Economic Report

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The Philippine Economy: Remaining Steadfast

The prospect of hitting the 2015 GDP growth target of 7.0-8.0 percent is quite dim. Nonetheless, the Philippine economy remains resilient amidst uncertainties particularly in its external environment. With national elections fast approaching, one of the biggest challenges for decision makers is ensuring the continuity of reform efforts.

The Philippines' gross domestic product (GDP) grew 5.6 percent in real terms during the second quarter of 2015, bringing the average GDP growth rate to 5.3 percent for the first semester of 2015. This implies that the economy need to register *at least* an 8.7 percent growth in the second half to hit the full-year growth target of 7.0 to 8.0 percent. This would be quite a challenge.

Nonetheless, the 5.6 percent growth in the second quarter is higher than the 5.0 percent growth in the previous quarter and reflects the economy's resiliency amidst the uncertainty and prevailing weakness in the global economy. This second quarter growth is currently the third highest among Asian economies, after China and Vietnam.

Selected Asian Economies GDP Growth
1st-2nd Quarter 2015

Country	Q1	Q2
China	7.0	7.0
Indonesia	4.7	4.7
Malaysia	5.6	4.9
Philippines	5.0	5.6
Thailand	3.0	2.8
Vietnam	6.1	6.4

Source: Bangko Sentral ng Pilipinas, Trading Economics

Growth in demand was boosted by private sector investment with capital formation averaging 14.5 percent in the first semester. Private construction maintained its double-digit growth, averaging 12.6 percent in the same period. Public construction likewise grew by 20.4 percent in the second quarter, a considerable rebound after its 24.0 percent contraction in the first quarter. This reflects government's efforts to spur spending, particularly on infrastructure projects. Also noteworthy is the 22.6 percent average growth of services exports, mainly supported by the business process outsourcing (BPO) sector. Exports of goods on the other hand, grew by only 0.6 percent during the first half of the year, significantly lower than the 13.3 percent average growth registered during the same period last year. This reflects weak demand from the country's main trading partners.

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GROSS NATIONAL INCOME AND GROSS DOMESTIC PRODUCT, 2014-2015
Growth rates (%), in constant prices

