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PHILIPPINES ECONOMIC UPDATE STAYING THE COURSE AMID GLOBAL UNCERTAINTY

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PREFACE

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

The PEU is a biannual publication of the World Bank's Macroeconomics, Trade & Investment Global Practice (MTI), prepared in partnership with the Poverty & Equity, Finance & Markets, and Social Protection & Labor Global Practices (GPs). This edition is prepared by Rong Qian (Senior Economist), Kevin Chua (Economist), Kevin Cruz (Research Analyst), and Karen Lazaro (Consultant) from the MTI GP, Pablo Ariel Acosta (Senior Economist) from the Social Protection & Labor GP, Isaku Endo (Senior Financial Sector Specialist) from the Finance & Markets GP, Lewis Hawke (Lead Public Sector Specialist) from Governance, Gabriel Demombynes (Program Leader), Xubei Luo (Senior Economist) and Sharon Faye Alariao Piza (Economist) from the Poverty & Equity GP. Ndiame Diop (Practice Manager for the MTI GP) and Birgit Hansl (Lead Economist and Program Leader) provided guidance. The report was edited by Oscar Parlback (Consultant), and the graphic designer was Christopher Carlos (Consultant). Peer reviewers were Richard Record (Lead Economist, GMTP2) and Derek Hung Chiat Chen (Senior Economist, GMTP2). Logistics and publication support were provided by Maria Consuelo Sy (Program Assistant) and Reinaluz Ona (Program Assistant). The Manila External Communications Team, consisting of Leonora Gonzalez (Senior Communication Officer), David Llorito (Communications Officer) and Stephanie Anne Margallo (Team Assistant) prepared the media release, dissemination plan, and web-based multimedia presentation.

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EXECUTIVE SUMMARY

Heightened global market uncertainty and rising domestic inflation weighed on the Philippines' economy in the first half of 2018. An increase in inflationary pressure since early 2018 along with rising interest rates in the United States and slowing global trade, weakened the demand for Philippine exports, fueling at the same time capital outflows and a depreciation of the peso. Growth moderated in the first half of 2018 to 6.3 percent, from 6.6 percent in the same period in 2017. Meanwhile, domestic demand continued to be driven by robust private consumption—partly due to lower income taxes, higher public wages, and strong remittance inflows—and an acceleration in public investment spending. Furthermore, strong domestic demand coupled with supply capacity limits, contributed to higher inflation.

In response to the buildup of inflationary pressure, Bangko Sentral ng Pilipinas embarked on a monetary policy tightening cycle. Inflation rose from an average of 2.8 percent in the first eight months of 2017 to 4.8 percent in the same period in 2018. Higher food prices accounted for about half of the rise in headline inflation, owing to weak agricultural and fisheries supply and a rise in demand, which was fueled by a reduction of personal income taxes that benefitted over sixty percent of wage earners. Higher global oil prices, a weaker peso, and new excise taxes also contributed to higher inflation. To reduce inflation expectations, the central bank raised its key policy rate to 4.5 percent—a cumulative increase of 150 basis points since May—to signal its commitment to price stability, but with limited impact so far. The central bank also intervened in the exchange-rate market to smooth excessive volatility. Still, the demand for U.S. dollars increased due to an increase in imports of capital goods, widening the current-account deficit. Meanwhile, the capital account worsened due to interest rate hikes by the United States' Federal Reserve and increased trade tensions leading to capital outflows, further weakening the peso.

Fiscal policy has focused on accelerating public spending, especially in infrastructure while the implementation of the first tax package has helped increase government revenue. In line with the government's ambition to reduce the country's infrastructure gap, public infrastructure expenditure grew by 41.6 percent in the first half of 2018, compared to 8.8 percent in the same period in 2017, driven largely by numerous small public works projects. Moreover, the wage bill increased by 20.1 percent in the first half of the year, partly due to the implementation of the ongoing salary standardization. On the revenue side, higher tax collection boosted overall revenue growth and helped contain the fiscal deficit at 2.3 percent of GDP in the first half of 2018, below the government's deficit ceiling of 3.0 percent for 2018.

The Philippines' economic growth outlook remains positive, yet downside risks have increased. An expected slowdown in global trade in the medium term is likely to further dampen Philippine exports. Nevertheless, baseline economic growth is projected at 6.5 percent in 2018, 6.7 percent in 2019, and 6.6 percent in 2020. The baseline investment growth outlook is positive and planned senatorial and local elections in May 2019 are expected to lead to higher public spending and higher private consumption. However, persistent high domestic inflation could have a dampening effect on consumption and investment growth. Also, a faster normalization of monetary policy in the United States and an increase in global uncertainty, including trade tensions, could not only worsen external financing conditions for emerging market economies like the Philippines but also elicit additional domestic interest rate hikes that could raise domestic borrowing costs for businesses and households.

In the short term, it is prudent to maintain Philippines' strong macroeconomic fundamentals. The country is fairly resilient to capital reversals given its large foreign reserves, flexible exchange-rate regime, low public debt, and robust remittance inflows. At the present juncture, preserving the country's resilience rests in large part on preventing the current-account deficit from widening too much and too fast. Given that export growth is not expected to accelerate in the medium term, future import growth driven by public investment will need to be monitored closely to manage the pace of current account deficit widening to prevent external funding gap challenges.

For the Philippines to expand its long-term economic growth potential to reach the Ambisyon Natin 2040 vision, deep structural reforms are needed to increase both productivity growth and capital accumulation. Priority policy areas include improving market competition through regulatory reforms, improving trade and investment climate policies and regulations, and reducing labor market rigidities and costs. In addition, the Philippines needs to address structural deficiencies in the agriculture sector to prevent future food supply constraints. Reforms aimed at boosting domestic growth and reducing vulnerabilities in the agriculture sector will be essential to sustain high and inclusive economic growth.

While progress on poverty reduction is likely to continue as the economy maintains its high growth rates, high food inflation will disproportionately affect poor and vulnerable households. Recent data from the 2017 Annual Poverty Indicators Survey suggests that the income of the bottom 40 percent of the population grew at a faster rate than that of the average population. Thus, while there is no official household survey data on poverty since 2015, the poverty rate likely continued to fall until 2017. However, rising inflation in 2018 may negatively impact the welfare of poor and vulnerable households, as they spend over two-thirds of their total expenditure on food and fuel, the main drivers of higher inflation in the first eight months of 2018. In addition, the recent typhoon Ompong may have had a disproportional impact on these households, as they are not only more exposed to shocks from natural disasters but also have a lower capacity to cope with their impact.





PART 01 RECENT ECONOMIC AND POLICY DEVELOPMENTS

The Philippine economic growth moderated from 6.6 percent year-on-year in the first half of 2017 to 6.3 percent in the same period in 2018, driven by export growth moderation. Meanwhile, inflation increased from an average of 2.8 percent in the first eight months of 2017 to an average of 4.8 percent in the same period of 2018 due to food supply constraints, higher global oil prices, continued peso depreciation, new excise taxes, and a rise in demand. To manage inflation expectations, the country's central bank embarked on a tightening cycle by increasing policy rates four times so far in 2018—from 3.0 percent in May to 4.5 percent in September, with limited impact so far. The Philippine peso continued to depreciate and reached a 12-year low in July 2018 influenced by the ongoing monetary policy normalization in the United States, uncertainties created by the United States-China trade tensions, and a strong demand for capital imports while exports growth moderated.

GROWTH: INVESTMENT-LED GROWTH AMID A WEAKENING EXTERNAL SECTOR

Philippine economic growth moderated to 6.3 percent in the first half of 2018 supported by robust private consumption and an acceleration in public investment spending. However, net export growth decelerated due to a slowdown in global electronics products demand.

The country's economic growth moderated in the first half of 2018. The economy expanded by 6.3 percent year-on-year in the first six months of 2018, moderating from 6.6 percent in the same period in 2017 and well-below the government's 7-8 percent target for the year. Since early 2018, the observed slowdown was mainly driven by the weak performance of net exports that started in early 2018. Economic growth was driven by investment spending in the first half of 2018, supported by a sharp increase in investments in durable equipment and buoyant activity in the construction sector. In addition, public consumption growth accelerated in the first half of 2018, as the government continued to ramp up public spending in line with its expansionary fiscal policy stance. Private consumption growth also remained robust despite increased inflation, supported by a stable labor market and a steady inflow of remittances.

A softening in global trade on electronics coupled with recent global growth weakening has resulted in lowered export growth (Box 1, Box 2). Export growth declined from 19.5 percent year-on-year in the first half of 2017 to 9.8 percent in the same period of 2018. The moderation was driven mainly by growth moderation of electronics components exports, the Philippines main export goods, which constitute more than half of the Philippines' total goods exports. Electronics export expanded 11.9 percent year-on-year in the first half of 2018, half of the 23.0 percent in the first six months of 2017. This is the result of the cyclical global softening in demand for electronics. Philippines, due to its high concentration of electronics products in its export basket, has been affected more intensely by this cyclical demand moderation than other countries in the region. In addition, agricultural exports contracted by 14.4 percent year-on-year in the first half of the year, reversing the 34.1 percent growth in the previous year. Meanwhile, import growth moderated but remained strong and far outpaced export growth. Imports moderated slightly in the first half of 2018, expanding by 14.6 percent year-on-year, compared to 18.6 percent a year ago.¹ As result of export moderation and robust import growth, net export contribution to growth

declined from -0.9 percent in the first half of 2017 to -3.9 percent in the same period in 2018.

Capital formation was the principal driver of growth in the first half of 2018, as investments in durable equipment and construction increased significantly (Figure 1). Fixed capital formation growth accelerated from 10.4 percent year-on-year in the first half of 2017 to 14.8 percent in the same period of 2018 driven by a growth acceleration in durable equipment and construction. Investments in durable equipment, which made up around 60 percent of fixed capital formation, expanded by 17.1 percent year-on-year in the first half of 2018 compared to 11.0 percent a year ago. Investments in industry-specific machinery drove durable equipment growth, as firms continued to invest in additional productive capacity given growing capacity constraints.² Construction accelerated from 7.5 percent year-on-year in the first six months of 2017 to 11.6 percent in the same period in 2018. Faster growth in the construction sector was mainly due to a 22.1 percent year-on-year surge in public construction spending in the first half of 2018, more than double the 9.3 percent registered in the previous year, fueled by the faster implementation of the government's infrastructure program mainly due to completion of many numerous small public work projects, and without a significant contribution yet from "Build Build Build".³

Private consumption growth moderated in the first half of 2018. Private consumption, which accounts for around two-thirds of the country's total GDP, expanded by 5.7 percent year-on-year in the first six months of 2018, moderating from the 5.9 percent in the same period of 2017. A rising inflation rate, which increased from 2.8 percent in the eight months of 2017 to 4.8 percent in the same period of 2018, contributed to the moderation in private consumption growth. Yet, despite the uptick in inflation, private consumption growth remained at a relatively strong level, supported by a steady job market, a continuous inflow of remittances coupled with a weaker peso,⁴ personal income tax reform that became effective

¹ Electronics imports, particularly components/devices (semiconductors) continued to grow at a rapid pace in the first half of 2018, expanding by 26.5 percent year-on-year, down from 31.6 percent a year ago. Meanwhile, imports of office equipment, machinery and mechanical appliances, and electrical machinery expanded by double-digits in the first two quarters of 2018, supported by the strong increase in capital formation.

² Investment growth in machinery specialized for particular industries accelerated from 16.4 percent year-on-year in the first six months of 2017 to 26.5 percent in the same period in 2018.

³ In the first six months of 2018, disbursements of public infrastructure outlays increased by 41.6 percent year-on-year in nominal terms.

⁴ Remittances increased by 6.8 percent year-on-year in peso terms as a result of a 7.3 percent depreciation of the peso in the first half of 2018.

Figure 1. In the first half of 2018, capital formation growth drove economic growth



DEMAND SIDE: CONTRIBUTION TO GDP GROWTH (PERCENTAGE POINT)

in 2018, which benefitted more than sixty percent of wage income earners,⁵ and a double digit growth in consumption loans.

Growth in the service and industry sectors remained robust in the first half of 2018 (Figure 2). The service sector, which contributed 3.7 percentage points to the country's GDP in the first six months of 2018, grew at 6.5 percent, lower than the 6.7 percent in the same period in 2017, driven by continued robust growth in the wholesale and retail trade, real estate, and finance subsectors. Industry growth remained largely the same in the first half of 2018 (7.0 percent year-on-year) as in the first half of 2017 (6.9 percent), although with a slight change in the composition. Growth in the manufacturing sector, the main growth driver of the industry, moderated from 7.8 percent year-on-year in the first six months of 2017 to 6.6 percent in the same period of 2018. Weaker manufacturing growth was the result of growth moderation in the food manufacturing and radio, television, and communications equipment and apparatus industries, which cumulatively accounted for nearly two-thirds of total manufacturing output.⁶ Growth in the construction subsector,

Figure 2. ... while growth in the service sector fueled growth on the production side



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

second largest component of industry, accelerated from 6.4 percent year-on-year in the first half of 2017 to 11.5 percent in the same period of 2018. The acceleration was driven mainly by public construction while private construction activity improved slightly.

The agriculture sector underperformed in the first half of 2018 compared to the same period last year due to weather conditions and persistent productivity challenges in the sector. Agriculture sector growth weakened significantly from 5.6 percent year-on-year in the first half of 2017 to 0.7 percent in the first half of 2018. The slowdown was the result of a contraction in both the crops and fisheries subsectors. The crops subsector, which account for over half of the country's agriculture output, contracted by 0.5 percent year-on-year in the first half of 2018, a sharp reversal from the 9.5 percent growth registered in the previous year.⁷ The fisheries subsector, which account for 12.7 percent of the country's total agricultural output, contracted by 1.7 percent year-on-year in the first six months of 2018, worse than the contraction of 0.8 percent in the same period in 2017.8

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Under TRAIN program those earning an annual salary of Php250,000 or below will no longer pay any income tax.

Food manufacturing, which makes up about half of total manufacturing, expanded by 5.1 percent year-on-year in the first half of 2018, down from 6.6 percent in the previous year. 6 Growth in the radio, television, and communications equipment and apparatus subsector, which includes the manufacture of electrical components, decelerated from 7.7 percent year-on-year in the first half of 2017 to 6.1 percent in the first half of 2018.

Contraction in crop was mainly because rice and corn farmers shifted to higher valued crops and planted early in the last quarter because of weather conditions and trade prices. In O2 2018, rehabilitation and closure of some irrigation canals also contributed to the reduction in rice planting. In the same quarter, the decline in corn production was also attributed to early plantings due to government distribution of seeds in Cagayan Valley. Other corn farmers also shifted to other crops such as ginger, tobacco, pineapple, banana and watermelon. In Mindanao, insufficient rains were blamed for the reduction in area planted and harvested, and some areas of the region where corn used to be intercropped with rubber, coffee and oil palm were reported to be no longer viable for corn production. (PSA, 2018b)

In Q1 2018, fewer fishing trips brought about by weather disturbances in the Visayas regions resulted to lower production of commercial and municipal fisheries, and a newly imposed regulation by Laguna Lake Development Authority caused a delayed stocking in freshwater pens in southern Luzon. A disease also affected seaweed farms in some parts of Visayas. In Q2 2018, weather condition is still principally blamed for the reduction in fish supply, aside from water pollution, high costs of feeding materials, high cost of fuels, repair of fishing nets, and decrease in fishing trips due to dry-docking. (PSA, 2018a and 2018b)

Box 1. Recent Global Developments

Global growth remains robust but has softened in recent months, as manufacturing activity and trade have shown signs of moderation (Figure 3 and Figure 4). After a period of synchronized global upturn, economic activity appears to be slowing. The deceleration is especially noticeable for global trade as trade volumes contracted in April for the first time since mid-2016. The slowdown reflects softening demand for imports in advanced economies – with the exception of the United States, as well as rising barriers to trade, moderating growth in China, higher energy prices, and elevated policy uncertainty. While global demand appears to be decelerating, labor markets remain tight and inflation is on an upward trajectory in many countries.

