessment and prioritization underlies an effective infrastructure investment plan as it is still the public sector's role to ensure that the right type of infrastructure will be built. Weak institutions and frameworks,

[106] Source: ADB, WB and JBIC, Connecting East Asia: A New Framework for Infrastructure, 2005.

however, have made it difficult to improve quality of spending for infrastructure. These include:

- *Planning, coordination and budget processes need to ensure that expenditures are well focused on areas that offer the best value for money in improving service quality.* The government has taken important initiatives to achieve this objective but much remains to be done. The quality of multi-year planning and the quality of project preparation and selection in the annual budgetary process could be improved. To date, infrastructure with private sector participation has been limited and characterized by strong reliance on unsolicited proposals that often result in overly generous incentives for the private sector.

- *Planning and budgeting is de-linked.* For example, congressional allocations, which make up a substantial share of the budget for transport infrastructure, are undertaken without regard to the planning systems in place further undermining their relevance for the budgeting process. Also, the lack of accountability engendered by inadequate revenue and tax decentralization, together with the short period of office, create poor incentives for planning and budgeting at the local level. At the local level, inter-regional infrastructure networks (which serves more than one LGU), are not being built because provinces suffer from acute lack or resources compared to cities and municipalities.[107] Even if a regional body coordinates and plan inter-regional infrastructure, they have little control over budgets and no political influence over LGUs or agencies which hold the budget.

- *Capacity constraint in the public sector to identify and develop a pipeline of commercially viable projects.* The quality of project proposals needs to be improved and proper cost-benefit and technical analysis of projects are not undertaken on a routine basis. For example, databases and project preparation in line agencies and NEDA to support proposed infrastructure projects in the Medium Term Public Investment Program (MTPIP) and Comprehensive Integrated Infrastructure Program (CIIP) have the following characteristics (World Bank, 2008d):

    a. Either line agencies do not have systematic project files (fiches, profiles) or do not submit all materials to NEDA;

    b. Few feasibility studies are being carried out, even for high profile projects;

    c. For PPP projects, broad assumptions have been made on whether the project qualifies for private sector participation, and on the shares of public and private financing;

    d. No project-specific information is being collected on sustainability criteria as environment, traffic safety, and social impact; and

    e. Most agencies do not give priority to and provide adequate funding for project preparation, i.e., feasibility studies and engineering. Also, their

[107] This is due to decentralization which strengthened cities and municipalities tax powers relative to provinces.

capacity to assess investment project proposals from line agencies is limited.[108]

Inadequate private sector participation

241. **The business environment in the Philippines is globally unfavorable to infrastructure development**. Competition, good governance, adequate cost recovery and government support to reach development goals allow for infrastructure to be build in the most effective and efficient manner. In the Philippines, each of these factors is lagging (Bocchi, 2008). In particular:

- *Insufficient competition.*[109] Full benefits from competition has yet to be realized in most infrastructure sectors: the Philippine Ports Authority, the port regulator and owner of a number of ports, can set charges to insulate itself from competition; insufficient competition in procurement processes in road projects affects quality of road construction and efficiency; and there are duopolies in regional provision of telecommunications that limit choices of consumers. Also, in engaging private investment, most are done in non-transparent and uncompetitive manner. The reliance of line agencies in undertaking projects through unsolicited bids or a negotiated route has led to sub-optimal outcomes (e.g., the cancellation of the NAIA Terminal 3 airport contract, excessive guarantees in power generation and light rail transport).

- *Poor governance, with particular concerns on corruption.* The development of strong, clean and efficient institutions, not only improves service delivery but also attracts and support positive partnerships within the government and between the government and the private sector or civil society. These, in turn, foster efficiency and develop opportunities to leverage resources for infrastructure. The infrastructure sector is highly susceptible to corruption because of the presence of natural (and artificial) monopolies, capable of generating large rents; large equipment and civil works contracts; and investments often cannot be re-deployed after implementation and become vulnerable to expropriation (World Bank, 2006). Some recent initiatives—such as DPWH's partnership with civil society in monitoring the road sector—show progress towards addressing corruption in the infrastructure sector.

  The Philippines has generally ranked in the lower quartile of countries in international surveys of perception of corruption. Recently, assessment of corruption risks in the transport sector have found a pattern of corruption, collusion and fraud affecting the execution of public expenditure in the road sector, often with links to special interest groups or elected officials outside the sector.

[108] A possible exception is the Department of Public Works and Highways (DPWH), which has instituted and used modern IT-based road planning systems and tools.

[109] Competition in our context is assessed by the following sectoral features: (1) there are many players; (2) no single player is big enough to influence the market and (3) there are no barriers to entry and exit. Bocchi (2008) provides a list of key infrastructure sectors that are shielded from competition. This results in high input cost for the rest of the private sector and undermines overall investment and growth prospects.

- *Inadequate cost recovery.* Cost recovery ensures that delivery of infrastructure services will be sustained. User fees or charges are one of the main sources of financing infrastructure and can make up around 70 percent of funds for investments. Setting tariffs too low to recover at least operations and maintenance, political intervention in the approval of proposals for rate adjustments and non-economic factor influencing tariff setting are hindering investment financing in the sector. Private operators of water supply systems in Manila (Manila Water and Maynilad) had to contend with delayed increases in tariffs even if there were contractual provisions for automatic increases. This has impacted their expansion plans (targeting, in particular, unconnected poor households) and their ability to provide better services. Inadequate cost recovery has likewise impacted the fiscal positions of infrastructure related GOCCs (PNR and pre-privatization MWSS, NPC) to provide adequate services. In roads, motor vehicle user charges are earmarked for road maintenance but a closer look at budget releases reveals that not enough were allocated to cover maintenance costs (World Bank, 2008d).

- *Constraints in raising financing in the domestic market.* The domestic financial markets are not deep and liquid enough for large infrastructure proponents to raise funds in the market. Combined with this relative underdevelopment of the domestic financial markets are the specific risks and uncertainties in the sector (price controls, regulatory, uncertainty, uncertain commercial demand, and political and social unwillingness to accept free and unfettered pricing flexibility) which greatly tips the risk-return tradeoff against infrastructure. Other constraints include single borrower limits imposed on local banks;[110] lack of experience of local banks in undertaking cash-flow and business risk analysis especially in complicated infrastructure operating structures; high rates on government paper (which tends to make issuances by other entities more expensive) and high issuance costs (as much as 5 percent of the issue amount). Pension funds and insurance are unlikely sources of financing given that (1) they are relatively small in size, and (2) parts of the pension funds industry is underperforming and, at least in the short- to medium-term, cannot grow rapidly enough to support a high level of infrastructure financing (World Bank, 2005).

