



Why the Philippine Economy Should Hold Up in 2009

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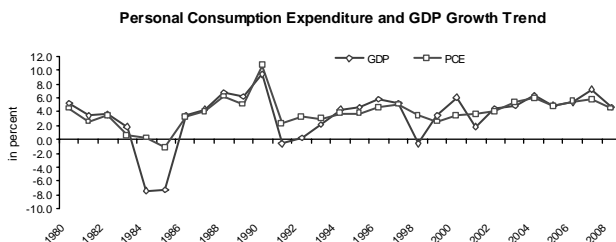
EDITORIAL

We are pleased to release the inaugural issue of the monthly BSP Economic Newsletter. The Newsletter aims to provide to the BSP community and the public a readily accessible, up-to-date, concise and reader-friendly compendium of studies on current economic and financial issues. The publication of the monthly Newsletter is one of the many initiatives of the BSP in marking the 60th anniversary of central banking in the Philippines.

While the Philippines is not immune to the global economic slowdown, it is expected to continue to expand in 2009. There are fundamental forces in the economy that would help it to withstand global shocks and avoid a major slippage in growth.

1. STRONG DOMESTIC DEMAND CONTINUES TO DRIVE GROWTH

A key factor that could drive the country's growth is the strength of domestic demand. Personal consumption, which accounts for more than two-thirds of the Philippine economy, has been historically firm, with private spending resilient across business cycles. The only time in the past 30 years that private consumption contracted was in 1985, when the economy underwent external debt restructuring. Structural factors are behind this underlying resilience. The Philippines' young and economically active population has propelled economic growth even in difficult times. In addition, a large share of the labor force is employed in industries that are less susceptible to external shocks, such as in agriculture, government, utilities and education. Incomes are also at a level where the majority of the population has a high propensity to consume.



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2. TRADE OPENNESS VULNERABILITY RELATIVELY MODEST

The country's dependence on external demand is comparably smaller relative to its Asian peers. The Philippines' exports-to-GDP ratio has gone down to 29 percent in 2008 from 49 percent in 2000. Worth noting as well is the drop in the share of Philippine exports that go into the US. Including indirect exports, or exports that go first into China but are re-exported to the US, the share of total Philippine exports to the US has also gone down by almost 10 percentage points during the six-year period from 2000 to 2006.²

Direct + Indirect Philippine Export Exposure (in percent to total exports)								
Destination	2000	2001	2002	2003	2004	2005	2006	2006 - 2000 ^a
US	30.7	28.9	26.1	22.0	20.2	20.6	20.8	-9.9
Japan	15.2	16.3	15.9	17.0	21.1	18.5	17.5	2.3
China	2.8	3.1	4.2	5.8	6.0	7.2	7.0	4.2
Rest of OECD	20.5	21.9	21.6	20.1	20.3	20.6	22.1	1.6
Rest of World	30.7	29.7	32.2	35.0	32.5	33.1	32.6	1.9

^a percentage point difference between 2000 and 2006

Source: HKMA Working Paper, 30 December 2008

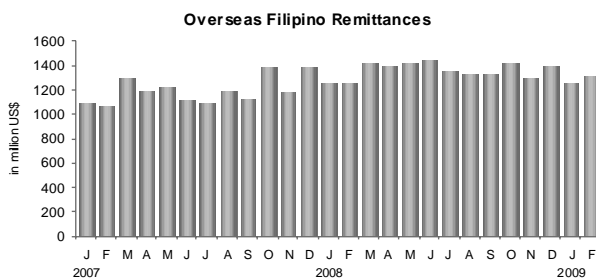
3. REMITTANCES ARE EXPECTED TO BE STEADY AND WILL CONTINUE TO DRIVE CONSUMPTION AND GROWTH

The strength of overseas Filipino remittances is supported by key fundamentals that would help the Philippine economy to withstand global shocks better. The number of displaced overseas workers as reported by the Department of Labor and Employment (DOLE) is small when compared to the stock of overseas Filipinos, estimated at

² Source: Hong Kong Monetary Authority (HKMA)



close to 9 million. Deployment has also continued to grow in 2009, and there has been a gradual increase in the share of workers with permanent resident status, suggesting a welcome shift from yearly contract renewals to more long-term employment. There has also been an observable rise in the deployment of skilled and professional workers. Apart from their higher earnings, they also tend to have more long-term work contracts. Moreover, the Philippine Overseas Employment Administration believes that labor demand could remain strong in some countries given the needs in their power/energy and tourism industries. The hiring program for nurses and caregivers in Japan under the Japan-Philippines Economic Partnership Agreement (JPEPA), which commenced this month, could also open up opportunities for Filipinos in the field of health and medical care. The DOLE has also been fielding labor teams in crisis-affected host countries to help displaced Filipino workers find other work opportunities.