PARTICULARS	2014 Q1	2014 Q2	2014 Q3	2014 Q4	2015 Q1	2015 Q2	2014 Sem I	2015 Sem I
GROSS DOMESTIC PRODUCT	5.6	6.7	5.5	6.6	5.0	5.8	6.2	5.3
GROSS NATIONAL INCOME	6.6	6.9	3.9	5.7	4.2	5.4	6.8	4.6
by Production shares								
1. Agri., Hunting, Forestry And Fishing	0.6	3.4	-2.6	4.2	1.1	-0.2	2.0	0.3
a. Agriculture and forestry	1.4	4.5	-2.6	4.3	1.9	-0.3	3.0	0.8
b. Fishing	-3.1	-1.6	-2.4	4.2	-2.9	-0.1	-2.4	-2.2
2. Industry Sector	5.4	9.1	7.8	9.1	5.5	5.9	7.3	5.8
a. Mining & Quarrying	9.0	2.1	4.2	5.9	-3.1	-7.1	5.6	-0.4
b. Manufacturing	7.0	11.1	7.5	7.7	6.0	4.7	9.1	5.3
c. Construction	1.0	7.2	13.1	17.9	5.4	15.3	4.1	10.0
d. Electricity, Gas and Water Supply	0.3	3.0	3.0	5.1	5.1	2.7	1.7	4.1
3. Service Sector	6.8	5.9	5.6	5.6	5.4	6.6	6.4	5.8
a. Transport, Storage & Communication	8.2	6.9	5.2	4.5	8.3	6.4	7.6	7.1
b. Trade and Repair of Motor Vehicles, Motorcycles, Personal and Household Goods	6.1	6.5	7.0	3.4	5.5	6.6	6.3	5.8
c. Financial Intermediation	5.7	6.1	8.4	8.9	4.3	5.8	5.9	5.1
d. R. Estate, Renting & Business Activities	10.2	8.5	6.7	9.7	6.3	7.0	9.4	6.6
e. Public Administration & Defense	6.3	1.2	-2.9	11.4	-3.5	-0.3	3.8	-1.9
f. Other Services	4.3	3.1	3.9	1.8	6.6	10.0	3.7	7.8
by Expenditure shares								
1. Household Final Consumption Expenditure	6.1	5.7	4.9	5.0	6.0	6.2	5.9	6.1
2. Government Final Consumption Expenditure	1.9	0.0	-2.5	9.4	1.7	3.9	1.0	2.8
3. Capital Formation	12.8	8.3	-0.2	3.0	11.6	17.2	10.6	14.5
A. Fixed Capital	1.7	6.9	10.7	8.0	10.0	8.9	4.3	9.5
1. Construction	-1.0	10.5	13.9	19.2	6.7	13.1	4.8	9.9
2. Durable Equipment	4.0	3.8	7.7	-0.1	13.5	6.4	3.9	10.1
3. Breeding Stock & Orchard Dev't	-4.4	-1.9	1.9	2.3	0.1	2.2	-3.2	0.5
4. Intellectual Property Products	13.0	28.8	35.7	6.8	13.1	-8.7	20.9	2.0
4. Exports	12.7	7.9	12.1	12.8	6.4	2.1	10.3	5.1
A. Exports of Goods	14.6	11.9	10.6	14.8	4.2	-2.1	13.3	0.6
B. Exports of Services	6.6	-5.9	20.7	5.0	14.1	19.7	0.4	22.6
5. Less : Imports	16.3	4.9	4.7	9.9	8.7	10.4	10.6	10.7
A. Imports of Goods	16.8	3.8	5.5	9.7	10.0	8.0	10.3	9.8
B. Imports of Services	14.6	9.8	1.5	10.3	4.1	20.6	12.2	15.2

Source: Philippine Statistics Authority

Growth in production was still mainly fuelled by the services sector, which grew by 5.8 percent in the first half of the year. Recreational, cultural, and sporting services in particular grew considerably by 22.3 percent in the second quarter. Industry likewise remained resilient with the construction sub-sector growing by 10.0 percent in the first semester, better than the 4.1 percent growth it registered in the same period last year. Manufacturing on the other hand, seemed to have lost some of its steam, growing by only 5.3 percent in the first semester of 2015, lower than the 9.1 percent growth in the same period last year.

The manufacturing sub-sectors that contributed to manufacturing growth in previous quarters (i.e., food and beverage manufacturing, publishing/printing, petroleum, fabricated metal products, and furniture/fixtures) grew albeit at a slower pace.

The *fiscal position* of the national government registered a surplus amounting to PhP13.7 billion for the first half of 2015. This is a reversal from the PhP53.9 billion deficit for the same period last year. Actual expenditure was PhP179.7 billion lower than what was programmed. Most of the national government agencies (NGAs) underspent, with the obligation rate for NGAs recorded at merely 43.2 percent. The only expenditure component that posted a higher-than-programmed amount was the allotment to local government units (LGUs).

Revenues on the other hand, grew by 16.3 percent year-on-year mainly due to the bigger collection of non-tax revenues. The interest income of the Bureau of the Treasury (BTr) grew by 6.5 percent year-on-year, PhP34.4 billion higher than programmed. Non-tax revenues also got a lift from the proceeds of the Coco Levy Fund case, which earned the government PhP60.0 billion in May. Despite these gains, actual total revenue still fell short of the target by PhP17.1 billion in the first half of 2015. The Bureau of Internal Revenue (BIR) and the Bureau of Customs (BoC) missed their targets by PhP106.2 billion and PhP29.7 billion, respectively.