- *Unclear policy on Government support for PPPs.* While infrastructure projects have an inherent risk structure, there are risks that private firms will not be prepared to bear when undertaking PPPs. Providing guarantees is one way the Government can give greater certainty and improve allocation of risks (Irwin, 2007). The Philippines has provided guarantees in major PPPs but these were, to some extent, provided indiscriminately without properly assessing whether the guarantee is optimal or it targets the appropriate risk.[111] Proper identification of risks, rigorous analysis of the level of Government support and accounting and monitoring of contingent liabilities arising from guarantees should be undertaken to maximize the benefits of private sector participation (Chapter 2).

[110] The ability of any single bank to fund large private infrastructure projects is limited by prudential exposure limits and by the small size of its capital base.

[111] For example, excessive guarantees were provided to the MRT 3 consortium, as almost all risks were covered by the government. This used-up more fiscal resources than intended and the Government is mulling whether to just buy-out the concessionaire to save resources (see Box 2.1 for details).

Another instrument that can be used to support PPPs is through cash subsidies, including output-based aid. These are often used to provide incentives to deliver services in non-viable areas or to increase poor households' access to these services. In the Philippines, subsidies are often provided to inputs of production. This however has not resulted into increased access by the poor. Output-based mechanism however links payment of subsidies to a third-party provider to the actual service delivered (output). This has been experimented to improve electrification in off-grid areas serviced by NPC-SPUG and also in improving water services to low income communities in the Rizal Province and Taguig City serviced by Manila's east zone concessionaire.

Infrastructure and the Global Recession

242. **Evidence from past crises shows that as budgets come increasingly under stress, infrastructure projects and maintenance are disproportionately cut.** Also, during economic downturns, consumers often lose the ability and willingness to pay for infrastructure services. This in turn affects the revenue stream needed to service any debts incurred to put-up infrastructure assets, putting further stress to the financial position of governments and private service providers. As for infrastructure projects with private sector participation, project financing becomes more constrained as lenders are more risk-averse and project proponents face higher financing costs. As a result, PPP projects face greater delays in financial closures and sometimes project cancellations.

243. **The Asian financial crisis showed that infrastructure spending cuts and postponement of long-gestating projects ultimately slows the recovery and growth.** Indonesia, for example, sharply reduced its ability to invest in infrastructure investment and maintenance as construction costs soared in local currency terms and the government's budget fell. A decade has passed and this decline in infrastructure investment eventually manifested in having one of the poorest infrastructure in the region, decreased global competitiveness standing and lower growth trajectory. In comparison to countries such as China and Vietnam that have maintained or increased infrastructure investment in the same period, growth has been robust and the country's competitiveness strengthened.

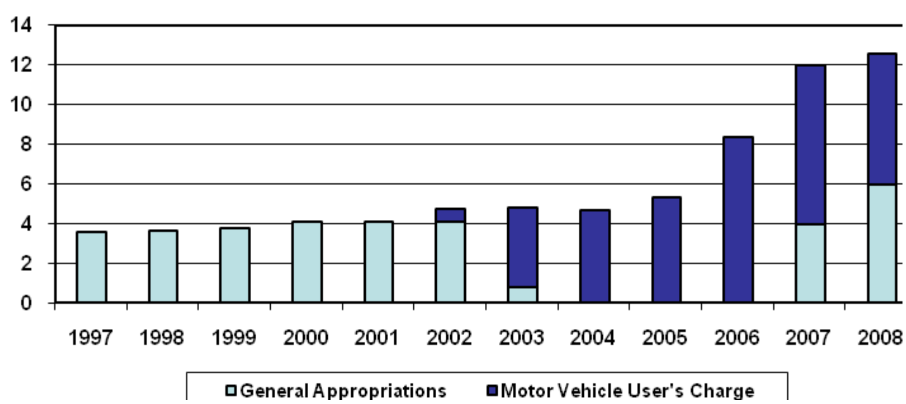
244. **The Philippines has long underinvested in infrastructure and previous crises only made it more difficult to improve investment levels**. The underinvestment eventually manifested in the country's continuing decline in global competitiveness and sluggish growth. Funding shortages for maintenance were also experienced during the financial and fiscal crises and became the primary cause of quality problems on the road network. Recognizing the volatility of maintenance funds, the Motor Vehicle User's Charge (MVUC) was introduced in 2001 to raise additional and earmarked resources for road maintenance, safety and vehicle pollution control. Annual financing for maintenance from the MVUC increased between 2002 and 2004.

But when the fiscal crisis erupted in 2004-2005, allotted resources from the general budget fell by an almost equal amount as the funding from the MVUC.[112]

Infrastructure spending: a response to the global recession

245. **During an economic downturn, provided a country has fiscal space, increasing spending on infrastructure—when such needs exist—has several benefits**. First, it can act as an effective counter-cyclical policy tool to pump-prime the economy (projects should have a high domestic component). It is a more potent form of fiscal stimulus compared to tax cuts as the additional resources made available are assured to be spent rather than be potentially saved. Second, it can be designed to act as a social safety net (such as public works programs described in Chapter 4 that have high job-intensity). Labor intensive projects, such as rural roads construction, road maintenance and community development infrastructure projects can provide immediate benefits to the most vulnerable citizens (these are also often projects with a relatively low import component). Third, if properly identified and implemented, infrastructure spending can lay the ground work for an economy's recovery and boost its long-term growth potential. Learning from the 'lost decade' of infrastructure investments following the Asian financial crisis, many countries—including the Philippines—have put into place some form of stimulus package focusing on infrastructure to counteract the effects of the current global financial crisis.

Figure 5.9. Philippines: Road Maintenance Funding 1997-2008 1/



Source: DPWH.
1/ In billions of Pesos, current prices.

246. **Over one third of the Government's Economic Resiliency Plan is allocated to infrastructure spending**. As detailed in Chapter 1, the headline P330 billion ERP includes P100 billion in infrastructure spending and part of the P160 billion in budget spending is also allocated to such spending.[113] Allocating a major share of its fiscal stimulus plan on such spending to mitigate the effects of the global recession is commendable: the government, thanks to its fiscal consolidation efforts from 2004 to

[112] Though the MVUC made sure that resources are available for maintenance, it covers only 21 to 32 percent of its annual estimated needs of about P19 billion.