Figure 3. Manufacturing activity slowed in the first half of 2018...

Figure 4. ...as well as trade activity.



Advanced economies continue to grow above their potential, notwithstanding some recent moderation. Although recent indicators in advanced economies suggest some growth moderation, they continue to point to solid investment and above-potential growth in 2018 across countries. Growth in the United States reached 2.3 percent in 2017, supported by broad-based strength in domestic demand, especially investment. However, the economy may be near its productive potential as both capacity utilization and the employment rate are nearing the peaks attained prior to the financial crisis.³ There has been a slowdown in economic activity in the euro area since the beginning of 2018, particularly as manufacturing purchasing managers' index values have continued to decline. Moreover, while Japan's economy grew by 1.7 percent in 2017, underpinned by supportive financial conditions and strong exports, it contracted at the beginning of 2018.

Among emerging market and developing economies (EMDEs), commodity exporters seem to have lost some momentum in the first half of 2018, while solid domestic demand and elevated energy prices are leading to rising inflation in many commodity importers. In Brazil, new data showed industrial production contracting by 10.9 percent (month-on-month) reflecting disruptions from the truckers' strike in late May, while the composite PMI fell to 47 in June, down significantly from a recent high of 53.1 in February. In Russia, the manufacturing PMI continued its downward slide, falling to 49.5 in June. Meanwhile, growth in commodity importers remains strong, although it is moderating somewhat this year in part due to capacity constraints. With output gaps closed, or in many cases positive, capacity constraints are becoming increasingly binding. With price and wage pressures rising, amid markedly higher oil prices and increasingly binding capacity constraints, several large commodity importers have begun to tighten their monetary policies (e.g., Georgia, Pakistan, the Philippines, Romania, and Turkey).

Rising policy uncertainty amid elevated protectionist sentiments have led to a moderation in global trade growth in 2018. Following a prolonged period of marked weakness since 2012,¹⁰ a cyclical recovery in global manufacturing and investment propelled global goods trade growth to 4.6 percent year-on year in 2017, three times the pace observed in the previous year. Since the beginning of the year, the United States has imposed tariffs on more than \$90 billion of its imports, with other countries retaliating with tariffs on more than \$70 billion worth of U.S. exports. The country subject to the newest tariffs is China, with tariffs imposed on about \$37 billion worth of its exports, with another \$16 billion coming into effect in coming weeks. On July 10th, the United States announced its intention to assess tariffs on an additional \$200 billion worth of goods from China. More broadly, new trade restrictions have been on the rise in the 620, with the number of new import tariff measures nearly tripling in the most recent six months (October 2017 to May 2018) compared to the previous six months. As a result, new export orders have been decelerating in recent months, suggesting that the momentum has been slowing. Overall global trade growth is expected to ease to 4.3 percent year-on-year in 2018, down from a six-year high of 4.8 percent in 2017.

Source: World Bank (2018a, 2018b, and 2018c)

9 Capacity utilization in April 2018, reached 78.0 percent, approaching the 81.1 percent peak capacity utilization prior to the financial crisis. Meanwhile, the employment to working-age population ratio reached 79.2 percent, approaching the peak of 80.3 percent prior to the global financial crisis.

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Box 2. The cyclical downturn of electronics exports in 2018

In 2017, the Philippines benefitted from the global technological cycle, driving faster exports of machinery, electronics, and integrated circuits. The Philippines, as a key player in the global value chain (GVC) for electronics products, was among the countries in the region that benefitted the most from the pickup in the global technological cycle, significantly accelerating export growth in electronics, and driving total merchandise export growth in 2017." In 2017, real value of electronics components exports (semiconductors) expanded by 23.8 percent year-on-year, compared to 7.8 percent in 2016. As electronics exports make up more than half of total goods exports in the Philippines, overall merchandise export growth expanded by 20.9 percent year-on-year in 2017, substantially higher than the 8.4 percent average between 2011-17.

However, the completion of technology inventory restocking has seen electronics exports soften markedly through 2018. Globally, the expansion of new orders of electronics equipment have softened significantly since January 2018, resulting in the deceleration of the manufacture of electronics equipment over that same period (Figure 5 and Figure 6). As a result, growth of exports of electronics products in the Philippines weakened to 11.9 percent year-on-year in the first half of 2018 compared to 23.0 percent a year ago. The growth moderation in electronics products was the primary reason for the softening of merchandise export growth, which decelerated to 8.9 percent year-on-year in the first six months of 2018 from 22.7 percent a year ago.

Figure 5. New orders of electronics equipment have decelerated in 2018...

Figure 6. ...leading to a decline in electronics equipment output globally.

MANUFACTURE OF ELECTRONIC EQUIPMENT (GLOBAL PMI, OUTPUT)



NEW ORDERS, ELECTRONICS (GLOBAL PMI, ELECTRONICS)

Source: Haver Analytics Note: A value of 50 and above in the Purchasing Mangers' Index (PMI) signifies an expansion.

Source: Haver Analytics

Note: A value of 50 and above in the Purchasing Mangers' Index (PMI) signifies an expansion.

The vulnerability of the Philippines' exports to global demand fluctuations highlights weaknesses in key areas of trade competitiveness, global value chain (GVC) integration, and product-space evolution. A product-space analysis reveals that the range of products exported by the Philippines has remained broadly constant over time, suggesting that the country did not pursue an appropriate diversification strategy. Having diversified only at the periphery, where products are less sophisticated and have less potential for transformation, the Philippines is less able to capture value addition and leverage transformative activities to create jobs and increase income. As a result, the Philippines is more exposed to both demand-based external shocks, as it is harder to quickly reallocate labor and capital to related products, and price volatility, as there are few intermediate industries to buffer the impact of volatile commodity prices. Finally, the Philippines has become more of a GVC taker, as it is increasingly exposed to the decisions of actors down the value chain, and less of a GVC taker, when it would be directing the market.

Sources: IMF (2017), World Bank (2017a, 2018d, and 2018e)



¹¹ China (including Hong Kong SAR, China), Malaysia, and the Philippines are among the top 10 exporters of integrated circuits. While their share in global markets is relatively low, exports of broadcasting equipment, computers, and other final electronic products represent more than 10 percent of total exports in Vietnam, Thailand, the Philippines, and Malaysia. These countries benefited disproportionately from the pickup in the global cycle due to their competitiveness and established capacity and experienced an acceleration of exports in these categories.

THE EXCHANGE RATE AND THE EXTERNAL SECTOR: WIDENING BALANCE OF PAYMENTS DEFICIT

Softening global growth and trade along with heightened uncertainty in the external sector have resulted in further depreciation of the peso.

The Philippine peso depreciated in the first eight months of 2018, weakening to a 12-year low. The peso depreciated, in nominal terms, by 7.0 percent year-to-date as of end-August 2018, from Php/US\$49.96 in end-December 2017 to Php/US\$53.47 in end-August 2018 (Figure 8). It breached the Php/USD\$53.60 mark in August, its weakest in 12 years. Similarly, the real effective exchange rate depreciated by 5.0 percent year-on-year in the first seven months of 2018, more than the 4.0 percent depreciation in the first seven months of 2017. The weakening of the peso was influenced by the ongoing monetary policy normalization in the United States, increased uncertainly over United States-China trade tension, and the widening current account deficit. In addition, the slowdown on electronic export growth coupled with the sustained growth of imports of capital goods and raw materials raised the demand for U.S. dollars. As a result, the country's level of international reserves steadily declined in the first eight months of the year, falling from US\$81.7 billion in August 2017 to US\$77.8 billion in August 2018. At its current level, the reserves can cover 7.5 months' worth of imports, down from 8.4 months in August last year and the historical average of 10.3 months in 2010-17.

Figure 7. Philippine exports have been contracting since January 2018.



The current account deficit widened in the first half of 2018 due to a larger trade deficit. The country's current account deficit registered US\$3.1 billion (1.9 percent of GDP) in the first half of 2018, substantially higher than the US\$0.1 billion (0.1 percent of GDP) deficit in the first half of 2017. The wider deficit was attributed to a larger trade deficit which reached 14.7 percent of GDP in the first half of 2018, compared with 12.1 percent of GDP deficit in the same period of 2017. Exports contracted by an average of 4.2 percent on the first half of 2018 from an expansion of 21.5 percent during the same period last year. Meanwhile, import remained robust by expanding 13.4 percent year-on-year, higher than last year's 12.3 percent (Figure 7). The wider trade deficit was not offset by the net service export growth of 55.0 percent in the first half of 2018, an impressive acceleration from the 9.2 percent growth in the same period in 2017, as tourist arrivals increased and sustained export revenue in the business process outsourcing (BPO) industry.¹² The growth of personal remittances moderated from 5.5 percent year-on-year in the first half of 2017 to 2.8 percent in the same period in 2018.¹³

Figure 8. The Philippine peso depreciated in the first eight months of 2018 in both nominal and real terms.



12 Travel exports expanded over 50 percent in the first quarter of 2018, faster than the 35 percent recorded in 2017. In addition, tourist arrivals to the Philippines rose by 10.2 percent year-on-year to 3.2 million visitors for the period January-May 2018. See https://www.dti.gov.ph/resources/statistics/tourist-arrivals.

13 Growth in the first quarter of 2018 was dragged lower by the 9.9 percent year-on-year contraction of personal remittances in March driven by base effects, the Holy Week holidays, and repatriations from Kuwait.

Capital inflows slowed down in the first half of 2018. Net inflows of foreign direct investment rose to US\$5.8 billion (3.6 percent of GDP) in the first half of 2018 from US\$4.0 billion (2.7 percent of GDP) in the same period in 2017. However, net foreign portfolio and other investments registered outflows due to the ongoing policy normalization by the U.S. Federal Reserve, coupled with global trade uncertainties. This is reflected in the persistent decline of the Philippine Stock Exchange Index which started in January, with netforeign selling in the first seven months of 2018.¹⁴

As a result, the surplus in the country's capital and financial accounts softened in the first half of 2018 to US\$0.3 billion (0.2 percent of GDP) from a surplus of US\$0.7 billion (0.5 percent of GDP) in the first half of 2017. The reduction of the capital and financial accounts' surplus and the larger current-account deficit led to a widening of the balance of payments deficit from US\$0.7 billion (0.5 percent of GDP) in the first half of 2017 to US\$3.3 billion (2.1 percent of GDP) in the same period of 2018.

Table 1. Balance of Payments, H1 2016 - H1 2018 in millions US\$ / in percentage of GDP H1 2016 H2 2016 H1 2017 H2 2017 H1 2018 (543) (0.4) (656) (133) (0.1) (2.030)(3.087) **Current account** (0.4)(1.2) (1.9) Goods (17,349) (11.8) (18,199) (11.5) (18,238) (12.1) (22,267) (13,7) (23,324) (14.7) Exports 20,327 13.8 22,407 14.2 25,738 17.1 26,126 16.0 25.339 16.0 Imports 37,677 25.7 40,606 25.7 43,976 29.2 48.394 29.7 48,663 30.7 2.4 3,785 2.5 5,867 3.7 Services 3,465 3,578 23 5,465 3.4 **Primary Income** 1,333 0.9 0.8 1,544 1.0 1,347 0.8 1,247 1,466 0.9 Secondary Income 12,008 8.2 12,719 8.1 12,777 8.5 13.307 13,023 8.2 8.2 Capital and Financial accounts 1,423 1.0 745 0.5 1,976 (1,536) (1.0)1.2 251 0.2 30 32 0.0 33 (0.0) Capital account 0.0 0.0 24 0.0 (1) Financial account (1,392) (0.9) 1,567 1.0 (720) (0.5) (1,944) (1.2) (252) (0.2) (1.4) (2.1) Direct investment (3,600)(2.5) (2,282) (3,160) (3, 385)(2.1) (4,080)(2.6)Net Acquisition of financial assets 0.5 1,628 1.0 0.6 2,632 1.1 769 881 1.6 1,675 Net incurrence of liabilities^{1/} 4,369 3.0 3,911 2.5 4,041 2.7 6,016 3.7 5,755 3.6 Portfolio investment 2,326 1.6 (846) (0.5)2,867 1.9 (358) (0.2) 3,094 2.0 **Financial derivatives** 57 0.0 (89) (0.1) (137) (0.1) 86 0.1 (53) (0.0)Other investments (174) (0.1) 4,784 3.0 (290) (0.2) 1,712 1.1 787 0.5 Net unclassified items^{2/} (246) (0,2) (1,318) (0,9) (104) (421) (0,3) 520 0.3 (0,1) **Overall BOP position** 634 0.4 (1.672) (1,1) (706) (0,5) (157) (0,1) (3,257) (2.1)Memo: Basic Balance 3,058 2.1 1,626 1.0 3,028 2.0 1,355 0.8 993 0.6

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

2/ The term "Net unclassified items" is a balancing figure. There are two methods of computing the BOP position: type first approach uses in net international reserves due to transactions, while the second approach computes the sum balances of the current account, capital account less financial account.

The two measures do not necessarily tally. The BSP uses the first approach to determine the overall BOP position.

FINANCIAL MARKETS AND MONETARY POLICY: AN ACTIVE MONETARY POLICY TO MANAGE PERSISTENT HIGH INFLATION

Inflation continued to rise in the first eight months of 2018, driven by rising food prices, higher global oil prices filtering through a weaker peso, new excise taxes, and a demand rise. The central bank started in May a monetary tightening cycle to manage inflation expectations. The Philippines' financial system remains stable and well capitalized.

Inflation pressures intensified in the first eight months of 2018 due to food supply constraints, higher global oil prices, a weaker peso, new excise taxes, and a demand rise. The headline inflation rate averaged 4.8 percent in the first eight months of 2018, substantially higher than the average of 2.8 percent in the first eight months of 2017 (Figure 9). It rose from 3.4 percent at the beginning of the year to 6.4 percent in August, breaching the Bangko Sentral ng Pilipinas (BSP) target range of 2-4 percent.¹⁵ Higher food prices accounted for more than half of the rise in the inflation rate, followed by higher energy and transportation costs. Lingering effects of weather disturbances led to a tighter supply of agricultural products in the first quarter, raising the prices of key products such as fish, corn, fruits, and vegetables (Box 3).¹⁶ In recent months, rice supply reached low levels raising the price of rice. Energy and transport prices increased, due to the rising price of international crude oil, a weaker peso, the effect of excise taxes on fuel, and the upward adjustment of electricity prices. In addition, reduction in personal income taxes benefitted over sixty percent of wage earners, boosting private demand. Core inflation, which does not include volatile food and energy items, averaged 3.7 percent in the first eight months of 2018, compared to 2.5 percent in the same period in 2017, which is an indication of demand-driven pressures of an economy operating near its capacity limits. To manage inflation expectations, the BSP raised its key policy rate by a total of 150 basis points four times so far in 2018, from 3.0 percent in May to 4.5 percent in September, but with limited impact so far..

The recent Typhoon Ompong may have a further impact on food inflation given crop damages in the affected area. Typhoon Ompong (internationally known as Mangkhut) struck Northern Luzon in mid-September, causing widespread agriculture and infrastructure destruction especially in hard-hit Cordillera Autonomous Region. Damage to agriculture is estimated as of September 19, 2018 at USD 265 million and damage to infrastructure at USD 42 million.¹⁷ Damage to rice, corn and vegetable supplies might place additional pressure on food inflation at a time when the country is already experiencing escalating prices. As a reference point, a similar event occurred in 2015, Typhoon Lando (international name Koppu) in Northern and Central Luzon. Agriculture damage was USD 233 million and infrastructure damage about USD 74 million.¹⁸ After Typhoon Lando, food inflation increased mildly but overall inflation, which was lower at the time, remained below the central bank target.