Fiscal Position (in PhP million)

Particulars	Jan-Jun 2014	Jan-Jun 2015		Program vs Actual		2014 vs 2015	
	Actual	Program	Actual	Variance	Change (%)	Variance	Growth (%)
REVENUES	933,734	1,102,812	1,085,735	(17,077)	(1.5)	152,001	16.3
Tax Revenues	824,449	1,029,199	892,941	(136,258)	(13.2)	68,492	8.3
Bureau of Internal Revenue	643,209	812,087	705,869	(106,218)	(13.1)	62,660	9.7
Bureau of Customs	173,402	208,385	178,649	(29,736)	(14.3)	5,247	3.0
Other Offices	7,838	8,727	8,423	(304)	(3.5)	585	7.5
Non-Tax Revenues	109,196	73,613	192,676	119,063	161.7	83,480	76.4
o/w Treasury Income	62,939	32,664	67,035	34,371	105.2	4,096	6.5
EXPENDITURES	987,708	1,251,695	1,071,989	(179,706)	(14.4)	84,281	8.5
Interest Payments	159,741	171,528	156,122	(15,406)	(9.0)	(3,619)	(2.3)
Allotment to LGUs	174,082	155,944	193,897	37,953	24.3	19,815	11.4
Equity	433	1,870	317	(1,553)	(83.0)	(116)	(26.8)
Net Lending	6,458	8,677	2,659	(6,018)	(69.4)	(3,799)	(58.8)
Subsidy	49,540	64,528	43,970	(20,558)	(31.9)	(5,570)	(11.2)
Tax Expenditures	12,340	11,338	7,536	(3,802)	(33.5)	(4,804)	(38.9)
Others	585,114	837,810	667,488	(170,322)	(20.3)	82,374	14.1
SURPLUS/(DEFICIT)	(53,974)	(148,883)	13,746	162,629	(109.2)	67,720	(125.5)

Source of actual data BTr, targets/program DBCC (DBM)

Inflation averaged 2.1 percent in the first semester, well within the government's target of 3.0 percent +/- 1.0 percent for 2015. Adequate supply of food items and lower prices of electricity and petroleum products helped ease inflationary pressures. Inflation is expected to settle further at the lower end of the 2015 target although upside risks including pending petitions for power rate adjustments and the potential impact of El Niño weather conditions on food supplies remain. Lower inflation is seen due to the slower-than-projected domestic economic growth. Also, the uneven pace of global growth amid soft commodity prices (including for oil), is expected to keep global inflation benign. In light of this, key policy rates were maintained by the Monetary Board during its regular meeting last June 2015. Rates for overnight borrowing (RRP) and lending (RP) remained at 4.0 percent and 6.0 percent, respectively. Reserve requirement ratios were likewise maintained.

Volatility in the world economy

US Fed rate hike: After the United States Federal Reserve announced its plan to taper its bond-buying program (i.e., quantitative easing program) back in 2013 and concluded the program on October 2014, markets have been anticipating the US Fed to begin normalizing monetary policy by gradually increasing interest rates. In June 2015, US Fed Chairman Janet Yellen reiterated that the US economic recovery has advanced far enough and that it is likely strong enough to support an interest rate increase.[1] Notwithstanding some concerns over labor market conditions (i.e., low labor force participation rates and the high level of part-time employment), the US Fed is expected to announce its first rate hike[2] following the scheduled two-day meeting of the Federal Open Markets Committee (FOMC)[3] in September. The Greece crisis and market volatility in China could weigh in on the US Fed's decision.

Greek quandary: The 2007-2008 global financial crisis considerably affected the Greek economy, with average annual GDP contracting by 4.0 percent from 2007 to 2014. In 2009, Greece's budget deficit hit 15.2 percent of GDP, exceeding the threshold 3.0 percent of GDP set in the Stability and Growth Pact for all Eurozone member states. It was clear that Greece's capacity to repay its creditors was drastically diminished. Although Greece is a small state (its share of the Euro area economy is less than 3.0 percent), many banks were exposed to Greek sovereign debt. The first bailout was handed out in March 2010. It allowed a €110 billion loan for Greece, conditional on the implementation of severe austerity measures.[4] The second bailout came in July 2011, totalling €140 billion, with lower interest rates but more complicated elements. While the austerity measures reigned in fiscal imbalances and generated some confidence in government finances and in the euro area, they had negative effects on economic growth (lower demand; reduced tax base) and generated social unrest. Greece defaulted on its International Monetary Fund (IMF) loan, amounting to €1.6 billion, on 30 June 2015.