[113] These include repair/rehabilitation of existing infrastructure facilities such as improvement works on major thoroughfares, linking of railway systems, upgrades on airports, road widening, construction of more farm-to-market roads and repairs of irrigation facilities.

2006, entered the current economic slowdown with some fiscal space (Chapter 1). The government is also using the global recession as an opportunity to move the infrastructure agenda forward more aggressively. The government could also seize the timing to tackle key constraints in infrastructure identified in the previous section. A timely and quality implementation of this infrastructure spending should help soften the impact of the global recession on the Philippines, help boost the country's competitiveness and promote its long-term growth.

247. **Aside from large infrastructure projects, small infrastructure programs targeting the urban poor have an important role to play in responding to the crisis.** Urban dwellers are particularly vulnerable to the economic slowdown as the most affected sectors of the economy—manufacturing and services—are concentrated in urban areas (Chapter 4). The urban poor are also weakly covered by the new conditional cash transfer program which has, so far, a strong rural component (only 8 percent of total recipients are in urban areas). Local government of cities and municipalities can target investments for the urban poor during times of crisis—though it is often difficult to reach the poor as they often live in informal settlements and are more transient than their rural counterparts.[114] Supporting national government programs that can be implemented locally (such as roads programs using congressional funds) or promoting existing local government small-scale public works programs could generate employment and mitigate short-term impacts of the crisis and help deliver long term benefits for the poor. Targeted programs already exist in the form of slum upgrading activities—which invest in providing roads, electricity, water and sanitation to urban poor communities—in a few cities and can be replicated elsewhere. A noteworthy example takes the form of a tri-partite partnership between local government units, the target urban poor communities and the civil society such as that of the Upscaling Urban Poor Community Renewal Scheme Project (Box 5.3). Another advantage of slum upgrading programs is that they are fairly easy to mobilize (given their scale) and can be designed to promote more labor intensive works and attract long-term infrastructure investments in the community.

248. **Ensuring completion of critical infrastructure—especially those that address bottlenecks and improve long-term productive capacity—will help in providing a foundation for recovery and sustained growth.** For example, the early completion of the gaps of the Subic-Clark-Manila-Batangas Growth Corridor could deliver both short and medium term benefits**.** The Subic-Clark-Manila-Batangas corridor has the potential to become the grand corridor for investments in the Philippines and serve as the major engine of growth. To realize this, the seamless movement of people and goods within this corridor must be facilitated by completing the remaining expressway links. In particular, the remaining gap between the South Luzon Expressway (SLEX) and the Southern Tagalog Arterial Road (STAR) tollway and the interconnection of SLEX and the North Luzon Expressway (NLEX) to avoid the heavily congested EDSA highway in Manila should be considered high priority. Their prompt completion would satisfy the criteria for infrastructure highlighted in the ERP.

[114] Baker, Judy. "Impacts of financial, food, and fuel crisis on the Urban Poor", *Directions in Urban Development*, Urban Development Unit, World Bank, Washington DC, December 2008,

Box 5.3. Philippines: Community Participation in Urban Slum-Upgrading

The Upscaling Urban Poor Community Renewal Scheme Project (UUPCRSP) brought together local government units, non-government organizations (NGOs) and community associations in urban poor communities in five cities in Luzon (San Fernando City, Quezon City, and Naga), Visayas (Mandaue City), and Mindanao (Iligan City) to support five selected urban poor communities to upgrade their community infrastructure. With a grant from the Japan Social Development Fund of the World Bank, the funds were channeled to community groups to help them prepare themselves technically, organizationally, and financially for the on-site community upgrading. NGOs served as implementing agencies; mobilizing communities to undertake the project. City governments on the other hand mobilized and contributed resources to the partnership—funding right of way payments; providing assistance in community mobilization; and in some areas developing the initial technical designs.

In undertaking the infrastructure-related sub-projects, many of the pilot sites went beyond the project's 20 percent community-labor requirement in construction activities. For example in San Fernando City, construction workers from the sites averaged about 40 percent of the work force; in Mandaue City, the number reached 50 percent; and in Iligan City, 70 percent. In Quezon City, community associations designed the work program to be undertaken by rotation or shifts to accommodate more workers. As a result, except for the site engineers, equipment operators, and supply officers, all construction workers came from the target communities.

In its two years of implementation, UUPCRSP not only provided immediate benefits—particularly increased employment during construction—but improved a total of 36 physical infrastructures in 17 communities. These infrastructures include: roads and drainage systems, water systems, multi-purpose building, material recovery facilities, concrete stairways, market stall, communal sewage facility, flood control facility, community assistance center and slope protection.

To ensure that these infrastructures will be adequately maintained, cost recovery measures were included in the design of the project. Various schemes such as individual household contributions, tapping income from installed water systems, road users' fees and rentals (in the case of market stalls) were adopted by community associations. In Naga City, noting the potential impact and benefits that the flood control sub-project to the City, the LGU offered to recover the infrastructure component costs through an increase in real property tax.

Source: Veneracion, Cynthia, et. al., *Scaling Up Urban Renewal–The JSDF/World Bank-PHILSSA Experience*, Partnership of Philippine Support Agencies, 2006, Quezon City.

Caveats and challenges in scaling up infrastructure spending

249. **International experience, however, point to significant challenges in rapidly scaling up infrastructure spending.** With large amount of resources being made available for critical infrastructure during times of crisis, an important temptation is to expedite the identification of a large number of projects so as to reach the scaled up resource allocation at the time when it is most needed for counter-cyclical reasons. Proper identification and vetting of infrastructure spending is a time-consuming process that can be speeded up in times of emergency but capacity constraints within the

administration often generate a trade-off between expediency and quality of projects selection and implementation. Equally important, especially in the context of the Philippines, is the need to be vigilant that implementation is governed with transparency, competition and undertaken with the best value-for-money. Beyond the need to be mindful of capacity constraints and the regulatory and governance environment, addressing these limitations and shortcomings are also important areas where the global recession could provide an opportunity for reforms.