Credit growth remained strong in the first half of 2018. Credit growth was not affected by the recent monetary policy rate increases. It accelerated slightly from 17.2 percent year-on-year in June 2017 to 17.7 percent in the same month of 2018. Domestic liquidity (M3) continued to grow and reached Php11.1 trillion pesos with the growth rate of 11.7 percent year-on-year in June 2018, a deceleration from 13.4 percent growth in June 2017. Production credit grew by 18.0 percent year-on-year in June 2018, up from 16.8 percent in June 2017. Similarly, household credit growth accelerated from 16.8 percent year-on-year in June 2017 to 18.0 percent in the same month of 2018. While the sectoral composition of firms' loan portfolios has remained broadly unchanged, lending in agriculture, forestry, and fishery and administrative and support services declined by 7.5 percent and 49.4 percent year-on-year, respectively, in June 2018 (Figure 10). The credit-to-GDP ratio continued to rise and reached 67.5 percent in June 2018 compared to 63.7 percent in June 2017.

The Philippines' financial system remains resilient. The share of non-performing loans remained at a low level of 1.9 percent in June 2018, similar to the level in June 2017, among the lowest in the region (Figure 11). Philippine banks are well capitalized, with a total capital adequacy ratio of 14.7 percent in March 2018, well above the regulatory minimum of 10 percent, but slightly lower than the 2017 average of 15.2 percent. While profitability remains high in the banking sector, with return on equity at an average of 9.8 percent and return on assets at an average of 1.2 percent, banks' profitability showed a slight decline in the second quarter of 2018. Similarly, the share of interest income to total operating income was 75.2 percent in the first half of 2018, a slight decline from an average of 74.7 percent in 2017.

¹⁵ Inflation rate in August 2017 was 2.6 percent.

¹⁶ In the second quarter, rice prices increased amid a tight domestic supply and lower inventory levels.

¹⁷ NDRRMC Situation Report No. 27, September 19, 2018.

¹⁸ NDRRMC Final Report, October 2015.





Figure 10. The commercial loan portfolio is dominated by the real estate, utilities, transport, and ICT sectors (June 2018).



Figure 11. The Philippines' credit-to-GDP ratio remains low, and its rate of non-performing loans is among the lowest in the region.



DOMESTIC CREDIT TO PRIVATE SECTOR BY BANKS (PERCENT SHARE FROM GDP) RHS: NON-PERFORMING LOANS RATIO (PERCENT)

Notes: Domestic credit to private sector by banks (% of GDP) data for Malaysia in 2017 is not yet available. Source: WDI

Box 3. The Drivers of Inflation in the Philippines since January 2018

Rising food prices were the main drivers of inflation since the beginning of 2018. The year-to-date inflation rate reached 4.8 percent in August 2018, breaching the BSP's 2-4 percent target range. Items that are highly volatile, including food and energy, were the main drivers of inflation in the first eight months of 2018. More than half of the year-to-date inflation was attributed to rising food prices caused mainly by higher prices of rice and fish-the staples of Filipino food (Figure 12). The country's rice supply reached critical levels earlier this year, as delays in the import of rice by the National Food Authority (NFA) exacerbated the supply shortfall. In February, the NFA's rice reserves could only satisfy the country's requirement for two days.¹⁹ Rice imports only arrived toward the end of the second quarter. To temper the rise in rice prices, the president has prioritized the rice tariffication bill, which is currently pending legislative deliberation. Meanwhile, fish prices have increased, as a dwindling catch, a fishing ban in the Visayas, and reduced fishing grounds in the West Philippine sea led to a 1.7 percent year-on-year contraction of fishing output in the first semester of 2018.

Figure 12. Higher food prices drove more than half of the August year-todate inflation.

Figure 13. The combined contribution of energy and transport prices to inflation has steadily risen since March.



COMMODITY GROUP SHARES FROM YEAR-TO-DATE INFLATION (PERCENT)

CONTRIBUTION TO INFLATION (PERCENT SHARE)



Rising housing, water, electricity, gas and other fuel, and transport prices constituted more than a guarter of the year-to-date inflation (Figure 14). Domestic energy prices rose in tandem with rising global crude oil prices coupled with the continued weakening of the peso. Upward adjustments in electricity rates made early in the year as well as the implementation of the new excise tax on oil and fuel contributed to energy inflation. The higher fuel prices consequently led to higher transport prices. For instance, the Land Transportation Franchising and Regulatory Board (LTFRB) approved a provisional fare increase of Php1.0 for public utility jeepneys in Metro Manila and adjoining provinces in July, which will effectively lead to a further increase in transport prices.²⁰

Besides the BSP raising its key policy rate, the government is proposing legislative and trade measures to temper rising inflation. The BSP raised its key policy rate four times in 2018, from 3.0 percent in May to 4.5 percent in September, in a bid to manage inflation expectations. The administration also plans on lowering inflation through other measures. One such measure is House Bill 7735, or the Revised Agricultural Tariffication Act, which Congress passed on August 14 and replaced the 805,200-ton limit on rice imports with a general tariff. The bill will allow more entry of rice into the country, effectively lowering the price of rice. A senate bill counterpart is currently being deliberated. Moreover, an executive order has been approved to ease importation of fish, vegetable, meat, and other food products to supplement the domestic supply shortage.

FISCAL POLICY: SUSTAINING THE REFORM AGENDA

Fiscal policy has focused on accelerating public spending, especially in infrastructure while the implementation of the first tax package has helped increase government revenue.

The fiscal deficit widened in the first half of 2018 as the government continued its expansionary fiscal path for the third year in a row (Figure 14). Public expenditure growth accelerated driven by an acceleration in infrastructure spending. Higher tax collection boosted revenue growth, partly due to Tax Reform for Acceleration and Inclusion (TRAIN) taking into effect in January 1, 2018. The fiscal deficit increased from 2.0 percent of GDP in the first semester of 2017 to 2.3 percent of GDP in the same period in 2018, still well below the government's deficit ceiling of 3.0 percent of GDP for 2018.

Figure 14. The government's budget deficit reached 2.3 percent of GDP on the back of an expansionary fiscal policy...



The government continued to mainly finance its fiscal deficit with domestic resources, although the share of foreign financing in the total financing mix has increased significantly in 2018²¹, from 81:19 in favor of domestic financing in 2017 to 64:36 in 2018 (Figure 15). Despite continued public borrowing, the Philippine government's overall debt-to-GDP ratio remained at 42.5 percent of GDP in the first half of 2018, as nominal GDP growth continued to outpace growth in the government's debt stock.





²¹ In the first six months of 2018, net domestic financing, which accounted for 80.0 percent of total financing, fell by 16.8 percent year-on-year in nominal terms to Php304.2 billion compared to Php365.7 billion in the first half of 2017. The decline in domestic financing coincided with the sharp increase in net foreign financing, which more than doubled in the first half of 2018 to reach Php75.8 billion, up from Php28.2 billion in the first six months of 2017.

Expenditure growth accelerated in first six months of 2018, driven by higher infrastructure outlays and wage bill (Table 2). In the first half of 2018, national government expenditures increased by 20.5 percent year-on-year in nominal terms to reach 19.5 percent of GDP compared to 17.6 percent of GDP in the first six months of 2017. The increase was driven by significant growth in capital outlays,²² which accounted for nearly a third of total public spending in the first half of 2018.23 In particular, infrastructure spending increased from 8.8 percent year-on-year in the first semester of 2017 to 41.6 percent in the first half of 2018, driven by ongoing projects at the Department of Public Works and Highways on road improvement, flood control, and maintenance of bridges and school facilities. At the same time, recurrent public spending on wage bill which accounted for a third of total public spending in the first half of 2018, increased significantly from 13.3 percent year-on-year as of June 2017 to 20.1 percent as of June 2018, primarily as a result of the increase

in public-sector salaries due to the implementation of the third tranche of the adjustment to the salary standardization law and the increase in pay of military and uniformed personnel.

Revenue expansion accelerated significantly, driven by recent tax reform and robust economic growth, containing the fiscal gap (Table 3). In the first six months of 2018, public revenue increased by 19.9 percent year-on-year in nominal terms to reach 17.1 percent of GDP compared to 15.6 percent of GDP in the same period of 2017. Strong growth in revenue collection was supported by a robust increase in tax revenue, which grew by 17.4 percent year-on-year in nominal terms in the first six months of 2018, nearly twice the 8.8 percent in the first six months of 2017. The rise in tax revenue is in large part due to the implementation of the first package of the government's Comprehensive Tax Reform Program (CTRP), which generated Php33.7 billion (0.4 percent of GDP) in additional tax revenue.

Table 2. Actual and Programmed Public Expenditures in the Philippines, H1 2016 - H1 2018										
	LEVEL						GROWTH			
	H1 2	016	H1 2	2017	H1 2	018	H1 2	017	H1 2018	
	Program	Actual								
Current operating expenditures	1,409	923	1,013	1,001	1,138	1,155	-3.4	8.5	12.3	15.4
Personal services	396	339	402	383	436	461	1.4	13.1	8.5	20.1
Maintenance and other operating expenditures	237	217	216	208	238	242	-8.8	-3.9	10.3	16.3
Subsidy	39	37	27	58	68	68	-30.8	59.0	152.8	16.3
Allotment to Local Government Units	171	171	196	195	212	211	14.7	13.7	7.8	8.1
Interest Payments	194	154	164	152	173	166	-15.9	-1.4	5.8	9.2
Tax Expenditures	12	5	9	5	8	8	-21.7	-11.3	-8.9	74.5
Capital Outlays	329	295	311	331	448	448	-5.3	12.4	43.8	35.1
Infrastructure and other capital outlay	261	229	237	249	353	353	-9.3	8.8	49.1	41.6
Equity	10	9	2	3	4	3	-77.2	-62.4	60.9	-18.8
Capital transfer to local government units	58	57	72	79	92	92	25.2	37.9	28.0	17.0
Net Lending	9	4	13	-1	1	1	45.3	-131.7	-88.8	-207.7
Total	1,386	1,221	1,337	1,331	1,569	1,604	-3.5	9.0	17.4	20.5

Source: DBM

²² Capital outlays are expenditures on goods and services, the benefits of which extend beyond the fiscal year and add to the government's assets, including investments in the capital stock of government-owned and controlled corporations and their subsidiaries. The following expense classes are included in capital outlays: i) infrastructure outlays; ii) equity; and iii) capital transfers to local government units. Source: https://www.dbm.gov.ph/wp-content/uploads/BESF/BESF2015/GLOSSARY.pdf.

Additional tax-policy and administrative reforms are currently undergoing legislative review. The government's second package of its CTRP is one of eight priority bills for the rest of 2018. The second package aims to improve the equity and efficiency of the corporate income tax (CIT)²⁴ and increase public revenue by rationalizing tax incentives while gradually lowering the CIT rate from 30 percent to 20 percent by 2029 under the House of Representatives' version, while the Senate version cuts the CIT rate to 25 percent in the first year of its implementation. While the Philippines' CIT rate is the highest in the region, the tax collection suffers from the lowest tax efficiency among peers (Table 4). The government aims to ratify the second package in November 2018. In addition, complementary package 1B (i.e., HB 7105) was filed in Congress on February 6, 2018 and aims to improve the tax administration by relaxing the country's bank secrecy law and encouraging new listings through a general tax amnesty and estate tax amnesty. Also, it aims to increase revenue collection through an adjustment of the motor vehicle user charge.

Table 3. Actual and Programmed Public Expenditures in the Philippines, H1 2016 - H1 2018										
		in billions PHP			Growth (percent)			Percent to GDP		
	H1 2016	H1 2017	H1 2018	H1 2016	H1 2017	H1 2018	H1 2016	H1 2017	H1 2018	
Revenues	1,101	1,176	1,411	1.4	6.8	19.9	16.0	15.6	17.1	
Tax Revenue	983	1,069	1,255	10.1	8.8	17.4	14.3	14.2	15.2	
Non-tax Revenue	118	107	156	-38.8	-9.0	45.2	1.7	1.4	1.9	
							0.0	0.0	0.0	
Expenditures	1,221	1,331	1,604	13.9	9.0	20.5	17.7	17.7	19.5	
Current operating expenditures	923	1,001	1,155	6.1	8.6	15.3	13.4	13.3	14.0	
Personal services	339	383	461	4.4	13.1	20.1	4.9	5.1	5.6	
Maintenance and other operating expenditures	217	208	242	20.8	-3.9	16.3	3.1	2.8	2.9	
Subsidy	37	58	68	-16.8	59.3	16.1	0.5	0.8	0.8	
Allotment to Local Government Units	171	196	211	9.9	14.2	7.6	2.5	2.6	2.6	
Interest Payments	154	159	166	1.5	3.1	4.4	2.2	2.1	2.0	
Tax Expenditures	5	5	8	-41.8	-11.3	74.5	0.1	0.1	0.1	
Capital Outlays	295	331	448	-47.2	12.3	35.3	4.3	4.4	5.4	
Infrastructure and other capital outlay	229	249	353	52.4	8.8	41.6	3.3	3.3	4.3	
Equity	9	3	3	2,733.3	-62.4	-18.8	0.1	0.0	0.0	
Capital transfer to local government units	57	78	92	15.6	37.1	17.7	0.8	1.0	1.1	
Net Lending	4	-1	1	57.7	-131.7	-207.7	0.1	0.0	0.0	
Budget surplus/deficit	-120	-154	-193	-975.3	28.4	25.0	-1.7	-2.1	-2.3	

Source: BTr.

Table 4. Corporate Income Tax Efficiency, 2006-16 (Average)

Corporate Income Tax	Philippines	Indonesia	Thailand	Malaysia	Vietnam
Tax Rate	30%	25%	20%	24%	20%
Revenue (% of GDP)	3.5	2.7	5.0	7.6	6.7
Tax Efficiency	11.6	10.8	25.0	31.8	33.5

Source: Haver Analytics, Bureau of Internal Revenue, KPMG, and Deloitte.

Notes: Tax Efficiency is calculated as the ratio of tax revenue as a share of GDP divided by the tax rate.

24 On September 10, 2018, the House of Representatives approved the second package of the government's CTRP, House Bill (HB 8083) also known as the Tax Reform for Attracting Better and High-quality Opportunities (TRABAHO). The corresponding senate version (i.e., Senate Bill No. 1906), known as the "Corporate Income Tax & Incentives Reform Act," was filed on August 2, 2018 and is currently undergoing hearings in the Senate Ways and Means Committee.

EMPLOYMENT AND POVERTY: LABOR MARKET CONDITIONS CONTINUE TO REMAIN TIGHT

The unemployment rate inched further down to 5.5 percent in the first half of 2018, indicating continued labor market tightness. Sustained growth in real household income among the poor suggests that poverty may have declined further until 2017.

A continuous decline in labor force participation has contributed to the persistent low unemployment rate. Labor force participation in the Philippines continued its declining trend in the first half of 2018 (Figure 17). It dropped sharply from 63.5 percent in 2016 to 61.2 percent in 2017, before falling to 60.9 percent (43.3 million people) in the first four months of 2018, well below the long-run average of 63.9 percent during the period 2005-2017. This was partly the result of a newly created senior high school program that extended basic education with an additional two years.²⁵ The recent estimate of 39.5 percent for the cohort 15-24 years old is 5.4 percentage points lower than it was in April 2016 a few months before the senior high school was implemented. However, the Philippines' female labor force participation rate (46.5 percent) continues to rank among the lowest in the East Asia Pacific region, behind that of Cambodia (84 percent), Vietnam (78 percent), China (69 percent), Thailand (68 percent), and Myanmar (65 percent).