China meltdown: Since the internationalization of the yuan began in 2009, there have been debates about whether the yuan is undervalued or is close to its fair value against the US dollar.[5] The yuan's exchange rate has always been tightly managed so the global market was surprised when the Chinese central bank allowed a devaluation of the yuan on 11 August. China's economic growth is projected to be 7.0 percent

[1] The US real GDP grew by 3.0 percent in 2014. In 2015, it grew by 0.6 percent and 3.7 percent in the first and second quarters of 2015, respectively. Average unemployment rate was 6.2 percent in 2014, lower than 7.4 percent in 2013. (US Department of Commerce, Bureau of Economic Analysis).

[2] Since 2006.

[3] The FOMC is the policy-making body that oversees and directs monetary policy (sets the target rate). If it were to decide on rate hikes this year, it only has three more scheduled meetings to do that.

[4] Austerity measures: (1) public sector limit of annual bonuses; (2) cut wages of public utilities employees; (3) limitations on payments to high earning pensioners; (4) a special tax on high pensions; (5) limitations on overtime pay; (6) special taxes on corporate profits; (7) increases in value-added tax (VAT) and increases in alcohol, cigarettes and fuel charges; (8) scaling of pension age to life expectancy changes; (9) increase retirement age of public sector workers; (10) public-owned companies to be reduced; and (11) In the 2nd bailout, Greece was also made to take measures to render its economy more competitive.

[5] The internationalization of a currency occurs in three stages: (1) its use in trade and financial deals; (2) its ease of conversion with other currencies at market rates (this requires liberalization of capital account); and (3) becoming a global reserve currency (e.g., US dollar, euro, yen, sterling, or Swiss franc). (See Kenen, Peter B. (2011). Currency internationalisation: An Overview. Bank of International Settlements).

this year, it's most languid rate in over two decades. Thus, the yuan's devaluation prompted concerns that China was ready to risk a series of competitive devaluations. On the other side of the coin, some believe that more than anything else, China's policy U-turn is a signal to the IMF that it is willing to allow the yuan to float, implying a more liberal use of capital controls—a consideration if the IMF were to grant the yuan reserve currency status.[6] This view is supported by the fact that the devaluation was too small.[7]

What do these mean for emerging markets like the Philippines?

The anxiety over the state of the world's two biggest economies is understandable. A rise in American yields would add to the allure of green-backed assets, potentially making the dollar stronger. Interests and repayment costs of dollar-denominated debts would rise and, depending on the level of debt, could potentially result in huge capital outflows. On the other hand, China's economic slowdown and its resulting falling demand have already adversely affected emerging economies, particularly those which make their fortune digging stuff out of the ground (e.g., Peru, Brazil, Indonesia, South Africa and Zambia). This has contributed to falling global commodity prices. Deflation in China could also put pressure on supplier firms in other countries to cut prices. Moreover, the yuan's devaluation could trigger a global currency war, with other exporters racing to weaken their currencies.

These two external developments coupled with the economic downturn in the European Union (EU) and in Japan will contribute to increasing volatilities in the flow of funds and weighed on investor sentiment. Knee-jerk reactions to such volatilities are expected to be manifested in the Philippines' financial accounts (foreign direct investments or FDIs and portfolio investments), peso-dollar exchange rates, stock market indicators, and eventually, exports.