250. **Strengthening capability for planning, budgeting, monitoring, coordination and conflict resolution to ensure the timely implementation of projects is needed**. There is a need to strengthen the capabilities of the oversight agencies of the Philippine Government's in planning, budgeting, monitoring, coordination and conflict resolution to ensure that once a decision is made to implement vital infrastructure projects, implementation will not suffer unnecessary delays. Currently, even if projects are approved by the NEDA-ICC, implementation is sometimes stalled because the budget allocation is insufficient. Moreover, during the implementation phase, problems are not promptly addressed contributing to delays in project implementation (one common issue is right of way). As a result, it is not uncommon for vital infrastructure projects to be completed significantly behind schedule.[115] This, in turn, creates large project cost overruns and undermines project viability.

251. **As preparation and implementation of infrastructure projects take time, a pipeline of infrastructure projects needs to be maintained, even during a downturn.** Given the tightening of fiscal space during economic downturns, governments often have little incentive to continue or develop infrastructure projects. However, once pipelines stall, they often take longer to restart, leading to large swings in budgetary infrastructure allocations over time and complicating fiscal policy making. Innovative ways of supporting the pipeline of infrastructure projects need to be introduced. Some possible solutions include: tapping ODA resources for infrastructure projects; using 'smart' subsidies to lessen impact on poor customers; restructuring PPI financing to include public sector debt and equity; and look into the possibility of re-designing public projects into PPI projects when the market begins to recover.[116]

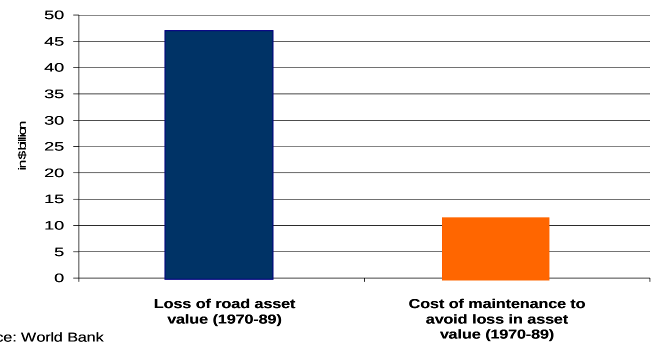
252. **On top of the need for scaling up infrastructure investments, funds for operation and maintenance of existing projects are critical to reaping their full benefits.** Concomitant to the scaling up of infrastructure projects, the Philippine Government should provide adequate funds and support for the operation and maintenance of infrastructure projects upon completion. This is to ensure that the project benefits will be sustained and their intended benefits fully realized: neglect of operation and maintenance is more costly in the long run. Past experience in the Philippines (and elsewhere) has revealed that operation and maintenance of large projects has, sometimes, been sub-optimal (Figure 5.10). In some cases, problems after

[115] As an example, in the Philippines, infrastructure projects are usually completed 7 to 8 years (sometimes even longer) after the signing of the JICA (Japan) Loan Agreements while JICA reports that the norm in other countries is 5 years.

[116] World Bank Group presentation "Infrastructure response to the crisis", March 2009; and Leigland, James and Russell, Henry. "New needs for technical assistance: Responding to the effects of the financial crisis on private participation in Infrastructure." Gridlines Note No. 49, PPIAF, June 2009

project completion are not properly addressed and no actions are taken. In the worst case, some completed projects are abandoned and forgotten. One possible reason is that post evaluation of completed projects has not been fully institutionalized by the Philippine Government. To address this issue post evaluation should be systematically undertaken. Post evaluation is a powerful tool to assess the project impact. If properly used, it can provide useful feedback in the evaluation of new projects by providing lessons from similar projects completed in the past.

Figure 5.10. Maintenance versus Replacement Costs of Roads in Developing Countries



Source: World Bank

253. **Notwithstanding the significant infrastructure issues, the Philippines made notable progress, especially during the 1990s, in setting an enabling environment for infrastructure development**. Despite the large outstanding reform agenda, it should be noted that the Government of the Philippines, over the last 15 years, has introduced several important sectoral reforms. These have already produced significant gains and improvement. Key measures include: (1) the liberalization of the telecommunications sector which eliminated the state-owned monopoly and led to increased access, lower costs and improved and diversified services;[117] (2) the privatization, through a concession, of Metro Manila Waterworks and Sewerage System which is responsible for providing water services in the country's largest urban agglomeration (This led to drastic improvements of services and expanded access, not least thanks to a reduction of NRW water rates.); (3) starting an ambitious reform program in the electricity sector by unbundling segments of the sector and introducing competition in these segments; (4) the liberalization in civil aviation and shipping in 1994 has provided consumers with more choices and better services; and (5) the Build-Operate-Transfer Law was the first legal framework for private sector participation in infrastructure in Asia.

254. **Cognizant of the large infrastructure needs and the effectiveness of such spending during a downturn, the Government boosted infrastructure spending.** In the short-term, undertaking labor intensive infrastructure—such as maintenance works and community public works—ensures social protection thereby acting as a good immediate response to the crisis. Identifying and implementing "shovel-ready" projects and speeding up implementation of on-going projects can be undertaken in the short to medium term to aide economic recovery. Given limited fiscal space and limited capacity,

[117] See, e.g., the beneficial impact of that measure on the emergence of the BPO sector—Box 5.1.

these should be complemented by efforts to improve the enabling environment for developing infrastructure to support long-term growth.

255. The following recommendations would help improve the quality and reach of infrastructure in the Philippines, as well as the efficiency of the funds spent; they would also better position the country for the recovery:

- R12. Increase total (public and private) spending on infrastructure, including spending for maintenance and operations (as a ratio of GDP). While the ERP significantly increased spending on infrastructure projects as part of the 2009 budget, the 2010 budget envisages a sharp reduction in such spending. Unless PPP projects fill the gap created by the lower budgetary allocation, the Philippines will continue to have low spending on infrastructure by regional standards;

- R13. Successful implementation of the large scale up in infrastructure spending calls for particular attention to (¶241):

  - (1) prioritization of and broad consensus on selected major projects—using the CIIP as starting point, the government would need to identify a more strategic list of projects with the desired economic and development impact, and suited to the financing and implementation capacities of line agencies. Wider consultation with stakeholders, if such would strengthen public support for these projects, should be undertaken. Coordination among various agencies that will be involved throughout the project cycle—from right of way acquisition to environmental and social safeguards to civil works—will have to be established up-front;

  - (2) budgetary support over the life of the project should be ensured (for projects that will be implemented by the public sector). Line agencies should demonstrate efficient use of such resources through transparent and competitive procurement methods, adherence to cost and time provisions of contracts, quality assurance of completed projects, and sustained maintenance;