4. BPO STRENGTH IS EXPECTED TO PUSH GROWTH FURTHER

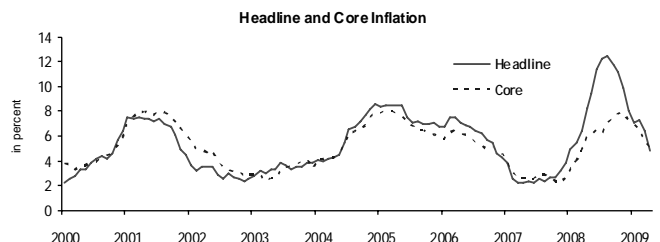
The Business Process Outsourcing Association of the Philippines (BPA/P) expects continued resilience of the BPO industry, with projection of a 10-20 percent growth in revenues in 2009. The continued shift to high-value services, notably back office services, IT outsourcing and engineering/design process delivery, along with the increasing need to outsource non-core business activities of firms operating in advance economies, are expected to propel the growth of the BPO industry in 2009.

The underlying fundamentals of the outsourcing industry should also remain

intact despite the difficult external environment. The onset of recessionary forces in the global economy is not expected to eliminate the cost differentials between the developed and developing countries, which is a primary factor driving the decision of firms to outsource or move business processes offshore. Moreover, the growing success of firms that adopt outsourcing/off-shoring could drive higher acceptance of such business model.

5. LOWER PRICES SHOULD SUPPORT DEMAND

The decline in food and energy commodity prices is expected to provide relief to real household incomes, which were compressed for the most part of 2008. Inflation, which hit a 16-year high of 12.4 percent in August 2008, has been on a trend decline as food and energy prices have softened. Headline inflation eased further to 4.8 percent year-on-year in April 2009 from 6.4 percent in March, bringing the year-to-date average to 6.4 percent. The easing of inflation should provide a boost to household purchasing power.



6. MONETARY EASING SHOULD ENHANCE LIQUIDITY AND SUPPORT DOMESTIC DEMAND

The expected sustained slowdown in inflationary pressures has enabled the BSP to implement considerable monetary stimulus and provide ample liquidity in the system. The BSP has responded pre-emptively, with interest rate reductions and a variety of liquidity-enhancing measures to ensure that there is ample resources to fund the growth requirements of the economy and to improve the functioning of financial markets. The BSP opened a dollar repo facility,



reduced the reserve requirement ratio, increased the rediscounting budget, and liberalized access to the rediscounting window. These preemptive measures are expected to reassure households and businesses that the BSP will utilize the full array of its policy instruments to maintain monetary and financial stability and prevent any long period of economic distress.

An accommodative monetary policy should support demand and minimize the corrosive feedback stemming from weakening economic and financial conditions in various ways. First, lower policy rates could help lower credit spreads thereby counteracting traditional credit problems which normally follow a weakened financial sector. Second, lower interest rates reduce the debt servicing costs of corporates, thus improving their cash flows. Third, lower interest rates make it easier to borrow for firms that are dependent on bank financing (e.g., small and medium enterprises, real estate, and other interest rate-sensitive sectors).

At 4.5 percent, there is still room to adjust policy rates should inflation outlook continue to be benign. Simulation results using the BSP's multi-equation model suggest that the policy rate may still be reduced in favor of a minimal increase in growth without breaching the inflation target in 2009 and 2010. A further 25-basis point cut in the reverse repurchase (RRP) rate in 2009 and 2010 will raise average inflation by 0.007 percentage point and 0.014 percentage point from their baseline values in 2009 and 2010, respectively. Under both scenarios, the inflation forecasts remain well within the target ranges of 3.5 + 1.0 percent for 2009 and 4.5 + 1.0 percent for 2010.