Foreign direct investments for instance, dropped by 40.1 percent year-on-year in the first semester of 2015, from US$3.4 billion to US$2.0 billion. All FDI components posted net outflows during the period. In particular, foreign investments in debt instruments fell by 55.6 percent. Also, considering that inflows were at exceptional levels last year, base effects may be at play.[8] Net foreign portfolio investments on the other hand, continued its downward trajectory, registering a net inflow of US$592.2 million in January to a net outflow of US$522.0 million in June, US$160.1 million in July, and US$542.5 million in August.

Philippine Peso-US Dollar exchange rate continued to slide from a monthly average of PhP44.6/US$1 in January to PhP46.1/US$1 in August. The depreciation is on account of increased capital outflows in light of the impending US interest rate hike and concerns over market volatilities from China. The depreciation of the peso is consistent with the movement of other regional currencies against the US dollar. The target range for the peso-dollar exchange rate for 2014-2016 was adjusted from PhP41.00-PhP44.00 to PhP42.00-PhP45.00.

[6] China is very much interested to obtain that status, partly for prestige and partly to help expand its financial sector without suffering the hot money flows that destabilized Asia in the late 1990s.

[7] It dropped by 1.9 percent, the biggest one-day currency move since 1993. It further dropped by 1.6 percent the next day.

[8] Resident's net incurrence of liabilities (FDIs) rose by 65.9 percent, from US$3.7billion in 2013 to US$6.2 billion in 2014. The Bangko Sentral ng Pilipinas expects net FDI inflows to hit US$6.0 billion in 2015.

Stock market indicators were still favorable at the end of the first semester of 2015. The Philippine Stock Exchange index (PSEi) went up by 7,564.5 points (4.6 percent) year-to-date. The market hit an all-time high of 8,127.48 points on 10 April 2015. Total market capitalization rose by 2.4 percent to PhP14.6 trillion year-on-year. Average daily value and total capital raised were recorded at PhP10.0 billion and PhP103.8 billion, respectively. Net foreign transactions however, declined to PhP16.6 billion, 63.7 percent lower year-on-year. Worries over China's economic growth came to a head in August and triggered a round of sell-off in global equities and currency markets. This resulted in red lights coming up from Southeast Asian bourses. On 24 August, the PSEi dropped by 6.7 percent, while the broader all shares index fell by 6.6 percent. Equities somewhat recovered in September although trading remains cautious ahead of the US Fed's announcement on its rate hike.

Exports for the first semester of the year grew by an average of 5.0 percent, a slowdown compared to the 10.3 percent growth during the same period last year. Merchandise exports grew slower this year compared to last year, while services exports grew robustly. In the second quarter, exports of principal agricultural products and fishery products contracted significantly by 44.5 percent and 32.7 percent, respectively. Exports of electronics on the other hand, recorded a strong 23.0 percent growth in the second quarter. Services exports was mainly supported by miscellaneous services (including BPO), which grew by 42.6 percent. On the average, 18.5 percent of the Philippine exports go to Japan, 14.5 percent to the US, 12.0 percent to China, and 12.0 percent to the EU.[9]

Can the Philippines withstand these external shocks?

Certainly, there are some parallels between the events that triggered the Asian Financial Crisis in the mid-1990s and the developments in the global market today.[10] This has led many to wonder if these developments foreshadow another region-wide bust. Asian nations have learned their lessons well from that crisis. Over the years, they have built up stronger current account balances, fiscal positions, foreign exchange reserves, not to mention, more stringent and prudent banking regulations. These serve as adequate buffers that would help Asian countries ride through the storm.

Current account balance has improved over the years as the Philippines transitioned from being a net borrower prior to 1997 to a net lender since 2003. The current account registered a surplus amounting to US$12.6 billion in 2014, higher than the US$11.4 billion recorded in 2013. A surplus was likewise recorded in the first quarter of 2015 amounting to US$3.3 billion. This is equivalent to 4.8 percent of GDP and is more than twice the amount of US$1.5 billion in the same period last year.