  - (3) where PPPs are envisioned, a common framework needs to be adopted among infrastructure, oversight and regulatory agencies. Principles of transparency and competition, cost-recovery, and proper allocation of risks need to be observed. It is recommended that the Government reconsiders unsolicited proposals and joint ventures under new guidelines as viable modes of implementation for PPPs. The solicited process under the BOT law provides the opportunity for government to properly prepare a project, and study the appropriate allocation of risks. A robust regulatory framework that balances consumers' and investors' interest is important to be in place. Lessons can be learned from delays in implementation of projects due to competing project proposals from agencies, failure in unsolicited proposals that were legally contested, or undue risks carried by government;

- R14. Introduce and scale up small scale infrastructure projects targeting the urban poor as an immediate response to the crisis (¶247). The urban poor, a rapidly growing share of the poor in the Philippines, are particularly at risk from the current economic slowdown and slow recovery. Urban households are also a small share (8 percent) of the conditional cash transfer due to difficulties in identifying and validating the poor in urban settings. Small scale infrastructure projects—such as slum upgrading—can therefore play a crucial social safety net role in times of hardship (as they have a high local job content) and structurally improve the welfare of the urban poor once projects are implemented;

- R15. Introduce innovative ways of engaging the private sector in infrastructure development (¶251). In the roads sector, tollways are already present in the Philippines. Output- and performance-based road contracts can be considered for road assets management, where similar principles for tollways apply except payment is made by the government and not by road-users. For ports and airports, the role of the private sector has not been tapped for operation of terminals.

  Over the medium to long term, the capacities of infrastructure agencies in strategic planning, project preparation, procurement, contract implementation, and assets managements, would need to be continuously upgraded to incorporate evolving international experience and best practices; and

- R16. Strengthen the investment climate, focusing on the key constraints to investment that are the weak governance and business enabling environments (¶¶214-217 and ¶241).

CONCLUSIONS AND POLICY RECOMMENDATIONS

256. **A weak investment climate is undermining the country's prospects.** A weak investment climate, and in particular weak governance and business enabling environments, are among the key factors behind (1) the country's long term investment decline, including but not limited to investment on public infrastructure, and (2) the significant challenges in accessing credit for micro, small, and medium enterprises. The latter is crucial to ensuring a quality and inclusive economic recovery as MSMEs and SMEs are the largest and most dynamic source of employment (formal and informal); yet these companies are also particularly vulnerable to economic downturns as they have limited financial strength and access to credit. The former is critical to raising the growth potential of the economy. Public infrastructure, in particular, is of poor quality in the Philippines which limits the positive benefits (e.g., complementarities) that public investment has on private investments. Effective and efficient implementation of resources devoted to infrastructure in the ERP as well as sustaining the additional spending efforts over time (including with private sector participation) will be critical to overcoming the existing infrastructure bottlenecks and boost the growth potential of the Philippine economy.

257. To address the above issues, the sub-sections of this chapter suggested the following set of recommendations (see the relevant sections for details):

Improving the investment climate:

- R1. Implement the recommendation of the 2007 Philippines Development Report entitled *Invigorating Growth, Enhancing its Impact* and aimed at improving the business climate.

Improving MSMEs and SMEs access to finance:

- R2. Prudential requirements should shift to a more risk-based assessment of borrower's credit;
- R3. Streamline the business regulatory process in local governments;
- R4. Develop electronic banking to reduce financial services costs to SMEs;
- R5. Explore expanding the supply of financial services by non-traditional actors;
- R6. Promptly implement the credit information system;
- R7. Improve SMEs' managerial and financial acumen;
- R8. Improve the absorptive capacity of the small farmers and fisherfolks, agri-enterprises and SMEs by increasing their productivity, thereby minimizing the lending risks of financial institutions;
- R9. Establish effective loan administration mechanisms, and minimize loan appraisal costs as well as transaction costs through the strengthening of linkages between financial institutions, intermediaries, and end-users;
- R10. Introduce programs to enhance capability of financial institutions to produce innovative financing schemes; and
- R11. Increase investments in infrastructure such as farm-to-market roads, irrigation facilities, and logistical infrastructures.

Improving infrastructure investment:

- R12. Increase total (public and private) spending on infrastructure, including spending for maintenance and operations;
- R13. Successful implementation of the large scale up in infrastructure spending calls for particular attention to: prioritization of and broad consensus on selected major projects, wider consultation with stakeholders, coordination among various agencies that will be involved throughout the project cycle, budgetary support over the life of the project along with demonstrable efficient use resources, adoption of a common and robust framework for PPPs ;
- R14. Introduce and scale up small scale infrastructure projects targeting the urban poor to mitigate the immediate social effects of the crisis;
- R15. Introduce innovative ways of engaging the private sector in infrastructure development; and
- R16. Strengthen the investment climate for infrastructure.