Figure 16. While the unemployment rate remained around 5.5 percent in the first half of 2018, underemployment increased slightly...



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

Unemployment rate hovered around 5.5 percent since 2016 (Figure 16). The unemployment rate stood at 5.5 percent in April 2018, slightly lower than the 5.7 percent in April 2017. Ilocos (7.3 percent), CALABARZON (6.6 percent)²⁶, and National Capital Region (NCR) (6.4 percent) were the regions with the highest unemployment rates in April. About 52,000 net jobs were created on average each month between April 2017 and April 2018. The industry sector expanded its share of total employment to 19.7 percent in April (compared to 18.5 percent in April 2017), mostly due to employment growth in the construction subsector. The service sector continues to employ more than half of the population, with a 56.4 percent share in April 2018, slightly higher than the 55.4 percent in April 2017. Meanwhile employment in agriculture continued to contract, from 26.1 percent in April 2017 to 23.9 percent in same month in 2018.



LABOR FORCE PARTICIPATION RATE (PERCENT)



25 The first cohort of grade 12 students graduated in March 2018

Figure 18. Between 2017 and 2018, new jobs were created in the construction and public services sectors...



Figure 19. ...while the professional services subsector experienced the highest job expansion among services.





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

While the underemployment rate remained relatively high at 17 percent, the quality of jobs showed signs of marginal improvement. The underemployment rate declined from 18.0 percent in January 2018 to 17.0 percent in April 2018, yet still higher than the average of 16.2 percent in 2017. Nevertheless, there were some indications that the quality of jobs is improving. First, most of the rise in overall underemployment was in service sector. Share of underemployment in services increased from 44.4 percent in April 2017 to 47.1 percent in April 2018.27 Second, a third of 625,000 net jobs created between April 2017 and April 2018 were in construction, followed by 18 percent in public administration, defense, and social security (Figure 18). Jobs in construction are on average higher paid jobs than nonskilled service jobs. There was also an increase in high-skilled jobs in sectors such as professional services in the same period. While professional services jobs represented only 4 percent of all new jobs created between April 2017 and April 2018, they grew by 22 percent in the same period (Figure 19). Third, the share of workers in private establishments increased from 48.8 percent in April 2017 to 50.3 percent in the same month of 2018, whereas the share of selfemployed workers without pay and family workers declined in the same period.

While real wage growth remained flat in the first month of 2018, wage income remained the main source of income for households in 2017. In January 2018²⁸, the real daily wage averaged Php282.4, a slight decline from same period in 2017 of Php285, but higher than 2017 average of Php281.8. (Figure 20 and Figure 21). Meanwhile, the movement of workers from agricultural employment to non-agricultural wage jobs has continued in recent years and it is reflected in the structure of household incomes. Based on estimates from the Annual Poverty Indicators Survey,²⁹ the share of wages in household income has increased over time, and wages accounted for about 50 percent of total household income in 2017 from 44 percent in 2007 (Figure 22). This has been especially evident among households in the bottom quintile where the share of wages in total income increased from 32 percent in 2007 to 44 percent in 2017. The World Bank's recent poverty assessment for the Philippines shows that the movement of labor out of agriculture and increase in wage income, government transfers, and remittances were the key drivers of poverty reduction in the last decade.³⁰

²⁷ Services sector tends to have the lowest quality job among non-agriculture jobs.

²⁸ Latest available Labor Force Survey data.

²⁹ Conducted by the Philippine Statistics Authority in non-Family Income and Expenditure Survey years. The survey collects an abridged version of the FIES modules on household income and expenditure. Though since 2014, the food expenditure module is the same as that of the FIES. Unlike the FIES, the reference period for the APIS is only for the first half of the year. This series is used in this analysis to reflect more recent information on welfare.

Figure 20. The average real daily wage increased in the first month of 2018 compared to 2017 average...



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

Figure 22. The share of wages in total household income has increased over time.



SHARE OF WAGE INCOME TO TOTAL HOUSEHOLD INCOMES (PERCENT)

Figure 21. ...while the average wage declined compared to the same period a year ago.





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

Figure 23. The share of transfers and remittances in the income of households in the bottom quintile nearly tripled in 2007-17.

SHARE OF TRANSFERS AND REMITTANCES TO TOTAL HOUSEHOLD INCOMES (PERCENT)



Source: Annual Poverty Indicators Survey, various rounds

While there is no definitive poverty data yet from the official household survey for the period since 2015, there are indications that poverty has been reduced until 2017. For instance, information from the 2017 Annual Poverty Indicators Survey suggests household per capita income continued to increase faster than inflation and the income of the bottom 40 percent of the population grew at a faster rate than that of the average population. (Figure 24).

Figure 24. Incomes of households in the bottom quintile are growing at a faster rate than the income of the average household.



Note: Real household income scaled to 2007 values. Source: Annual Poverty Indicators Survey, various rounds





PART 02 OUTLOOK AND RISKS

The Philippines' medium term economic growth outlook remains positive, yet downside risks have increased. World Bank baseline economic growth is projected at 6.5 percent in 2018, 6.7 percent in 2019, and 6.6 percent in 2020. The baseline investment growth outlook is positive and planned senatorial and local elections in May 2019 are expected to lead to higher public spending and higher private consumption. However, persistent high domestic inflation could have a dampening effect on consumption and investment growth. Also, a faster normalization of monetary policy in the United States and an increase in global uncertainty, including trade tensions, could not only worsen external financing conditions for emerging market economies like the Philippines but also elicit additional domestic interest rate hikes that could raise domestic borrowing costs for businesses and households. While progress on poverty reduction is likely to continue as the economy maintains its high growth rate, persistent high food inflation presents a risk to poverty alleviation in 2018 as food items represent over two-thirds of the total expenditure of poor households.

GROWTH OUTLOOK

Economic growth in 2018 is projected to recover from a slowdown in the first half of the year to reach 6.5 percent for the whole year, driven by a rise in public investment and a robust private demand. The World Bank expects growth of 6.7 percent in 2019 and 6.6 percent in 2020. The government is expected to continue its expansionary fiscal policy while monetary policy will continue to manage inflation expectations.

The Philippines' medium term growth outlook remains strong, supported by an expected rise in public investment spending and a robust private demand. The World Bank baseline forecast projects the Philippines economy to expand by 6.5 percent year-on-year in 2018, 6.7 percent in 2019, and 6.6 percent in 2020 (Figure 25).³¹ GDP growth is expected to accelerate in the second half of 2018 and in early 2019, boosted by upcoming senatorial and local pre-election spending and continued strong public investment growth. This is consistent with the government's plan to speed up the implementation of its infrastructure program. Investment spending is expected to accelerate given the slowdown in global trade. Private consumption growth is projected to remain strong, supported by a steady labor market, a continued inflow of remittances, and inflation easing.

Global growth is expected to moderate in the medium term, driven by a gradual slowdown in advanced economies and a moderate slowdown in global trade (Box 4). Although global growth is expected to remain strong at 3.1 percent year-on-year in 2018, it is expected to moderate in both 2019 and 2020. Underlying factors for the moderation include a slowdown in global trade and tightening

financing conditions related to monetary policy normalization in the United States. The expected slowdown in global trade will mute the growth prospects of Philippine exports. GDP growth projections assume similar export growth of the second quarter of 2018 in the medium term, as no rapid recovery in global trade is expected in the next couple of years.

Figure 25. The Philippines' Growth Trajectory is Positive but Lower than Expected.



Source: PSA, World Bank staff estimates

The current-account deficit is expected to widen as export growth moderates while import growth remains strong. While export growth is expected to remain moderate given the slowdown in global trade, import growth is likely to remain strong, as the government is expected to speed up the implementation of its infrastructure investment plan. This is consistent with the recent acceleration in public construction growth, which accelerated from 9.9 percent year-on-year in the first half of 2017 to 15.9 percent in the first half of 2018. In addition, public spending on infrastructure and capital outlay increased by 41.6 percent year-on-year in the first half of 2018, substantially higher than the 8.8 percent in the same period in 2017. The growth momentum in investment spending is expected to continue in the coming years as the government's infrastructure investment projects gain traction.

The World Bank's growth forecasts for the Philippines assume an acceleration in public investment growth in the medium term. Public consumption growth is expected to sustain at a high level until the first half of 2019, driven by upcoming senatorial and local pre-election spending, and is likely to remain at high levels in the medium term as the government continues to focus on closing the human and physical capital gap. Meanwhile, the implementation of projects under the Build Build Build program is expected to

accelerate in 2019 (Box 5). This is reflected in the proposed 2019 budget as it increases the share of allocated cash-based expenditure on public works and transportation. The share of expenditure allocated to public works is set to increase from 13.3 percent in 2018 to 14.8 percent in 2019, while the share for transportation will increase from 1.2 percent to 2 percent in the same period (Box 6).

The government's proposed 2019 national budget of Php3.76 trillion (around 19.4 percent of GDP) focuses on ramping up investments in infrastructure and education. The proposed 2019 budget will shift to an annual cash-based budget for the first time in history. The proposed budget was submitted to Congress by the Department of Budget and Management on July 23, 2018 and is 13.0 percent larger than the 2018 cash-based equivalent. It continues the government's spending priorities from previous years, focusing on increasing investments in infrastructure and education to achieve rapid and sustained inclusive growth for the country (Box 7). The transition to a cash-based budget aims to improve fiscal discipline and accountability in the national government to improve underspending in the government through reforming the budget process (Box 6). The budget is currently undergoing parallel deliberations in the House of Representatives and the Senate of the Philippines.

Box 4. The Global Economic Outlook

Global growth is projected to remain strong in 2018, but early indicators hint of slowing economic activity. Global growth is expected at 3.1 percent year-on-year in 2018—the same growth rate as the 2017 projection for 2018 (Figure 26 and Table 5). However, growth projections for 2019 and 2020 have softened to 3.0 percent and 2.9 percent, respectively, as trade and investment growth moderate and financing conditions tighten. Economic growth in advanced economies is expected to decelerate toward their potential rates, as monetary policies normalize and the effects of fiscal stimuli wane. By contrast, growth in emerging market and developing economies (EMDEs) is expected to rise in the next three years, reflecting sustained growth among commodity importers and rising growth among commodity exporters.

The pace of global trade growth is expected to moderate. The global trade of goods and services is expected to grow by 4.3 percent year-on-year in 2018, down from a six-year high of 4.8 percent in 2017 (Figure 27). A projected decrease in capital spending in China and in most advanced economies will contribute to more moderate global trade growth in the short term. Over the medium term, structural factors such as slower growth of global value chains and a reduced appetite for further trade liberalization will constrain global trade growth. On the policy front, the outcome of some trade negotiations remains uncertain, and the risk of escalating trade restrictions has intensified, as new tariff announcements by the United States have led to retaliatory responses by major trading partners. Global financing conditions are expected to tighten over the medium term more rapidly than previously envisioned. Following a prolonged period of stable and favorable global financing conditions, prospects of a faster normalization of monetary policy in advanced economies have led to rising global borrowing costs since the start of 2018. These prospects combined with fears of escalating trade tensions and rising geopolitical risks sparked bouts of volatility in global equity markets in the first half of 2018.

In the medium to long term, policymakers in advanced economies and EMDEs need to prioritize, among others, structural reforms to boost productivity. In the short term, monetary policy in advanced economies will gradually become less accommodative, as output gaps close and inflation picks up. As monetary and fiscal stimuli wane and potential growth softens, the outlook is expected to weaken, highlighting the need for structural reforms to boost productivity and labor force participation. Meanwhile, EMDEs need to be able to cope with monetary policy normalization in advanced economies as well as manage possible bouts of financial market volatility and inflation risks. Furthermore, deteriorating debt dynamics have reduced fiscal space in many countries, underlining the importance of revenue mobilization and medium term fiscal frameworks to rebuild fiscal buffers. EMDEs face various structural challenges to achieve long-term growth, including the need to improve skills and adaptability to confront rapid technological change, promote regional trade integration, and enhance productivity.

Box 4. The Global Economic Outlook (continued)

Figure 26. Global growth in 2018 is projected to grow at the same rate as in the previous.

AGGREGATE GROWTH RATES (IN PERCENTAGE)

mm



Figure 27. Global trade is expected to slow down in 2018.

GLOBAL TRADE AND INVESTMENT (AVERAGE OF EXPORT AND IMPORT VOLUMES)



Notes: EMDEs = emerging market and developing economies. Shaded area indicates forecasts. Aggregate growth rates calculated using constant 2010 U.S. dollar GDP weights. Data for 2017 are estimates. Source: GEP June 2018 Notes: Shaded area indicates forecasts. Trade measured as the average of export and import volumes. Source: GEP June 2018

Table 5. Real GDP Growth Rates, Recent and Projected

	2015	2016	2017e	2018f	2019f	2020f	
World	2.8	2.4	3.1	3.1	3.0	2.9	
Advanced economies	2.3	1.7	2.3	2.2	2.0	1.7	
Emerging market and developing Economies	3.7	3.7	4.3	4.5	4.7	4.7	
Developing East Asia & Pacific	6.5	6.3	6.6	6.3	6.1	6.0	
Philippines	6.1	6.9	6.7	6.7	6.7	6.6	

Note: Developing East Asia & Pacific includes Cambodia, China, Fiji, Indonesia, Lao PDR, Malaysia, Mongolia, Myanmar, Papua New Guinea, Philippines, Solomon Islands, Thailand, Timor-Leste, and Vietnam. Source: World Bank (2018c)

Box 5. Progress on the Build, Build, Build Program

As of July 27, 2018, seven out of 75 flagship projects under the Build, Build, Build program have begun implementation.^{32,33} Out of 75 infrastructure projects (amounting to Php-9 trillion), 35 (totaling Php1.24 trillion) have received approval from the board of directors of the National Economic and Development Authority (NEDA) (Table 6). 31 projects, at an estimated cost of Php624.5 billion, are still under review, and the remaining nine projects do not require approval from NEDA's board. 17 out of the 35 approved projects are targeted to be implemented in 2016-18 (Table 7). Nine projects with approved infrastructure plans are expected to start in 2019 at an estimated cost of Php418 billion, five more in 2020 at an estimated cost of Php13.7 billion,

and another four in 2021 at an estimated cost of Php12.1 billion. These projects are targeted for completion between 2021 and 2025. The government expects construction activities to have started for a majority of the 35 approved projects by the end of 2018. However, only seven projects have been implemented since 2016. Right-of-way issues, contractors' lagging schedule, and delays in fund disbursements were some of the reasons for the setbacks.³⁴ Moreover, procurement laws that restrict foreign contractors, a supply shortage of local contractors, and inefficient domestic construction firms also contributed to the delays.³⁵

Table 6. Projects Pending NEDA's Board Approval under the Build, Build, Build Program

Target start of implementation	Project cost (Php billion)	Number of projects
2018	254.8	12
2019	232.1	10
2020	55.5	5
2021	10.5	1
TBD	71.6	3
Total	624.5	31

Table 7. Flagship Projects with Target Implementation under the Build, Build, Build Infrastructure program

Target start of implementation	NEDA Board-Approved	For NEDA Board's approval	Not for NEDA Board's approval	Total
2014			1	1
2016	1			1
2017	2		1	3
2018	14	12	4	30
2019	9	10		19
2020	5	5	1	11
2021	4	1		5
TBD		3	2	5
Total	35	31	9	75

Source: NEDA

³² Source: NEDA. Infrastructure Flagship Projects as of July 27, 2018. Available at: http://www.neda.gov.ph/wp-content/uploads/2017/07/IFPs-as-of-July-27-2018-final.pdf

³³ Gonzales (2018), Rivas (2018), and Velasco (2018).