7. HIGHER PUBLIC SPENDING IS ALSO EXPECTED TO INCREASE DOMESTIC DEMAND

Recent adjustments in fiscal targets also provide policy space to support growth. The postponement of the balanced-budget objective due to the global economic slowdown will provide countercyclical fiscal space for the government to boost infrastructure spending

and enhance social safety nets to support the most vulnerable segments of the population. For 2009, the emerging budget deficit is expected to reach 2.5 percent of GDP. The government has identified energy, transport and water systems to be the most critical sectors that would need infusion of public funds with a view to creating jobs, upgrading the country's capital stock and boosting growth.

The Government has announced a P330-billion Economic Resiliency Plan (ERP). The ERP aims to pump prime the economy in 2009 by upgrading the infrastructure and capital stock, and by expanding social safety nets. Some of the fiscal stimulus measures that have already been implemented are programs to encourage exporting firms to diversify, innovate and upgrade their products; and provide tax relief to the private sector by reducing the corporate income tax from 35 percent to 30 percent, exempting minimum-wage earners from personal income tax, and increasing the personal exemption of non-minimum wage earners.

8. BANKING SYSTEM REMAINS STABLE AS CREDIT CHANNEL

As a result of purposeful reforms in the past, that included the cleaning up of bad assets in the banking system, aligning accounting practices with international standards, enhancing risk management systems, and strengthening bank capitalization, the banking system remains sound as evidenced by:

- Steadily expanding asset base – total bank assets grew by 13.4 percent in February 2009 to reach P5.8 trillion.
- Improving asset quality – the non-performing loan (NPL) ratio of U/KBs dropped to 3.72 percent as of end-February 2009 from 12.9 percent in 2004.



- Strengthening bank capitalization – the capital adequacy ratio (CAR) of banks remains above regulatory and international standards at 14.6 percent and 15.5 percent on solo and consolidated basis, respectively as of September 2008.

9. OTHER MITIGATING SECTORS

There are also potential growth areas that provide pockets of opportunities and comparative advantage for business and investment in the country. The construction sector is seen to ride out the global economic downturn and be a key growth driver for 2009, as the government realigns the budget to implement fast-moving infrastructure projects. The real estate sector is also expected to remain resilient, given the continued demand from outsourcing firms and overseas Filipinos. Positive prospects can also come from agriculture as the government continues to provide substantial support to this sector.

10. RP BETTER PREPARED NOW THAN IN PAST CRISES

The country has been able to withstand the shocks of the current crisis so far because valuable lessons have been learned from the 1997-1998 financial crisis, and policy measures and reforms have been implemented accordingly to better prepare the economy to face shocks and challenges. In particular, external balances have been strengthened, foreign exchange reserves have been increased, the public debt burden has been reduced and banking supervision has been substantially improved.

Selected Philippine External & Banking Sector Indicators		
	1997/1998	2008/2009
External sector		
Current account, in % of GDP	(5.1) ^a	2.5 ^c
External debt, in % of GDP	70.8 ^b	32.0 ^c
Gross International Reserves (GIR) in months of import cover	3.08 ^b	6.28 ^e
Banking sector		
Non-performing loan (NPL) ratio, in %	11.0 ^b	3.7 ^d
Return on equity (ROE), in %	5.9 ^b	8.7 ^c
Return on assets (ROA), in %	0.8 ^b	1.0 ^c

^a 1997

^b 1998

^c 2008

^d February 2009

^e April 2009

11. RECENT TAILWINDS COULD OFFER SOME SUPPORT TO GROWTH

As a major trading partner and source of foreign investments and remittances for the Philippine economy, the sharp downturn in the US economy could indeed dampen considerably Philippine growth prospects. However, recent developments provide some encouraging news on the US economy, engendered by the following events: (a) the passage of the US fiscal stimulus package amounting to US\$787 billion, which is expected to boost consumer spending in the US and result in higher growth and employment; (b) purchase of distressed assets from some major US banks by the US Treasury, which will bring back public confidence in the financial system; (c) reports of positive first quarter 2009 earnings of major US financial institutions prompting speculations that the banking industry slump has ended; and (d) the drop in initial claims for unemployment insurance in early April 2009 which was larger than any week since the start of the year.

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