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STATISTICAL APPENDIX

Table A.1. Philippines: Selected Economic Indicators, 2000-14

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
	Actual									Act,/Est.	Projections				
Growth, inflation and unemployment															
Gross domestic product (% change)	6.0	1.8	4.4	4.9	6.4	5.0	5.3	7.1	3.8	0.9	3.5	3.8	4.0	4.3	4.3
Inflation (period average)	4.0	6.8	3.0	3.5	6.0	7.6	6.2	2.8	9.3	3.2	4.8	4.5	4.0	4.2	4.5
Savings and investment															
Gross national savings	18.2	16.5	17.3	17.2	18.6	16.6	19.1	20.3	17.8	19.5	16.7	16.5	15.9	15.9	15.5
Gross domestic investment	21.2	19.0	17.7	16.8	16.7	14.6	14.5	15.4	15.2	14.0	13.8	13.6	13.6	13.6	13.4
Public sector															
National government balance (GFS basis) 1/	-4.6	-4.6	-5.6	-4.9	-4.1	-3.0	-1.4	-1.7	-1.5	-4.1	-3.8	-3.4	-3.2	-3.2	-2.9
National government balance (Govt Defn)	-4.0	-4.0	-5.3	-4.6	-3.8	-2.7	-1.1	-0.2	-0.9	-3.9	-3.5	-3.1	-3.0	-3.0	-2.7
Total revenue (Govt Defn)	15.3	15.6	14.6	14.8	14.5	15.0	16.2	17.1	16.2	14.6	14.7	14.9	15.0	15.0	15.0
Tax revenue (Govt Defn)	13.7	13.6	12.8	12.8	12.4	13.0	14.3	14.0	14.1	12.8	13.0	13.1	13.3	13.3	13.3
Total spending (Govt Defn)	19.3	19.7	19.9	19.5	18.3	17.7	17.3	17.3	17.1	18.5	18.3	18.0	18.0	18.0	17.7
National government debt	64.6	65.7	71.0	77.7	78.2	71.4	63.9	55.8	56.9	57.3	58.7	60.5	61.8	63.3	64.5
Balance of payments															
Merchandise exports (% change)	9.1	-16.2	9.9	2.7	9.8	3.8	15.6	6.4	-2.6	-21.9	12.0	7.0	7.0	7.1	7.1
Merchandise imports (% change)	7.7	-13.3	6.3	3.1	8.0	8.0	10.9	8.7	5.0	-24.2	13.1	7.8	7.3	7.3	7.1
Remittances (% change of US$ remittance)	0.5	-0.3	14.2	10.1	12.8	25.0	19.4	13.2	13.7	5.6	6.0	8.5	9.0	9.0	9.0
Current account balance	-2.9	-2.4	-0.4	0.4	1.9	2.0	4.5	4.9	2.5	5.5	2.9	2.8	2.3	2.4	2.1
FDI (billions of dollars)	2.1	0.3	1.5	0.2	0.1	1.7	2.8	-0.6	1.3	1.3	2.0	1.8	1.8	1.8	1.8
Portfolio Investment (billions of dollars)	-0.6	1.0	0.7	0.6	-1.7	3.5	3.0	4.6	-2.6	1.7	1.0	1.0	1.0	1.0	1.0
International reserves															
Gross official reserves 2/ (billions of dollars)	15.7	16.4	17.1	16.2	18.5	23.0	23.0	33.8	37.6	44.2	47.1	48.9	51.6	55.1	55.6
Gross official reserves (months of imports)	4.0	3.9	4.0	3.6	3.8	4.2	4.2	5.7	6.0	8.7	8.3	8.0	7.8	7.6	7.5
External debt															
Total 3/	76.8	81.8	78.0	78.6	70.1	62.4	51.29	45.8	38.9	42.2	42.6	41.6	41.6	41.1	39.9

Source: Government of the Philippines, and World Bank staff
1/ Excludes privatization receipts (these are treated as financing items, in accordance with GFSM) and includes CB-BO restructuring revenues and expenditures
2/ Includes gold
3/ Worldbank definition

Table A.2. Philippines: National Income Accounts, 1997-2009

	1997	1998	2003	2004	2005	2006	2007	2008	2009
	(In percentage change, unless otherwise stated)								
Gross national product	5.3	0.4	5.9	6.9	5.4	5.4	7.5	6.2	3.0
Gross domestic product	5.2	-0.6	4.9	6.4	5.0	5.3	7.1	3.8	0.9
By industrial origin									
Agriculture, fishery and forestry	3.1	-6.4	3.8	5.2	2.0	3.8	4.8	3.2	0.1
Agriculture and fishery	3.4	-6.4	3.7	5.0	2.0	3.7	5.0	3.2	0.1
Forestry	-30.0	3.3	24.3	53.2	4.2	25.7	-23.9	1.7	-1.1
Industry	6.1	-2.1	4.0	5.2	3.8	4.5	6.8	5.0	-2.0
Mining and quarrying	1.7	2.8	16.8	2.6	9.3	-6.1	26.0	1.9	21.1
Manufacturing	4.2	-1.1	4.2	5.8	5.3	4.2	3.3	4.3	-5.1
Construction	16.2	-9.6	-0.8	3.4	-5.9	9.6	21.1	7.8	5.8
Utilities	4.8	3.3	3.2	4.2	2.5	6.4	6.7	7.3	-2.8
Service	5.4	3.5	6.1	7.7	7.0	6.5	8.1	3.3	3.2
Transport, storage, communication	8.2	6.5	8.6	11.2	7.3	6.3	8.3	4.2	1.8
Trade	3.9	2.4	5.7	6.8	5.6	6.1	8.2	1.2	2.9
Finance	13.0	4.4	5.9	9.9	13.5	11.3	13.1	2.5	7.1
Real estate	3.8	1.6	4.0	5.3	5.3	5.7	5.8	5.7	-1.0
Private services	4.8	4.7	8.1	10.6	7.5	6.9	8.4	4.9	3.8
Government services	2.5	2.3	2.9	0.5	5.0	2.5	2.7	5.5	5.0
By expenditure class									
Personal consumption	5.0	3.4	5.3	5.9	4.8	5.5	5.8	4.7	3.8
Government consumption	4.6	-1.9	2.6	1.4	2.3	10.4	6.6	3.2	8.5
Capital formation	11.7	-16.3	3.0	7.2	-8.8	5.1	12.4	1.7	-9.9
Fixed capital	11.5	-11.2	3.8	1.3	-6.6	3.9	10.9	2.9	-3.5
Construction	14.6	-5.3	-1.2	-0.8	-7.3	7.6	19.4	4.6	3.9
Durable equipment	9.2	-18.1	9.2	3.2	-7.1	1.3	4.5	1.9	-11.4
Breeding stock & orchard development	…	7.9	0.3	-0.5	0.9	0.7	0.8	3.7	-1.5
Changes in stocks	24.5	-280.0	141.7	-444.1	-58.1	64.1	60.4	-25.3	-205.4
Exports	17.2	-21.0	4.9	15.0	4.8	13.4	5.4	-1.9	-14.2
Imports	13.5	-14.7	10.8	5.8	2.4	1.8	-4.1	2.4	-5.8
Statistical discrepancies	-79.3	572.3	131.2	-53.0	71.7	-136.6	336.0	-28.9	-76.8
Memorandum items									
GIR (billions of dollars)	8.8	10.8	17.1	16.2	18.5	23.0	33.8	37.6	44.2
Exchange rate (period average)	29.5	40.9	54.2	56.0	55.1	51.3	46.1	44.5	47.6
Tax effort (percent of GDP)	17.0	15.6	12.8	12.4	13.0	14.3	14.0	14.1	12.8
Deficit (percent of GDP)	0.1	-1.9	-4.6	-3.8	-2.7	-1.1	-0.2	-0.9	-3.9
Nominal GDP (billions Php)	2,427	2,665	4,316	4,872	5,444	6,031	6,647	7,423	7,669