³⁴ Velasco (2018).

³⁵ Torres (2018).





The Philippines government will change the basis of public budget appropriations in 2019. Congress has previously approved budgets on an obligations basis, meaning that agencies were authorized to spend cash and enter into contractual commitments during the budget year up to a limit of the budget approved by Congress. 'Obligated' amounts do not have to be paid during the budget year. Moreover, goods and services under 'obligated' contracts do not necessarily have to be delivered in the budget year and payments can be made in future years within the conditions set in contracts and annual budget laws.

Annual cash appropriations will require agencies to obtain and pay for goods and services within the relevant budget year. In 2019 the Philippines government proposes to allow a three month 'extended payment period (EPP)' after the end of the budget year for payments on goods accepted by December 31 of the budget year. This may be continued for future years, subject to budget policy.

This change of appropriations will entail a significant tightening of the timeframe for expenditures compared with obligation-based appropriations. This aims to increase discipline in agencies to plan, execute and pay for their expenses during a single year. This will have little impact on agencies whose expenses are primarily recurrent outlays such as salaries and existing contractual arrangements, it will require robust estimates of the timing for contract award, delivery, and payment for capital investments and new major procurements during the budget year. The move to annual cash appropriations is an extension of the gradual firming up of appropriations that has occurred in the last few years. In 2017 the budget moved from a 2-year obligation based budget to a 1-year obligation-based budget.

The government has made special provisions for multi-year activities by establishing a multiyear obligational authority (MYOA), drawing on an existing policy included in procurement law (RA 9184). This will enable agencies to plan and commit expenditures beyond the budget year for activities covered by the MYOA.

This change in appropriations will bring the Philippines into line with most other countries and will institute a generally accepted good practice in budget discipline. It will provide greater certainty to Government and Congress on the expected amount of disbursements during the budget year. It will also benefit agencies as it will provide more focus on planning and implementing the current year's budget. It will facilitate better aggregate cash planning and may result in savings from more predictable cash balances. At the agency level, it will encourage greater focus on accurate planning, timely procurement and budget execution, and cash monitoring.

Box 7. The Proposed 2019 National Budget



The 2019 national government budget continues to build on the Duterte Administration's budget priorities from past years, following the government's 0-10 Point Socioeconomic Agenda. The proposed budget, amounting to PhP3.76 trillion, represents a 13.0 percent expansion compared to the Php3.32 trillion cash-based equivalent in 2018. Similar to the previous year's budget, the proposed 2019 budget prioritizes investments in infrastructure and education (Figure 28). On a cash-appropriation basis, the education budget is set to increase by 12.3 percent year-on-year in nominal terms compared to its 2018 cash-based equivalent, to reach Php659.3 billion in 2019, which represents around 17.5 percent of the proposed total 2019 budget—similar to the 17.7 percent share of the education budget in the total 2017 budget. In addition, the 2019 budget for the government's flagship infrastructure program "Build, Build, Build, Build" amounts to Php909.7 billion, roughly a quarter of the proposed total 2019 cash-based budget and equivalent to around 4.7 percent of GDP.³⁶ Through the government's "Build, Build, Build



Figure 28. Top Recipients of the National Budget (2018 & Proposed Cash-based 2019).

A commitment to maintain fiscal discipline is central to the government's programmed budget and its medium term fiscal stance. As the government continues to increase spending in priority sectors, it raised its fiscal deficit target from 3.0 percent of GDP in 2018 to 3.2 percent of GDP in 2019. Despite raising the fiscal deficit target, the government remains committed to maintaining the overall fiscal health of the Philippines, and it aims to lower the overall fiscal target back to 3.0 percent of GDP in 2020 and 2021. To that end, the government seeks to pass additional revenue-generating tax-policy reforms and improve the tax administration through passing the comprehensive tax reform package 1B and continuing to implement package 1A of the TRAIN law. Packages 1A and 1B are expected to raise additional revenue of Php181.4 billion in 2019 (around 0.9 percent of GDP), which is expected to help keep the government's fiscal balance at a manageable level.

Source: Department of Budget and Management.

Inflation is expected to remain above the central bank's target in 2018 and 2019, before gradually declining to below 4.0 percent in 2020. The recent rise in inflation was driven by supply-side factors in agriculture, higher global oil prices filtering through a weaker peso, new excise taxes, and demand-driven pressures. As supply restores and various measures to temper inflation become effective³⁷, inflation is projected to decline gradually from an average of 5.2 percent in 2018 to 4.4 percent and 3.8 percent in 2019 and 2020, respectively. These projections are in line with those of the BSP, which estimates that the inflation rate will remain above target range in 2018 and 2019, before falling to below 4.0 percent 2020. The decline in inflation is expected to be gradual, as global oil price is forecast to remain high and fuel excise tax rates will be updated in 2019 and 2020.³⁸ Higher fuel costs would spill into the rest of the economy. In addition, crop damages caused by new weather disturbances such as the recent Typhoon Ompong might add additional pressure to food inflation. As a result, inflation rate is expected to remain relatively high during the forecast period. Nevertheless, the BSP is committed to closely monitor inflation developments and manage inflation expectations by raising the key policy rate.

Private consumption growth is expected to remain strong in the medium term, supported by a steady labor market, a continued inflow of remittances, and inflation easing. Growth in private consumption is expected to accelerate slightly from 5.7 percent year-on-year in the first half of 2018 to 5.9 percent in the second half of 2018 as economic growth accelerates driven by an acceleration in public spending and inflation rate eases. It is expected to remain strong at around 6.0 percent year-on-year in 2019 supported by a boost from pre-election activities, before decelerating slightly

to 5.8 percent in 2020. In addition, a faster implementation of infrastructure projects will support growth in the construction sector and generate job opportunities. Furthermore, a sustained inflow of remittances and inflation easing up will support robust private consumption.

The services sector is expected to remain the main growth engine in the medium term while growth in manufacturing and agriculture follows recent trends. The upcoming elections in 2019 and an acceleration in public infrastructure projects implementation is expected to accelerate service growth to 6.8 percent year-on-year in 2018 from 6.7 percent in 2017, and 6.9 percent in 2019, before moderating to 6.7 percent in 2020. Government services and the trade, transport, commerce, and storage sectors are expected to sustain their 2018 growth rates, 14.2 percent and 6.4 percent in the first half of 2018, respectively (7.1 percent and 3.8 percent over the same period in 2017). In addition, growth in the financial sector is expected to remain strong. Industry growth is expected to accelerate slightly from 7.2 percent year-on-year in 2017 to 7.3 percent in 2018, and to 7.6 percent in 2019 and 2020, driven by a dynamic construction sector. Meanwhile manufacturing growth is projected to remain strong, although at a lower level relative to previous years, as global trade is expected to slow down. Growth in the agriculture sector is expected to recover slightly from 0.7 percent year-on-year in the first six months of 2018 to average 1.0 percent in 2018 and 1.1 percent in both 2019 and 2020. The slow projected recovery in agriculture growth is partly related to the high base in 2017 (4 percent year-onyear), the sector's unresolved productivity challenges, and increasing loss from natural disasters, the most recent one being Typhoon Ompong.

	2015	2016	2017	2018f	2019f	2020f	
Real GDP growth, at constant market prices	6.1	6.9	6.7	6.5	6.7	6.6	
Private Consumption	6.3	7.1	5.9	5.8	5.9	5.8	
Government Consumption	7.6	9.0	7.0	12.8	11.9	9.8	
Gross Fixed Capital Investment	16.9	26.1	9.5	16.2	15.0	15.0	
Exports, Goods and Services	8.5	11.6	19.5	11.4	13.0	13.0	
Imports, Goods and Services	14.6	20.2	18.1	15.7	15.7	15.3	
Inflation (period average)	0.7	1.3	2.9	5.2	4.4	3.8	
National government balance (% of GDP)	-0.9	-2.4	-2.2	-2.5	-2.8	-2.8	
Current account balance	2.5	-0.4	-0.8	-1.1	-1.3	1.4	

Table 8. Economic Indicators for Baseline Projection

Source: PSA, BSP, BTr, World Bank Staff estimates

37 The BSP raised its key policy rate from 3.0 percent to 4.5 percent in a bid to manage inflation expectation. The government also banks on other measures to temper rising inflation. One such measure is House Bill 7735 or the Revised Agricultural Tariffication Act, to lift the 805,200-ton limit to rice imports and replace with a general tariff. The bill will allow more entry of rice into the country which will lead to lowering of the price of rice. A senate bill counterpart is currently being deliberated. Moreover, an executive order has been signed to ease restriction on the importation of fish, vegetable, meat and other food products is to manage food prices. Meanwhile, social mitigation measures such as the unconditional cash transfer are being fast-tracked, and transport-related subsidies under the TRAIN law being considered to address the soaring prices.

38 The excise tax rate for regular gasoline will increase from Php7.0 per liter in 2018 to Php9.0 and Php10.0 per liter in 2019 and 2020, respectively, while the rate for diesel fuel will increase from Php2.5 per liter in 2018 to Php4.5 and Php6.0 per liter in 2019 and 2020, respectively.

POVERTY AND SHARED PROSPERITY OUTLOOK

Household incomes will continue to grow but persistent high inflation may slow down poverty reduction

Inclusive growth is likely to continue to contribute to poverty reduction. Sustained high economic growth will facilitate growth of household incomes through wages and sustained domestic remittances. Social cash transfers from government are likewise expected to continue in the coming years. Based on economic growth outlook, poverty rate based on the lower middle-income poverty line of US\$3.20/day, is projected to decline from 27.0 percent in 2015 to 23.0 percent in 2018, 21.8 percent in 2019, and 20.9 percent in 2020. These projections would imply a continuing trend of one million Filipinos being lifted out of poverty each year (Figure 29).

However, rising inflation may negatively impact the welfare of the poor. The increase in inflation is to large extent due to higher prices of basic commodities such as food and non-alcoholic beverages and fuel. These prices picked up by the first half of the year at a faster rate than the average in 2017. Poor households are disproportionately affected by the increasing prices since they spend a significant share of their incomes on these basic commodities. Estimates from APIS 2017 show that about 67 percent of expenses of households in the bottom quintile are on food and transportation.

The recent Typhoon Ompong might have impacted the poor and vulnerable households disproportionately. As of September 19, there are 264,304 family affected, about a third of the number of families affected during Typhon Lando. A large share of the population displaced and affected by Typhoon Ompong are farmers and vulnerable groups. Given the poor households are more likely to live in fragile housing, have less savings and insurance, and have less resources, they are more exposed to the shocks and have lower capacity to cope. Many displaced households lost their jobs and incomes, or even family members. In addition, if food prices

Figure 29. Poverty reduction will likely continue in the coming years



surge after the typhoon, the poor and vulnerable households would be disproportionally more affected as a larger share of their consumption is on food.

Mitigation measures are being roll out for the poor households. The government has started to roll out the unconditional cash transfer program. Existing 4Ps beneficiary households have started to receive cash grants of Php200 per month since February 2018. The government has allocated Php25.7 billion for the program this year and 10 million households are expected to benefit from the program. In 2019, the unconditional cash transfer program will increase the transfer amount to Php300 per month. Other counteracting factor to the high inflation includes farm gate prices co-moving with increasing food prices resulting to income gain of farming households. In addition, the government has rolled out fuel voucher cards to public utility jeepney drivers and operators to mitigate the impact of recent oil price increase and higher excise taxes.³⁹



Figure 31. ... and poor households are affected



HOUSEHOLD EXPENDITURE SHARES BY INCOME QUINTILE (PERCENT)

Source: Annual Poverty Indicators Survey 2017, PSA

RISKS AND POLICY CHALLENGES

Economic growth outlook is subject to several downward risks. External risks include a rapid slowdown in global trade and a tighter than expected financing conditions. Domestic risks include persistent high inflation and slower than expected implementation of the government investment program. Pace of current account deficit widening will need to be monitored closely to preserve macroeconomic fundamentals.

External risks have increased. Protectionist sentiments have intensified in some advanced economies recently, and a further escalation of the ongoing trade war remains a possibility. In addition, there is a risk of disruption in financial markets, as the situation in Turkey worsens and contagion fear in emerging markets triggers faster capital reversals. These risks affect the Philippines through trade and financial markets. A slowdown in Chinese exports may indirectly impact Philippine exports, as the country is integrated into China-led value chains. While the impact of the risk through trade is currently small, they are not negligible if trade disputes escalate (Box 8).

In particular, financial risks are high as the Philippines is more vulnerable to capital flows than neighboring countries. Philippines has a relatively low "basic balance", that is the difference between foreign direct investment and current account balance compared to Malaysia and Thailand. This implies that the Philippines peso is more sensitive to changes in portfolio capital flows of smaller magnitude as equity flows are the main "mover" of the peso. For instance, the uncertainty in global financial markets has led to foreign capital outflow from the Philippines Stock Exchange, whose index dropped from above 9,000 in January 2018 to 7,856 in August 2018. The intensified net portfolio investment outflow and the deceleration in net export growth further weakened the peso, which depreciated by 7.0 percent year-to-date in the first eight months of 2018. Therefore, an increased uncertainty in the financial markets and weakened investor sentiments toward emerging markets may have a large impact on the Philippines, resulting in more capital outflows, higher financing costs, and a further pressure on the peso.

The effect of persistent high inflation on private consumption growth constitutes a domestic risk to economic growth. The BSP is committed to managing inflation expectations and lowering the inflation rate to the 2-4 target range in 2020. However, delays in resolving the economy's supply constraints including the added pressure by the recent Typhoon Ompong, and the further depreciation of the pesos may raise inflation in the medium term. Persistent high inflation may slow private consumption growth. Recent high inflation was mainly driven by rising food prices, and it disproportionally affected vulnerable households, as they spend more than half of their budget on food, eroding real income and depressing demand. Higher inflation may also trigger further policy rate increases that in turn will increase overall financing costs and decelerate private investment growth.

The investment growth outlook depends on the timely and effective implementation of government investment program. Although data from early 2018 showed signs of improvement in budget execution, underspending remains a concern for the national government, particularly in terms of its Build, Build, Build infrastructure program. In an effort to improve budget execution and program implementation, the government transitioned to a cash-based budget for 2019, which limits the validity of the national budget to one year, compared to the multi-year validity of the previous obligation-based budget. The government hopes that a cash-based budget will improve budget execution by ensuring that only implementation-ready projects are included in the budget. It also expects that this will improve the planning and fiscal discipline among public agencies. However, binding constraints to efficient budget execution must be addressed at the agency level to ensure a smooth transition to the cash-based system. Specifically, the government needs to tackle issues related to weak program and project design, procurement difficulties, and limited absorptive capacity.

Box 8. Potential Impact of the United States-China Trade War on the Philippines⁴⁰

The United States-China trade war raises fear of global trade disruptions and slower global growth. A recent World Bank simulation shows that the trade war between the United States and China could reduce global exports by up to 3.0 percent and global income by up to 1.7 percent, with losses across all regions.^a The trade dispute threatens the world economy by increasing the costs of inputs and final products, dampening investors' sentiment and disrupting trade. Many countries in the East Asia Pacific (EAP) region are particularly exposed to the trade war, given their integration into the global economy via trade and investment linkages. The Philippines is no exception and can potentially be impacted by the trade war through financial market, investment, and trade channels.

The escalating trade war heightens uncertainties in financial markets and weakens investor sentiments toward emerging markets like the Philippines. Although recent financial market volatility in the Philippines and capital outflows from the country were initially driven by tighter monetary policy in the United States, the threat of trade wars has contributed to heightened uncertainty. This uncertainty contributed to foreign capital outflows from the Philippine Stock Exchange, whose index steadily dropped from an all-time high of 9,058 in January 2018 to a low of 6,923 in June 2018. This divestment of assets, a result of investors flying to 'safe havens', also contributed to a further weakening of the peso, which depreciated by 4.1 percent year-on-year in the first seven months of 2018. In general, the trade tension can spillover into a moderate loss of investor confidence, leading to a reduction in global investment, which can have a negative impact on the country's financial market.