Gross international reserves (GIR) refers to the country's (BSP) holding of foreign exchange that serves as stand-by fund that would finance a deficit arising from current, capital, and financial transactions. Assuming that no other sources of foreign exchange could be tapped, GIR levels should be sufficient to cover external payments (e.g., imports and debt service). The rule of thumb is that GIR levels should cover at least three-months' worth of import requirement.[11] Prior to the Asian Financial Crisis in 1997, the

[9] Average from 2010 to 2014. Less than one percent go to Greece.
[10] Back then, the US Fed also kicked off an interest rate tightening cycle and China devalued its currency.
[11] Or to cover for (all) the country's total external (foreign) indebtedness that is due within the immediate 12-month period.

country's GIR level was enough to cover for 2.9 months of imports. In the first seven months of 2015, total GIR amounted to US$80.3 billion, equivalent to 10.5 months of import requirement.

External debt is the sum of foreign debt held by the public and private sector. The Philippines has learned to manage its debt over the years as reflected in the marked improvement of its external debt indicators. This bodes well for the country's ability to meet its maturing obligations. External debt as a percentage of GDP for instance, has been on a downtrend for almost 15 years now. Debt maturities have likewise lengthened, with almost 90 percent of external debt being long-term.

Philippines Key Economic Indicators

	Key Indicators	1990-1996 Ave.	2007-2013 Ave.	2014	2015	
Resilient growth	Real GDP growth (%)		5.3	6.1	5.3	(Jan-Jun)
Manageable inflation	Headline inflation (%)		4.3	4.1	1.9	(Jan-Jul)
Modest fiscal deficit	Fiscal balance (% of GDP)	-0.9	-2.0	-0.6	0.2	(Jan-Jun)
Ample liquidity and credit	Domestic liquidity (% of GDP)		51.0	60.9	59.7	(Mar)
	Domestic credit (% of GDP)		50.5	55.8	54.6	(Mar)
Sound and stable banking system	Non-performing loans (% of total loans) - U/KBs*		3.0	1.8	1.8	(Jun)
	Capital Adequacy ratio (consolidated basis) - U/KBs**		16.9	16.2	NA	
Robust external payments position	Current Account Balance (% of GDP)	-4.1	3.4	4.4	4.8	(Jan-Mar)
	GIR (months of imports)	2.9	9.6	10.4	10.5	(end Jul)
	External debt (% of GDP)	53.0	36.0	27.3	26.1	(end May)
	External debt service burden (% of exports)	18.1	9.6	6.4	5.8	(Jan-May)

Sources ADB Statistical database, BSP

Prospects, risks, and policy implications

The growth target for 2015 is 7.0-8.0 percent. The prospect of hitting the growth target is dim in light of slower-than-expected growth during the first semester. If the economy were to grow at an average of *at least* 6.5 percent in the second half of the year, full-year growth would stand at 6.0 percent.

Positive outlook will very much depend on maintaining robust levels of household consumption and private investment. Consumer and business sentiment remain positive. Aside from the usual boost that comes from strong growth of the BPO industry and inflow of remittances, election-related spending is likewise expected to enhance domestic demand. Moreover, falling global commodity prices, including oil, bodes well for inflation expectations and demand.

Risks to the growth outlook will likely come from sluggish government expenditure (attributed to slow budget disbursement, despite efforts to improve budget execution). Also, the results of the upcoming election will determine the continuity of reform efforts and growth momentum. Thus, investors may adopt a wait-and-see attitude before making major commitments. On the international front, the economic slowdown of the country's major trading partners (China, Japan, and the EU) will result in lackluster export performance. Moreover, currency revaluations will likely contribute to financial market volatilities and weigh on investor sentiment.

Looking forward, the BSP is expected to be mindful of the trade-offs from utilizing the exchange rate to boost export competitiveness. While exchange rate intervention should remain in the toolkit to moderate excessive volatilities, it should also be permitted to respond to shifts in balance of payments flows (current, capital, financial). With the remaining few months left for the current administration, the government should remain steadfast on working to address supply bottlenecks by expanding essential infrastructure and raising productivity.

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