Sources: National Statistical Coordination Board, Bangko Sentral ng Pilipinas, Bureau of Treasury

Table A.3. Philippines: Inflation Rates, 2003-08

	2003	2004	2005	2006	2007	2008	2009
	(Annual average)						
All items	3.5	6.0	7.6	6.2	2.8	9.3	3.2
Food, beverages and tobacco	2.2	6.2	6.5	5.5	3.3	12.9	5.8
Clothing	3.4	2.7	3.5	3.0	2.3	4.2	2.5
Housing and repairs	4.3	3.7	4.6	3.9	1.5	4.3	2.9
Fuel, light and water	6.3	7.3	18.1	12.9	3.2	6.5	-2.6
Services	5.7	9.3	11.8	8.9	2.8	8.6	-0.2
Others	1.9	2.1	3.2	3.0	1.6	2.9	2.6

Source: National Statistics Office

Table A.4. Philippines: Monetary Survey, 2001-09

	2001	2002	2003	2004	2005	2006	2007	2008	2009
	(In billions of pesos)								
Total liquidity	2,355	2,561	2,718	2,984	3,211	3,811	4,081	4,669	5,058
Broad money (M3)	1,686	1,846	1,924	2,121	2,339	2,870	3,174	3,668	3,972
Narrow money	392	477	518	565	617	769	886	1,071	1,222
FCDU deposits	599	644	695	787	788	853	751	942	1,026
Other liabilities	71	71	99	76	85	89	155	58	60
Net domestic assets	2,003	2,068	2,120	2,307	2,300	2,445	2,422	2,738	2,615
Net domestic credit	2,363	2,478	2,625	2,849	2,804	3,007	3,162	3,691	3,963
Public sector	684	764	862	1,000	960	1,040	1,027	1,199	1,269
Private sector	1,679	1,714	1,763	1,849	1,844	1,967	2,134	2,492	2,694
Net other items	-361	-410	-505	-543	-505	-562	-740	-953	-1,348
Net foreign assets	353	493	598	678	912	1,366	1,659	1,931	2,443
Central bank	456	550	637	689	846	1,077	1,365	1,686	2,028
Deposit money banks	-103	-57	-39	-12	66	289	294	245	415
	(Growth rates)								
Total liquidity	..	8.7	6.1	9.8	7.6	18.7	7.1	14.4	8.3
Broad money (M3)	..	9.5	4.2	10.3	10.3	22.7	10.6	15.6	8.3
Narrow money	..	21.6	8.6	9.1	9.2	24.7	15.2	20.9	14.1
FCDU deposits	..	7.4	8	13.1	0.1	8.2	-11.9	25.4	8.9
Other liabilities	..	0.7	38.9	-22.6	10.8	5.2	74.7	-62.5	3.5
Net domestic assets	..	3.3	2.5	8.8	-0.3	6.3	-1	13.1	-4.5
Net domestic credit	..	4.9	5.9	8.5	-1.6	7.2	5.2	16.8	7.4
Public sector	..	11.6	12.9	16	-4	8.3	-1.2	16.7	5.8
Private sector	..	2.1	2.8	4.9	-0.3	6.7	8.5	16.8	8.1
Net other items	..	-13.8	-23	-7.5	7	-11.3	-31.7	-28.8	-41.4
Net foreign assets	..	39.8	21.2	13.4	34.5	49.9	21.4	16.4	26.5
Central bank	..	20.6	15.8	8.2	22.8	27.3	26.7	23.5	20.3
Deposit money banks	..	44.7	31.1	70.5	665.6	341.3	1.8	-16.8	69.6
	(In percent of GDP)								
Total liquidity	64.9	64.6	63	61.3	59	63.2	61.4	62.9	65.9
Broad money (M3)	46.4	46.6	44.6	43.5	43	47.6	47.8	49.4	51.8
Narrow money	10.8	12	12	11.6	11.3	12.7	13.3	14.4	15.9
FCDU deposits	16.5	16.2	16.1	16.1	14.5	14.1	11.3	12.7	13.4
Other liabilities	1.9	1.8	2.3	1.6	1.6	1.5	2.3	0.8	0.8
Net domestic assets	55.1	52.2	49.1	47.3	42.2	40.5	36.4	36.9	34.1
Net domestic credit	65.1	62.5	60.8	58.5	51.5	49.9	47.6	49.7	51.7
Public sector	18.8	19.3	20	20.5	17.6	17.2	15.5	16.2	16.5
Private sector	46.2	43.3	40.8	38	33.9	32.6	32.1	33.6	35.1
Net other items	-9.9	-10.4	-11.7	-11.1	-9.3	-9.3	-11.1	-12.8	-17.6
Net foreign assets	9.7	12.4	13.8	13.9	16.7	22.7	25	26	31.9
Central bank	12.6	13.9	14.8	14.1	15.5	17.9	20.5	22.7	26.4
Deposit money banks	-2.8	-1.4	-0.9	-0.2	1.2	4.8	4.4	3.3	5.4