While heightened uncertainty dampens investment prospects in the short term, the United States-China trade war could lead to the relocation of direct investment away from China. Heightened uncertainty could induce producers and traders to postpone both investment plans and trade in the short term. Nonetheless, by raising the cost of serving the U.S. market from China, the trade war could lead to a diversion of investments toward Chinese competitors in the medium term. The extent to which investment may relocate to other countries would partly depend on each country's ability to produce the same affected products. Among the Philippines' southeast Asian neighbors, Vietnam and Malaysia are best positioned to host these investments, followed by Indonesia, Thailand, and the Philippines (Figure 33). If the relocation of investment is driven by Chinese investors, countries which are already large recipients of Chinese outward FDI would be in a better position to capture such flows. Again, Malaysia and Vietnam were the largest recipients of Chinese FDI in 2017, followed by Indonesia, Thailand, and the Philippines. In general, the Philippines is behind its southeast Asian neighbors in the potential relocation of direct investment away from China.

The impact of United States and Chinese tariff increases is expected to be relatively small on the Philippines' export. The July tariff hike is expected to generate a US\$11.4 billion drop in Chinese exports to the United States, concentrated in capital equipment and electronics goods. This could slightly reduce Chinese demand for intermediate goods in EAP countries, including the Philippines, which are integrated in China-led value chains. However, the expected drop in exports to the United States represents less than 1.0 percent of Chinese manufacturing exports and an even smaller proportion of total Chinese manufacturing production. As a result, the rise in tariffs is likely to have a small or negligible impact on the Philippine export, especially as the Philippines has a lower exposure to Chinese imports of intermediates compared with Vietnam, Malaysia, Thailand, and Indonesia.

The Philippines is also less likely than peers to take advantage of the potential diversion of United States imports from China. The trade diversion will depend on the similarity of export baskets between EAP countries and China. Of the 1,153 products targeted against China, only 362 of the Philippines' export product lines are similar, compared with Malaysia's 590, Thailand's 553, and Vietnam's 415 product lines. Given the different export baskets between China and the Philippines, the probability of supplying the United States market with alternative Philippine-sourced products is relatively low. Based on World Bank estimates of potential export markets (as a percentage of GDP), Vietnam has the largest potential to replace China in terms of satisfying the demand in the United States, followed by Malaysia, Thailand, and the Philippines (Figure 33).

Figure 32. Degree of similarity between export baskets to the U.S. for affected Chinese products.

Figure 33. Potential replacement of Chinese exports to the U.S. by countries in the East Asia Pacific.

POTENTIAL EXPORT MARKETS AS PERCETANGE OF GDP



PAIRWISE US IMPORT CORRELATION

4.0% 3.5% 3.0% 2.5% 2.0% 1.5% 1.0% 0.5% 0.0% Vietnam Malaysia Thailand Philippines Indonesia Potential exp mkt (X>0) (% GDP) Potential exp mkt (X>US\$1 million) (% GDP) Source: World Bank estimates.

*For affected products as of July 2018.

40 The content of this box has largely been drawn from "Potential Impact of the Trade Wars on East Asia and the Pacific," a note prepared by Max Cali et al., under the guid-

Given increased global uncertainties and inflation pressures, medium term fiscal sustainability is crucial to allow for countercyclical fiscal policy. Fiscal deficit widened in the first half of 2018. As the government continues its expansional fiscal policy, fiscal deficit is expected to further widen which will reduce fiscal space needed for countercyclical fiscal policy amid negative shocks. For instance, the government plans to allocate more resources for its ambitious infrastructure agenda and raise public-sector wages in 2019.42 To keep the fiscal deficit within the target of 3.2 percent in 2019 and 3.0 percent in 2020, the government will need to improve revenue collection. While additional revenue will be generated from TRAIN (estimated at Php144. billion, approximately 0.7 percent of GDP) in 2019, the government is also expected to generate Php37.2 billion (0.2 percent of GDP) from package 1B of the CTRP, which will help contain the fiscal deficit in 2019. However, the government needs to ensure that the second package of the CTRP, which introduces reforms to the corporate income tax and fiscal incentives, remains revenue neutral to maintain the country's overall fiscal health.

Furthermore, as global financing conditions tightens, it would be prudent to monitor the pace of current account deficit widening to maintain macroeconomic stability. The country is fairly resilient to capital reversals given its large foreign reserves, flexible exchangerate regime, low public debt, and robust remittance inflows. At the present juncture, maintaining the country's resilience rests in large part on preventing the current-account deficit from widening too much and too fast. Given that export growth is not expected to accelerate in the medium term, future import growth driven by public investment will need to be monitored closely to manage the pace of current account deficit widening to prevent external funding gap challenges. In addition, keeping a healthy recurrent expenditure growth will be important to retain fiscal flexibility. Wage bill expenditure increased over 20 percent in the first half of 2018 and it is expected to increase by 11.7 percent in the proposed 2019 budget. While the rapid increase was related to the expected public workers' salary increase approved in 2016, it is crucial to contain recurrent expenditure growth at similar rate of the economy growth. This is because if recurrent spending grows at a higher rate than the overall expenditure, the proportion of rigid expenditure increases⁴³, thus it reduces fiscal space needed to adopt countercyclical measures under a negative shock.

To sustain high inclusive growth in the medium term, the Philippines needs to accelerate structural reforms to boost productivity growth. External environment is expected to be less favorable going forward as global growth and trade activities moderate. While the country has been shown to be resilient, the government needs to speed up the implementation of structural reforms to boost productivity growth if it is to meet the goals set out in the AmBisyon Natin 2040. Priority policy areas include: i) improving market competition through regulatory reforms; ii) improving trade and investment climate policies and regulations; and iii) reducing labor market rigidities and costs (see Chapter 3: Special Focus Note for more details). In addition, the Philippines needs to address structural vulnerabilities in the agriculture sector to mitigate the negative effects of weather conditions on the sector and to increase domestic supply.

^{42 2019} is the last tranche of public workers salary increase that was approved in 2016. The proposed budget for personnel expenditures is 11.7 percent higher than the programmed budget for 2018 Source: http://www.officialgazette.gov.ph/2016/02/19/executive-order-no-201-s-2016/

⁴³ High rigidity expenditures include personnel expenditure (permanent), net-lending and loans outlays, and interests payments. Medium high rigidity expenditures include personnel expenditures (temporary), current transfers to educational institutions. Medium rigidity expenditures include non-staff services and other current transfers. Low rigidity expenditures include consumption goods, other current expenditure, non-financial direct investment, financial investment, and other capital transfers.



PART 03 SUSTAINING HIGH PRODUCTIVITY FOR LONG-TERM GROWTH⁴⁴

The Philippines has experienced impressive economic growth in the last two decades partly as a result of past structural reforms and the government's commitment to macroeconomic and fiscal stability. The country aims to continue its growth success by tripling its income per capita by 2040 through the government's growth plan AmBisyon Natin 2040. Accelerating capital accumulation and sustaining high TFP growth are essential to achieve the government's goals. This focus note highlights four policy reform areas that are crucial to sustaining high TFP growth in the Philippines: i) improve market competition through regulatory reforms; ii) improve trade and investment climate policies and regulations; iii) create an enabling environment for innovation; and iv) reduce labor market rigidities and costs. Market competition coupled with a flexible labor market and abundant labor supply allows higher productivity to reduce product prices, which raises the real incomes of workers. As result of more and higher paid jobs, more people will be able to move out of poverty, helping the government achieve the AmBisyon Natin 2040 and realize its vision of a society free of poverty.

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INTRODUCTION

The Philippines has become a strong growth performer since 2010, as the government implemented business-friendly reforms and the external environment improved. The country's volatile macroeconomic and political environment in the 1980s resulted in low and highly volatile growth rates that averaged 2.5 percent per year in 1980-1997⁴⁵ much lower than the average of 4.6 percent among structural peers and 7.6 percent among regional peers in the same period.^{46,47,48} However, the Philippines experienced relatively high economic growth between 1998 and 2009, as the government implemented trade, investment, and privatization reforms in the late 1980s and the 1990s. Moreover, economic growth benefited from a commitment by the government to strengthen macroeconomic stability. Favorable domestic and external conditions allowed economic growth to accelerate to an average annual rate of 6.3 percent in 2010-16, surpassing the average of both structural and regional peers.

The Philippines has articulated an ambitious goal of tripling the country's income per capita and transforming the country into a prosperous middle-class society free of poverty by 2040 (AmBisyon Natin 2040). The Philippines tripled its GDP per capita in the past 20 years as result of strong economic growth, which the government aims to repeat in the next 20 years. The government's goal is based on a set of household consumption and asset-ownership targets, including "owning a house and a car and having the ability to send children to college while maintaining a middle-class lifestyle." This focus note shows that the Philippines will need to sustain high productivity growth for the next two decades if it is to triple its GDP per capita, which will require substantial reform efforts.

GROWTH DRIVERS IN THE Philippines since the Early 1980s

Structural reforms played a key role in the Philippines' economic growth recovery and acceleration. The reforms initiated in the late 1980s and the 1990s were important for the country's initial growth recovery and subsequent acceleration two decades later. They also highlight the existence of a time-lag between the implementation and payoff of reforms, as reforms started to have an impact only in the second half of the 2000s. The growth recovery in the late 1990s was driven by trade openness, gradual financial sector opening and deepening, and infrastructure development that boosted the Philippines' external competitiveness. The cumulative effect of past reforms coupled with prudent fiscal and macroeconomic policies resulted in an impressive acceleration of economic growth in 2010-16.

Macroeconomic stability is a necessary (albeit not sufficient) condition for sustained growth. In the 1980s, the Philippines experienced a debt crisis (1983) and multiple coup d'état attempts (1986-1990), leading to growth contracting by 7.6 percent in 1984-85 and a "lost decade" in terms of economic growth. As a result, GDP per capita fell from US\$1,687 in 1980 to US\$1,572⁴⁹ in 1999. By contrast, the economic recovery of the 2000s was preceded by a restoration of fiscal discipline and a reduction of inflation. Moreover, growth acceleration in 2010-16 coincided with the continuation of macroeconomic stability and favorable external conditions. Greater macroeconomic stability coupled with the implementation of structural reforms in 2000-16 led to a near-doubling of the Philippines' GDP per capita— from US\$1,607 in 2000 to US\$2,753 in 2016.

47 The regional peer average, with the exception of China, was 5.0 percent over the same period.

48 The Philippines' growth volatility in the 1980s was five times the average of structural and regional peers, while growth volatility was around the average of structural peers but higher than the average of regional peers in subsequent decades.

⁴⁵ The Philippines experienced a debt crisis in 1983 that led to an economic contraction of 7.6 percent in 1984-85; multiple coup d'état attempts in 1986-90 that led to the 1991 recession; and the Asian financial crisis in 1997 that resulted in a 0.6 percent contraction in economic growth in 1998.

⁴⁶ Bangladesh, Kenya, Morocco, Pakistan, Sri Lanka, and Vietnam are defined as the Philippines' structural peers based on the following criteria: a) they are lower-middle-income countries; b) their natural resource exports are lower than 20 percent of total exports; c) they score above average on the Natural Disaster Risk Index; d) each country's population is above 20 million; e) they are all oil importers; f) their exports are not concentrated according to the Herfindahl index; and g) they are not landlocked countries, small states, or fragile states. China, Indonesia, Malaysia, Thailand, and Vietnam are identified as regional peers.

Figure 34. Capital accumulation in the Philippines, as a share of GDP, is the lowest among peers...



GROSS CAPITAL FORMATION: THE PHILIPPINES AND REGIONAL PEERS (% OF GDP, 1998-2016 AVERAGE)

Capital accumulation has been relatively limited in the Philippines compared to peers. The Philippines had the lowest level of capital accumulation among peers between 1998 and 2016, which was exacerbated by low net FDI inflows, averaging a mere 1.5 percent of GDP per year in 1998-15 (Figure 34 and Figure 35). The low investment rate was mainly driven by the low level of public

Figure 36. The level of public investment in the Philippines is among the lowest in the region...



PUBLIC INVESTMENT IN THE PHILIPPINES AND REGIONAL PEERS (% OF GDP)

Figure 35. ... and the inflow of net FDI is also low relative to peers.



investment, averaging only 2.5 percent of GDP each year in 1998-2015, much lower than the annual average of 8.6 percent and 3.8 percent among regional and structural peers, respectively (Figure 36 and Figure 37). While the level of private investment in the Philippines was similar to the average of peers, it was insufficient to compensate for the low level of public investment.

Figure 37. ... and significantly low relative to structural peers.



Nevertheless, capital accumulation has been the main driver of economic growth in the Philippines since the 1980s. A decomposition of real GDP growth shows that capital accumulation has consistently been the main driver of economic growth in the country, contributing about three-fifths of the growth between 1981 and 2016. By contrast, labor accumulation, defined as the increased labor employed in the economy, contributed 31.3 percent of the growth in the same period, and its contribution to growth has steadily declined in the past three decades.

Total factor productivity (TFP) has been the second largest contributor to growth since the 2000s. The contribution of TFP

Figure 38. TFP's contribution to growth has increased since 2010...

REAL GDP GROWTH AND CONTRIBUTION (PERCENTAGE POINTS)





CONTRIBUTION TO GROWTH, THE PHILIPPINES AND REGIONAL PEERS, 1995-2010 (%) 120 100 80 60 40 20 Λ -20 Philippines China Malaysia Thailand Indonesia Vietnam Capital Stock Labor Human Capital per Labor Total Factor Productivity Source: Staff calculations based on PSA data and WDI.

to economic growth in the Philippines has increased since 2000, mirroring the evolution of the country's economy over the last two decades (Figure 38 and Figure 39). TFP consistently contributed to growth during the economic recovery and growth acceleration of the 2010s, contributing one-third of growth on average during this period. Furthermore, the contribution of TFP to growth was higher in the Philippines than in regional peers in 1995-2010, with the only exception of China (Figure 40 and Figure 41). The growth in TFP reflects the implementation of a wide range of structural reforms since the 1990s, as these reforms increased not only economic growth but also the contribution of TFP to growth.

Figure 39. ...after it declined temporarily in 2009 at the height of the global recession.



Figure 41. ...as well as in many structural peers.



PATTERNS AND DRIVERS OF AGGREGATE PRODUCTIVITY

Although labor productivity growth has accelerated in the Philippines, it remains low compared to that of peers, suggesting an opportunity to increase growth by closing productivity gaps. The county's labor productivity growth has been consistent with the evolution of its TFP growth. It accelerated substantially from an average annual rate of 1.6 percent in 1998-2004 to 3.6 percent in 2010-16. However, productivity growth was still lower in the Philippines than in regional peers (Figure 42 and Figure 43). For instance, China and Vietnam's labor productivity growth reached 7.6 percent and 4.2 percent, respectively, in 2010-16. As a result, the labor productivity gap remains wide between the Philippines and many regional peers. The country's low labor productivity has been partly caused by historic low levels of capital accumulation, resulting in low capital per worker, which limits labor productivity growth despite higher TFP growth. This represents an opportunity for the Philippines to increase labor productivity growth by increasing capital accumulation and sustaining high TFP growth.

Figure 42. Labor productivity in the Philippines is below the average of regional peers...



VA PER WORKER: THE PHILIPPINES VS. REGIONAL PEERS (CONSTANT 2011 PPP \$)

Source: WDI.