Source: Bangko Sentral ng Pilipinas

Table A.5. Philippines: National Government Operations, 2000-09 (GFS 1/)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
	(in percent of GDP, unless otherwise stated)									
Total Revenue	15.5	15.8	14.7	14.9	14.6	14.9	16.1	15.7	15.8	14.6
Tax revenue	13.7	13.6	12.8	12.8	12.4	13.0	14.3	14.0	14.1	12.8
Bureau of Internal Revenue	10.8	10.7	10.2	9.9	9.7	10.0	10.8	10.7	10.5	9.8
Net income & profits	6.0	6.2	5.7	5.7	5.7	5.9	6.3	6.4	6.5	5.7
Excise tax	1.8	1.6	1.4	1.3	1.2	1.1	1.0	0.8	0.8	0.8
Sales taxes & licenses	2.3	2.4	2.3	2.3	2.2	2.2	3.0	2.8	2.4	2.8
Other domestic taxes	0.5	0.5	0.7	0.6	0.5	0.6	0.6	0.7	0.7	0.6
Travel tax	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Bureau of Customs	2.8	2.8	2.5	2.7	2.6	2.8	3.3	3.2	3.5	2.9
Other offices	0.1	0.1	0.1	0.1	0.2	0.2	0.1	0.1	0.1	0.1
Nontax revenue	1.7	2.1	1.8	2.1	2.2	2.0	1.9	1.7	1.6	1.8
Grants	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total Expenditure 2/	20.0	20.4	20.3	19.8	18.7	18.0	17.5	17.4	17.3	18.7
Total primary expenditure	15.1	14.9	15.2	14.2	13.0	12.2	12.2	13.3	13.5	14.9
Current Expenditures	16.6	17.4	17.1	17.1	15.9	15.6	15.2	14.4	14.1	15.1
Personal services	6.7	6.6	6.7	6.4	5.8	5.4	5.4	5.3	5.0	5.4
MOOE	2.4	2.4	2.1	1.8	1.7	1.6	1.7	1.9	1.9	2.3
Subsidy	0.2	0.2	0.1	0.3	0.1	0.1	0.2	0.3	0.2	0.2
Allotment to LGUs	2.4	2.5	2.8	2.7	2.3	2.2	2.3	2.2	2.3	2.6
Interest payment	4.9	5.5	5.1	5.6	5.8	5.8	5.3	4.1	3.9	3.8
Tax expenditures	0.1	0.1	0.3	0.3	0.1	0.4	0.3	0.5	0.8	0.7
Total capital outlay	3.3	2.9	3.1	2.6	2.7	2.4	2.3	2.9	3.0	3.6
Net lending	0.1	0.1	0.1	0.1	0.1	0.0	0.0	0.1	0.2	0.1
Others	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Balance (GFS definition)	-4.6	-4.6	-5.6	-4.9	-4.1	-3.0	-1.4	-1.7	-1.5	-4.1
Balance (Govt definition)	-4.0	-4.0	-5.3	-4.6	-3.8	-2.7	-1.1	-0.2	-0.9	-3.9
Primary balance (GFS)	0.3	0.9	-0.5	0.7	1.6	2.8	4.0	2.5	2.3	-0.3
Memorandum Items:										
Privatization	0.1	0.0	0.0	0.0	0.0	0.0	0.1	1.4	0.4	0.1
CB-BOL Interest Payment	0.7	0.7	0.4	0.4	0.4	0.3	0.2	0.1	0.2	0.2
Nominal GDP (PHP billions)	3,355	3,631	3,964	4,316	4,872	5,444	6,031	6,647	7,423	7,669

Source: Bureau of Treasury, Department of Budget and Management
1/ GFS basis. Excludes privatization receipts as these are treated as financing items in accordance with GFSM; Includes CB-BOL revenue collection in the non tax-revenue side and CB-BOL interest payments in the expenditure side; Data on CB-BOL were taken from IMF Staff reports.
2/ Data taken from Department of Budget and Management; The capital outlay excludes capital transfers to LGUs and equity.

Table A.6. Philippines: Consolidated Public Sector Fiscal Operations, 2001-09

	2001	2002	2003	2004	2005	2006	2007	2008	2009 1/
	(in percent of GDP)								
Consolidated public sector balance	-4.8	-5.6	-5.1	-4.8	-1.9	0.2	0.3	0.4	-3.1
Public sector borrowing requirements	5.2	6.8	6.4	5.9	3.5	1.3	-0.7	1.2	4.9
National government	-4.0	-5.3	-4.6	-3.8	-2.8	-1.1	-0.2	-0.9	-4.3
CB restructuring	-0.6	-0.4	-0.4	-0.4	-0.3	-0.2	-0.1	-0.1	-0.3
Monitored GOCCs	-0.7	-1.2	-1.5	-1.9	-0.5	0.0	0.9	-0.4	-0.6
OPSF	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Adjustment of net lending and equity to GOCCs	0.1	0.1	0.1	0.2	0.0	0.0	0.2	0.2	0.2
Other adjustments	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other public sector	0.4	1.2	1.2	1.0	1.6	1.5	-0.4	1.6	1.9
SSS/GSIS	0.4	0.6	0.4	0.5	0.9	1.0	0.5	0.9	0.7
BSP	0.0	0.0	0.2	0.1	0.1	0.0	-1.3	0.1	0.1
GFIs	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
LGUs	-0.1	0.4	0.5	0.3	0.4	0.4	0.3	0.5	0.9
Timing adjustment of interest payments to BSP	0.0	0.0	0.0	0.1	0.1	0.0	0.0	0.0	0.0
Other adjustments	0.0	0.0	0.1	-0.1	0.0	-0.1	0.0	0.0	0.0

Source: Department of Finance
1/ Jan-June 2009

Table A.7. Philippines: Consolidated Public Sector Debt, 2001-09

	2001	2002	2003	2004	2005	2006	2007	2008	2009 /1
	(in percent of GDP)								
Consolidated public sector debt	106	110.2	117.6	108.7	93	82	71.8	71	71.7
Domestic	32.7	34.4	35.5	35.1	32.1	31.7	33.1	31.5	32.8
Foreign	73.3	75.9	82.1	73.7	61	50.2	38.7	39.5	38.9
Financial public sector debt	34.6	34	33.9	27.3	19.3	22	27.7	26.7	27.7
Domestic	18.8	19.8	20.1	16.4	11.2	17	23.9	22.2	23.7
Foreign	15.9	14.2	13.8	11	8.1	5	3.8	4.4	3.9
Consolidated non-financial public sector debt	87.4	93.7	100.8	95.2	85.9	73.9	61.1	60.9	59.8
Domestic	29.9	32	32.4	32.5	33.5	28.7	26.2	25.4	24.5
Foreign	57.5	61.7	68.3	62.7	52.3	45.3	34.9	35.4	35.3
GOCC debt	31.7	34.7	38.4	31.9	28.9	24.1	…	…	…
Domestic	5.9	6.1	6.5	6.4	8.5	6.9	…	…	…
Foreign	25.8	28.6	32	25.5	20.5	17.1	…	…	…
Consolidated general government debt	63	67	71.7	69.2	61.7	53.6	…	…	…
Domestic	29.6	31.4	32	31.1	29.4	25.4	…	…	…
Foreign	33.3	35.6	39.6	38.1	32.3	28.2	…	…	…
National government debt	65.7	71	77.7	78.2	71.4	63.9	55.8	56.9	57.3
Domestic	34.4	37.1	39.5	41.1	39.8	35.7	33.1	32.5	32.2
Foreign	31.3	33.9	38.3	37.2	31.7	28.1	22.7	24.3	25.1

Source: Department of Finance
/1 January to September 2009 except for NG debt which is fiscal year

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