The improvement in labor productivity in the Philippines mainly reflects a rise in within-sector productivity growth. Sector-level productivity growth was the main driver of the country's labor productivity growth between 1998 and 2016, which was reflected in the increased contribution of many individual sectors to aggregate productivity over time. In 1998-2016, mining, transport, communication and storage, utilities, and manufacturing were the sectors with the highest annual growth in labor productivity. By contrast, real estate, renting and other business activities, and construction experienced negative productivity growth in the same period (Figure 44). The Philippines relies more heavily on within-sector productivity growth than other countries in East Asia, including China, Indonesia, Malaysia, and Thailand.⁵⁰



Figure 43. ...but above the average of structural peers.



The steady shift in employment from agriculture to services underpins the productivity gains from structural change. Figure 45 shows changes in employment shares and the relative productivity of sectors, measured as log of the ratio between sectoral productivity and economy-wide average productivity between 1998 and 2016. For positive gains to occur through structural change, sectors need to

be in either the top-right corner (e.g., services) where labor shifts into relatively high-productivity sectors, or in the third quadrant (e.g., agriculture) where labor shifts out of low-productivity sectors. Structural change contributed around 0.3 percentage points and 1.1 percentage points per year to labor productivity growth in 1998-2009 and 2010-16, respectively.

Figure 45. Labor is transitioning from agriculture to more productive sectors.



CHANGES IN AVERAGE EMPLOYMENT SHARE AND DEVIATION FROM AVERAGE VA PER WORKER, 1998-2016 (RATIOS)

Source: Staff calculations based on PSA and WDI.

Note: The figure plots the logarithm of sectoral VA per worker (relative to the average across all sectors) and the change in the employment share for 11 economic sectors in 1998-2016. The size of the circle reflects the employment share in 2016. On the vertical axis, sectors above zero are more productive than the average sector in the economy. On the horizontal axis, sectors to the right of zero have had increases in their employment shares.

PATTERNS AND DRIVERS OF PRODUCTIVITY AT THE INDUSTRY AND FIRM LEVEL

Firms contribute to aggregate productivity growth through the capacity of markets to efficiently allocate resources across firms (i.e., allocative efficiency) and the evolution of firm productivity (i.e., technical efficiency). Allocative efficiency involves the allocation of resources to the most productive activities and firms, while technical efficiency occurs when firms generate more output from the same level of input. To improve overall productivity through better resource allocation, resources from firms with low returns on production factors need to flow to firms with high returns in the same or different sectors.

Firm Characteristics and Productivity

The Philippine economy is dominated by small firms that are less productive than medium and large firms. In 2014, two-thirds of the country's manufacturing firms and over 80 percent of services firms employed less than 20 workers (Figure 46 and Figure 47). Yet, small firms are on average less productive than medium or large firms in both manufacturing and services (Figure 48 and Figure 49). This is also common in other countries, as larger firms tend to have better access to credit and technology, benefit from economies of scale, and be more resilient to shocks than smaller firms. However, a large share of small firms in an economy can be an indication that firms are suffering from stunted growth.



Figure 46. Most firms are small in the manufacturing sector...

Figure 47. ...as well as in the service sector.



Figure 48. Large firms are more productive than small and mediumsized firms in manufacturing...



The relationship between the age and size of firms differs across sectors in the Philippines. When product and factor markets work efficiently, unproductive firms exit the market while more efficient firms remain and expand. This pattern is observed in the United States where old firms (i.e., firms 40 or more years old) are about eight times larger than firms with less than five years in the market. In the Philippines, the economy-wide ratio of average employment to young firms shows a similar pattern, as old firms are about seven times larger than young firms (Figure 50). However, there are vast

Figure 49. ...as well as in services.



differences across sectors. In manufacturing, for example, old textile firms are on average smaller than younger firms, while old firms in the motor vehicles industry are 21 times larger than younger firms. In services, old financial firms are 13 times larger than younger firms, while firms in administrative and supporting services do not seem to grow over time. The distinct growth patterns of firms in different sectors could be caused by differences in sectors' product and/or factor market efficiencies.



Figure 50. Labor is transitioning from agriculture to more productive sectors.

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The share of firms with foreign capital remains small in the overall economy, although the degree of foreign ownership is relatively high in some services and manufacturing sectors. Less than 10 percent of all firms in the Philippines have some degree of foreign ownership, with most foreign owners in industry (their share has, however, declined in recent years) (Figure 51). Across sectors, firms in manufacturing and services that have foreign ownership, such as in information and communication technologies (ICT) and professional services, receive on average more than 50 percent of their capital from foreign sources (Figure 52). Firms with foreign ownership are on average more productive than fully domestically owned firms. Between 2010 and 2014, firms with foreign capital were more productive than firms with 100 percent domestic capital (Figure 53). In addition, firm productivity tends to increase with more foreign ownership (Figure 54). For instance, Philippine firms in agriculture with between 50 percent and 75 percent foreign capital were substantially more productive than firms with only domestic capital during this period, which is consistent with evidence from other developing countries.



Figure 51. The share of firms with foreign ownership remains small.

Figure 52. Foreign ownership is high in some services and manufacturing sectors.



Source: Staff calculations based on PSA data.

Figure 53. Firms with foreign ownership are on average more productive than fully domestically owned firms.



Source: Staff calculations based on PSA data.

While the number of exporting firms remains small across sectors, they are on average more productive than firms that only focus on the domestic market. Consistent with aggregate data, firm-level data show that the share of firms that export remains small in the Philippines (Figure 55). In agriculture, a mere 5 percent of sampled firms exported in 2014, down from less than 10 percent in 2010. A

Figure 55. The share of Philippine firms that export declined in 2010-14.



Source: Staff calculations based on PSA data.

Figure 54. Foreign ownership is correlated with higher productivity.



similar trend can be observed in industry: the share of exporting firms declined from 10 percent in 2010 to 7 percent in 2014. The share of export service firms also remains small, declining from 2 percent in 2010 to 1 percent in 2014. Yet, firms that export are on average more productive than firms that focus on the domestic market (Figure 56).

Figure 56. Firms that export are on average more productive than firms that focus on the domestic market.



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A better allocation of resources could help expand more productive firms and raise sector-level productivity. While firms that are large, export, and have foreign ownership are more productive than firms that are small, domestically owned, and focus exclusively on the domestic market, they represent a very small share of all firms in the Philippines. This is not likely to be the result of lack or insufficient policies to support specific industries but might be explained by inefficient allocation of resources. The removal of distortions in the economy will increase the likelihood that resources for the production of goods and services (i.e., capital and labor) will flow from less to more productive firms.

Factor misallocation in Philippine manufacturing has improved in recent years. The misallocation of resources in the manufacturing sector declined from 180 percent in 2009 to 98 percent in 2014 (Figure 58), which was consistent with positive labor productivity growth at the sector level. This also confirms that within-sector productivity growth was driven by both improvements in withinfirm productivity growth and factor allocation across firms in the same sector, resulting in reduced misallocation. The improvement in the allocation of resources, which started in 2010, is consistent across manufacturing subsectors, suggesting that macro factors

Figure 57. The misallocation of resources has declined in Philippine manufacturing since 2009...



Source: Staff calculations based on PSA data.

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Note: Figure only includes formal firms and sectors with more than 10 firms. Sectors with less than 10 firms have been excluded to avoid results that are driven by outliers.

such as macroeconomic stability and a gradual and continuous implementation of structural reforms are driving this trend rather than improvements within individual subsectors. A comparison with peer countries shows that the misallocation of manufacturing resources in the Philippines are in line with that of China in 2005 and Malaysia in 2010 but lower than that of Kenya in 2010 (Figure 58).

Still, productive manufacturing firms face more distortions than less productive firms in the Philippines, preventing faster economic growth. Evidence suggests that productive firms face larger idiosyncratic distortions than less productive firms in manufacturing,⁵¹ which means that productive firms are "taxed" at a higher rate in term of distortions. As a result, productive firms could have expanded their production more if they had acquired more resources. Examples of distortion include preferential market access and preferential tax incentives to certain firms, which lead productive firms to produce below their optimal levels. However, this could also mean that unproductive firms continue to operate and use resources in the economy, as their output is possibly being subsidized. The constraints faced by productive firms will ultimately worsen the economy's overall productivity growth.

Figure 58. ... and is in line with selected regional peers.



Source: Data for the Philippines are based on staff calculations using PSA data, Shieh and Klenow (2009), Nouven, H., T. Taskin, and A. Yilmaz (2016), Chuah et al (2018)

POLICY OPTIONS FOR INCREASING PRODUCTIVITY AND ECONOMIC GROWTH IN THE PHILIPPINES



Government policies affect how resources are allocated across firms and the efficiency with which firms use resources. A preferential policy treatment of unproductive firms allows them to remain in operation (or even thrive) and deny market shares to more productive firms that could use the resources more efficiently. Meanwhile, policies that encourage firms to improve their managerial quality, access technology, and innovate contribute to higher within-firm productivity. Government policies can be divided into measures that affect the external environment of firms, such as the policy environment for (i) competition and private-sector investment; (ii) trade integration; (iii) foreign investment; (iv) access to finance and capital allocation; and (v) education quality and labor market regulations, and those that influence firms' internal operations, notably innovation and managerial quality. This section will provide policy options for boosting productivity growth in the Philippines.

Improve market competition through regulatory reforms

Market rules and regulations may be hindering competition in the Philippines. In manufacturing, Philippine markets are more concentrated than those of regional peers and have a higher proportion of monopoly, duopoly, and oligopoly markets (Figure 59), which are typically more prone to collusion and abuse of market power. There has also been a recent increase in the number of monopolies and duopolies in Philippine manufacturing markets (Figure 60). As a result, market competition is perceived to be weak in the Philippines. The country ranked 114th out of 138 economies on market dominance in the World Economic Forum's 2016-17 Global Competitiveness Report, which was below the average of the countries in the sample and lowest among regional peers (Figure 61). Limited competition affects business risks, especially related to vested interests and unfair competitive practices (Figure 62).⁵²

Anticompetitive restrictions in the service sector not only distorts the services business but also sectors that use services as production inputs such as manufacturing. The results from an analysis of input-output linkages that measured the trickle-down impacts of regulatory barriers to competition in the service sector on manufacturing suggest a misallocation of resources. Specifically, downstream manufacturing sectors, for which the incidence of anti-competitive restrictions in services is higher, tend to have productivity distributions that are more dispersed and skewed to the left, which is an indication that resources are potentially misallocated. This suggests that anticompetitive regulations in service sectors may in fact be acting as a form of friction that prevents the allocation of resources to more productive firm, thereby hampering productivity performance at both the firm and aggregate level.

Figure 59. Philippine manufacturing markets are more concentrated than peers'...

MARKET CONCENTRATION IN MANUFACTURING IN THE PHILIPPINES AND SELECTED EAP COUNTRIES (IN PERCENT)



Source: Fostering Competition in the Philippines,World Bank (2018g).

Note: Regional peers were selected among those countries with available information from the World Bank's Enterprise Survey.

In addition to sector-specific restrictions, the cost of doing business is high in the Philippines. High entry costs discourage firms from entering markets, dampening the productivity enhancing effect of creative destruction. The Philippines ranked 173st out of 190 economies in the ease of starting a business in the World Bank's Doing Business report in 2018. According to product market regulation (PMR) indicators, the absence of simplifying tools in the

Figure 61. Competition is perceived to be low in the Philippines

MARKET DOMINANCE

(1= DOMINATED BY A FEW BUSINESS GROUPS; 7 = SPREAD AMONG MANY FIRMS)





Figure 60. ... and they have become more concentrated in recent years.

Source: Fostering Competition in the Philippines, World Bank (2018g).

system of licenses and permits raises the complexity of regulatory procedures. In addition, high barriers to FDI due to constitutional and legislative limitations for foreign participation in selected sectors and economic activities have resulted in low levels of FDI in the country. These barriers to entry limit competition and could raise input costs for Philippine firms.





Source: Fostering Competition in the Philippines, World Bank (2018g).

6

Note: The index is constructed by adding the individual values of each indicator in a 0-4 scale.

Source: WEF, 2017-2018.

The Philippines could accelerate GDP growth by removing restrictions in the service sector. Evidence suggests that an improvement of sector-wide PMR indicators of 10 percent would result in an increase of TFP by at least 1.3 percentage points.⁵³ Results from a simulation performed by the World Bank in 2017 based on enhancing the regulatory environment in the service sector implied that the Philippines could move from the fourth to the second quartile in terms of PMR indicators if 86 restrictions mapped by the PMR indicators were lifted. Moreover, a reduction of PMR restrictiveness in key service sectors (i.e., energy, professional services, transportation, and communications) could add US\$0.6 billion (0.2 percent of GDP) to the country's annual GDP by boosting competitiveness in downstream industries that use these services.

Improve trade and investment climate policies and regulations

The Philippines' level of trade openness has been declining over the past two decades despite its relatively low tariff rates. The country has a liberalized trade regime reflected in its low most-favored-nation tariff of 6.3 percent in 2016, the lowest among structural peers and only slightly higher than Malaysia's among regional peers (Figure 63 and Figure 64). By contrast, its trade openness, measured as the share of total trade to GDP, declined from 98.7 percent in 1998 to 64.9 percent in 2016 (Figure 65 and Figure 66). From being considered a pioneer of trade openness in the late 1990s, the Philippines currently ranks below both Vietnam and Morocco and in line with the average of structural peers. The country's trade openness also ranks below the average of regional peers.

Figure 63. The Philippines has a liberalized trade regime reflected in its low average most-favored-nation rates among structural peers...

SIMPLE AVERAGE TARIFF RATES: THE PHILIPPINES VS. STRUCTURAL PEERS (IN PERCENT)



Source: World Integrated Trade Solution (WITS). Note: latest data available.

Figure 64. ...as well as among regional peers.

SIMPLE AVERAGE TARIFF RATES: THE PHILIPPINES VS. REGIONAL PEERS (IN PERCENT)



Source: World Integrated Trade Solution (WITS). Note: latest data available.





TRADE AS SHARE OF GDP, THE PHILIPPINES VS. STRUCTURAL PEERS (IN PERCENT)

especially low on connectivity to international markets. The Global Competitiveness Index shows that trade is affected by the country's government regulations, overall infrastructure quality, and customs procedures.

Non-tariff measures (NTMs) are also high in the Philippines. Besides tariffs, importing and exporting firms need to comply with NTMs, which encompass a wide range of requirements, including technical regulations, product standards, and custom procedures. NTMs have become an increasingly important obstacle to trade in the Philippines. A survey conducted by the International Trade Center in 2015 showed that 60.7 percent of Philippine exporters and 69.6 percent of importers reported obstacles due to NTMs, relatively high among peers (Figure 67). Furthermore, almost all NTMs faced by Philippine importers are obstacles within the home country, the highest among peers (Figure 68).

Figure 66. ... to well below that of regional peers.



The country's export competitiveness is impeded by high trade costs. Trade costs in the Philippines are among the highest in the Association of Southeast Asian Nations, according to the 2016 Doing Business report. Investors in the Philippines pay twice as much to export or import a shipping container as investors in Thailand. In addition, the Philippines ranks lowest among peer countries on the World Bank's Logistics Performance Index,⁵⁴ and it scores

Figure 67. More Philippine trade companies face NTM-related obstacles compared with companies in peers.

SHARE OF COMPANIES AFFECTED BY NTM-RELATED OBSTACLES (IN PERCENT)



Source: ITC NTM Survey.

Note: Sri Lanka (2010), Kenya (2011), Morocco (2011), Indonesia (2013), Thailand (2014), Bangladesh (2015), Philippines (2016).



Figure 68. Philippine importers face more domestic NTMs than importers in peers.



SHARE OF NTM-RELATED OBSTACLES EXPERIENCED AT HOME BY IMPORTERS (IN PERCENT)

Source: ITC NTM Survey.

Note: Sri Lanka (2010), Kenya (2011), Morocco (2011), Indonesia (2013), Thailand (2014), Bangladesh (2015), Philippines (2016).

While the inflow of FDI into the Philippines increased during the last two decades, it remains low relative to many peers. Net FDI in the Philippines increased by 74 percent between 1999 and 2016, the largest increase among structural peers, with the exception of Morocco (Figure 69). However, the level of FDI in the country is still low relative to many regional peers (Figure 70). For instance, net FDI in the Philippines reached 2.6 percent of GDP in 2016, up from 1.5 percent in 1999, while it represented around 4.3 percent of GDP in Malaysia. Moreover, a decomposition of net FDI into direct-equity and inter-company borrowing reveals that direct-equity investment in the Philippines' economic sectors fell from 0.8 percent of GDP in 2005 to 0.7 percent of GDP in 2016 (Figure 71). Most of the increase in net FDI was due to an increase in inter-company investment through debt instruments, which increased from 0.3 percent of GDP in 2005 to 1.7 percent of GDP in 2016.55

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Figure 71. The level of FDI in the country's economic sectors remains small...



Figure 70. ... but is still low relative to regional peers.



Figure 72. ...and most investment was concentrated in the service sector in recent years.



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Create an enabling environment for innovation

The country's innovation infrastructure is of poor quality. In 2017, the World Economic Forum ranked the Philippines 74th out of 137 countries on the availability of scientists and engineers and 75th on the availability and quality of research capital, lower than most peers (Figure 73). Similarly, the availability of information technology infrastructure, such as mobile subscriptions and internet access, was lower in the Philippines than in many regional peers while its cost was higher (Figure 75 and Figure 76). Market dominance and business regulations are also not conducive to creating an enabling environment for innovation, as uncontested markets with high profit margins provide little incentives for innovation and productivity growth. Finally, the country's low level of trade openness and FDI limits knowledge spillover.

Figure 73. The availability and quality of research capital in the Philippines is low.

AVAILABILITY AND QUALITY OF RESEARCH CAPITAL (7=BEST) 7 6 5 4 3 2 1 0 Malavsia China Kenya Sri Lanka Thailand Pakistan Vietnam Philippines Bangladesh Indonesia

Availability of scientists and engineers

Quality of scientific research institutions

Source: World Economic Forum.

As a result, Philippine firms lag behind peers in adopting existing technologies. On the 2017 Global Innovation Index, the Philippines ranked 73rd out of 128 countries, behind regional peers such as Thailand (51st), Vietnam (47th), Malaysia (37th), and China (22nd). The country's underperformance in innovation can be partly explained by low spending on R&D, merely 0.1 percent of GDP, compared with an average of 0.9 percent of GDP among regional peers and an average of 0.4 percent of GDP among structural peers. In addition, Philippine firms are less likely to adopt existing technologies than firms in peer countries. For instance, only 8.8 percent of firms in the Philippines have internationally recognized quality certifications and only 11.2 percent of firms use technology licensed from foreign companies, lower than in most peers.

Figure 74. More collaboration between universities and industry could yield better technology diffusion.



Source: World Economic Forum



Figure 75. The Philippines lags behind regional peers in the availability of information technology...



Source: Access to telecommunications, International Communication Union (2015).

High costs, insufficient resources, market dominance, and lack of skills are the most prominent factors that prevent firms from innovating in the Philippines (Figure 77). Firms point to the high cost of innovation as the primary factor that prevent them from engaging in innovation activities in the country, followed by lack

Figure 76. ... and the cost of telecommunications services.



Source: Price of telecommunications, International Telecommunication Union. Measuring the Information Society Report 2016.

of funds from within firms and external sources. Moreover, market dominance and lack of qualified personnel are also important factors that discourage innovation, especially among micro, small, and medium enterprises (MSMEs).

Figure 77. High costs and lack of funds are the most prominent factors hampering innovation.



MSMEs 📃 Large firms

Source: 2015 Survey of Innovation Activities, Philippine Institute for Development Studies.

Reduce labor market rigidities and costs

Employers find labor regulations in the Philippines more restrictive than in peer countries. On the Global Competitiveness Index, the Philippines ranked 77th out of 137 countries on the ease of hiring and firing, more restrictive than in peers (Figure 78). Specifically, the country suffers from long administrative processes for regular employment. In addition, the Philippines ranked 86th out of 137 countries on wage determination, which makes it less flexible than the average of both structural and regional peers (Figure 79). Moreover, the country's minimum wage is considered high by several measures, both relative to Filipino worker productivity and to the minimum wage of other countries with similar income levels.⁵⁶ Finally, redundancy costs are very high in the Philippines, 27 weeks of salary, resulting in a rank of 118th out of 136 countries. Of all the indicators in the index, the ease of hiring and firing has progressed the least in the Philippines since 2007.

High dismissal costs have led to an increase in temporary employment, which discourages on-the-job training and learning. The dismissal of an employee with a regular employment contract involves a long administrative process that includes notices to

Figure 78. Labor regulations in the Philippines are more restrictive than in peers.

the employee, hearings, and payment of separation benefits. Furthermore, an employee has the right to contest the validity of the dismissal through a dispute resolution mechanism, which could be lengthy and costly and whose decision often favors the employee. As result of high dismissal costs, the incidence of non-regular employment is increasing and reached about 40 percent of all wage employment in 2013. However, workers under non-regular contracts have less employment security and receive lower wages.⁵⁷ Their turnover is also expected to be higher, and there is less job-training and learning, limiting their contribution to productivity growth.

The Philippines' restrictive labor regulations and high labor costs have contributed to the growth of the country's large informal sector. High minimum wages and dismissal costs discourage the formalization of jobs. Informal employment represents 76.3 percent of total employment in the country.⁵⁸ Even excluding the agriculture sector, 66.8 percent of total employment is informal, which is relatively high among peer countries (Figure 80). Moreover, informality occurs across age and education groups: around 30.8 percent and 63.2 percent of employed college graduates and undergraduates, respectively, have informal employment (Figure 81). However, it is especially high among non-college graduates.

Figure 79. Wage determination is also more restrictive in the Philippines compared with peers.



FLEXIBILITY OF WAGE DETERMINATION (7=BEST)

EASE OF HIRING AND FIRING (7=BEST)



Source: World Economic Forum

56 World Bank (2013); Betcherman (2014).

57 World Bank (2016).

58 Informal employment refers to the total number of persons with informal main jobs. A job is informal when it lacks basic social or legal protections or employment benefits and may be found in the formal sector, informal sector, or households. Persons in informal employment include the following types: wage workers, self-employed workers, and unpaid family members. First, wage workers are categorized as formal if they meet at least two of the following three criteria: (1) have a written employment contract, (2) have employer-provided social insurance, or (3) are protected from arbitrary dismissal. Otherwise, they are categorized as informal. Second, self-employed workers are formal if they meetina a proper bookkeeping system. If not, they are classified as informal. Finally, unpaid family members are informal by definition. This definition is based on the World Bank's Philippine Labor Market Review from 2016.



Figure 80. Informal employment is high in the Philippines.





Informal employment: Outside informal sector

Informal employment: Informal sector

Source: Informal Sector Survey (ISS) 2008.

Figure 81. Informal employment is high among non-college graduates.



INFORMALITY BY EDUCATION LEVEL (IN PERCENT)

Source: Informal Sector Survey (ISS) 2008.

ACHIEVING THE AMBISYON NATIN 2040 TARGET

The Philippines will need to reach a GDP per capita of about US\$9,350 by 2040 to meet the goals set out in the AmBisyon Natin 2040.⁵⁹ This is a rough target that is aligned with the government's goal of tripling per capita income from its current level. Assuming that net factor income from abroad represents 15 percent of GNI, the per capita GDP of US\$9,350 corresponds to a per capita GNI of US\$11,000, which is nearly the threshold for a high-income country.⁶⁰

A long-term growth model was used to evaluate and assess ways to achieve the growth target by 2040. The model assessed various growth scenarios and the potential mix of growth drivers needed to reach the government's goals. A baseline scenario was created based on the premise that key growth drivers such as labor, human capital (Box 9), investment, and technology sustain their historical growth rates. Various scenarios were then created relative to this baseline, and growth rates of select variables were adjusted to assess the most realistic combination that will help the country achieve the AmBisyon Natin 2040.

Simulations show that sustaining high TFP growth will be crucial to achieve the GDP per capita target by 2040. The GDP per capita target can be reached if the Philippines manages to sustain a TFP growth rate of 1.8 percent per year for decades to come, which is lower than the annual average of 2.2 percent in 2011-16. However, this will be a challenge as experiences from other countries, such as the fast-growing Asian Tigers and China, show that continuous efforts to remove constraints and distortions in the markets are needed to sustain high TFP growth in the long term.

Moreover, accelerating capital accumulation in the medium term will be critical to achieve the government's target. This will require the investment-to-GDP ratio to grow by 3.0 percent per year until 2022 (through public and/or private investment) followed by the historical annual rate of 0.8 percent until 2040. This will result in an investment-to-GDP ratio of 33.6 percent of GDP in 2040, higher than the average of many peers. This level of capital accumulation will require a TFP growth rate of 1.5 percent per year to achieve the GDP per capita target by 2040.

Box 9. Human Capital and the Philippines

Human capital encompasses the health, nutrition, skills, and experience of a country's people. Boosting human capital is not just good for the people but also critical to achieving growth as it contributes to the productivity of the next generation of workers. This is more the case at present moment as good jobs are increasingly found in knowledge-based sectors of the economy.

The World Bank is developing a new Human Capital Index that will measure the human capital that a child born today can expect to achieve by age 18, given prevailing conditions for health and education⁶¹. The Human Capital Index will bring together nutrition, education quality, and other aspects of human capital into a measure that illustrates how investment in human capital pays off in productivity of the next generation of workers. The intent is for the index to help policymakers recognize the beneficial effects that investing in human capital has on worker productivity, so that they see a child's learning in school as providing the foundation for economic growth just as much as the asphalt that goes into a new roadway. Greater investments in human capital will help prepare everyone to compete and thrive in the economy of the future—whatever that may turn out to be.

A notable weak point for the Philippines in those conditions is the very poor state of child nutrition. One in three children under the age of 5 is stunted—a key marker of malnutrition—and there has been no progress over a decade. Children who are denied proper nutrition and stimulation in utero and during early childhood fail to develop a full set of neural connections. Those children face cognitive impairment, perform poorly in school, and are more likely to drop out earlier, resulting in limited job opportunities and income throughout their lives.

In terms of education, the country has achieved gains in access to schooling but still lags in quality. Increased resources to education, mandatory kindergarten, and the creation of senior high school have been important steps to increase schooling. However, schooling is not the same as learning. Students may sit for years in classrooms without achieving basic numeracy and literacy. The most recent international test scores for the Philippines show the country ranking towards the bottom among countries in East Asia.

59 The base year corresponds to the per capita GDP of US\$2,892 in 2017.

60 NFIA totaled about 18.4 percent of GNI in 2000-16. A lower ratio 15.0 percent is assumed in the long term considering the declining trend of remittance growth coupled with the outlook of fewer Filipinos seeking employment abroad as the domestic economy strengthens.

IMPLICATIONS FOR POVERTY REDUCTION

Higher productivity growth would help to accelerate poverty reduction by creating more well-paying jobs. The reduction in poverty that occurred between 2006 and 2016 in the Philippines was driven by an increase in wage income, a movement of labor out of agriculture, government transfers, and remittances.⁶² An increase in productivity would raise wages and create new jobs, contributing to poverty reduction. It will be especially important to increase productivity growth in low-productivity sectors such as agriculture, as it would primarily benefit the poor and most vulnerable population. Furthermore, accelerating structural change (i.e., movement of labor out of agriculture) would also contribute to faster poverty reduction, as productivity (and thus wages) is on average higher in non-agricultural sectors.

Improving the link between labor productivity and real wage growth will be critical. Real wages have been stagnant in the Philippines despite improvements in labor productivity (Box 10). Aggregate real wages remained flat in 2001-16, with real wages falling in 7 out of 15 years. Meanwhile, labor productivity increased by 57 percent in the same period. Except for public workers, the pattern of stagnant real wages and increasing labor productivity growth has been consistent across employees' level of education, work status (permanent or short-term contracts), and class of work (private household, private establishment, or family operated). It has also been true across sectors (agriculture, industry, or services) and regions. Therefore, poverty alleviation efforts need to include policies that would allow a rise in labor productivity to result in higher real wages.

Figure 82. A large share of Philippine migrants is highly educated...

SHARE OF REGISTERED FILIPINO EMIGRANTS BY EDUCATIONAL ATTAINMENT PRIOR TO MIGRATION



Source: Commission on Filipinos Overseas.

A lack of product market competition is likely contributing to real wage stagnation in the Philippines. There is a positive relationship between labor productivity growth and real wage growth in an environment of competitive labor and product markets, as competition normally leads to lower output prices. Nonetheless, there can be an observed correlation between sectoral productivity gains and real wages or profit when either labor or product markets are not perfectly competitive. While the Philippines' labor supply is abundant, and its labor market is somewhat competitive in many sectors. Market dominance, the presence of monopolies and duopolies, and high entry costs contribute to a lack of competition in many sectors. As result, productivity gains are not always reflected in real wages but rather in profit, which is consistent with the increasing share of capital in the Philippines' national income.

An inability to create well-paying jobs and lift real wages is likely to further encourage emigration, limiting productivity growth. Productivity growth requires a process of efficiently combining human and physical capital. However, over 15 percent of the Philippines' total labor force emigrates each year, higher than in many peers. More than half of all emigrants are under the age of thirty and hold college or higher degrees (Figure 82 and Figure 83). This human capital flight features a vicious cycle of high emigration due to limited domestic job opportunities, which leads to an insufficient supply of skilled workers for firms to expand and grow. Therefore, it is crucial for authorities to increase both productivity and real wage growth by encouraging greater market competition.

Figure 83. ...and those planning to emigrate have the highest levels of educational attainment.



Source: Commission on Filipinos Overseas.

Box 10. Stagnant Real Wage with Rising Labor Productivity

The disconnect between real wages and labor productivity is consistent across sectors. Surprisingly, agriculture, the sector with the lowest labor productivity growth, was the only sector that experienced minor real wage growth in 2001-16 (Figure 86). While real wages in the agriculture sector grew by barely 6 percent during this period, they declined by 5 percent in industry and remained flat in services (Figure 87 and Figure 88). Within industry, real wages declined in all subsectors (i.e., mining, manufacturing, construction, and utilities) while labor productivity increased, especially in manufacturing and mining. In services, there was a large disparity among subsectors. For instance, real wages in transport, government services, and renting of non-real estate and other business activities increased along with labor productivity. However, trade and finance experienced positive labor productivity growth while real wages declined. In real estate, labor productivity experienced its biggest decline in the services sector while real wages experienced their biggest increase.

Figure 84. Real wages have remained flat despite rising GDP and productivity growth.

The divergence between labor productivity and real wages can also be observed in the country's various regions. While there has been an increase in labor productivity across most regions, real wages have been stagnant. Moreover, real wages have been declining in the Autonomous Region in Muslim Mindanao, the country's poorest region in 2015. The gap between labor productivity and real wages has been widening over time. By 2015, three of Mindanao's six regions were among those with the largest gap, while regions in Luzon had the smallest. Rising labor productivity and sluggish real wages can help to explain the situation in Mindanao, while stagnation in both labor productivity and real wages may explain the situation in Luzon.

Figure 85. Agriculture experienced minor real wage growth despite its low productivity.



Employment

Source: PSA.

INDUSTRY GROWTH TRENDS (2001 = 100)

Figure 86. Real wage growth in industry has remained flat despite rising productivity...







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