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The European Turmoil and Its Impact on the Philippine Economy

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This article provides an update on the March-April 2010 issue of the BSP Economic Newsletter entitled "The Greece Turmoil and Its Implications on the Philippine Economy" by Mr. Roy R. Hernandez.

Background

What started out in the past two years as a Greece sovereign debt problem has spilt over across Europe and conflagrated into a sovereign debt crisis, a banking crisis and a growth crisis rolled into one. When the tentacles of the sovereign debt turmoil in Greece ensnared other Eurozone member-countries, including the bigger sized economies and systemically important member-countries such as Spain and Italy, Eurozone's real economic activity has started to deteriorate. The consensus is that the Eurozone's economy will contract this year.

Table 1. Concensus Growth Forecast for the Euro Area (in percent)

	2012	2013
IMF[1/]	-0.3	0.7
IIF[2/]	-0.5	1.1
OECD[3/]	-0.1	0.9
Bloomberg Concensus[4/]	-0.5	0.6

[1/] International Monetary Fund (IMF), World Economic Outlook, July 2012
[2/] Institute of International Finance Inc. (IIF), Euro Area Forecast Update, August 2012
[3/] Organization of Economic Cooperation and Development (OECD) Economic Outlook, 29 July 2012
[4/] As of 23 August 2012

Economists and policymakers are divided in their views as to what the reasons are behind the current European debt crisis. One school of thought, which garners the support of non-crisis-hit Euro area-countries particularly Germany, argues that the ongoing crisis was the direct result of profligacy of irresponsible governments that spent beyond their means. Bailing out these countries could create a moral hazard problem – that is, these countries will be more likely to practice profligacy again knowing that they will be rescued anyway. In the words of Germany's Deputy Finance Minister Steffen Kampeter, "strategies to resolve the sovereign countries should rule out socialization and redistribution of bad political decisions made by over-indebted countries."[2]

The other school of thought argues that the establishment of a uniform currency has been plagued by inherent structural complications to the disadvantage of member-countries in the periphery. An article in The Economist magazine described the current woes of Southern Europe as follows:

> *"Southern Europe, in particular, has suffered a triple blow: (1) the Mediterranean countries were hit hard by globalization and the loss of low-tech industries such as textiles; (2) they faced competition from cheaper labor in ex-communist member states when the EU was enlarged eastward; and (3) the adoption of the euro made it hard for southern countries with a tradition of high inflation to adjust through the time-tested method of devaluation. Without a lender of last resort in the European Central Bank, which prevents it from lending directly to governments, members of the Eurozone are akin to developing countries using a foreign currency: they are more easily pushed into insolvency when the markets panic."*[3]

The divergent views on the origin of the Eurozone debt crisis have made policy responses more complicated. Proponents of the moral hazard school of thought are keen on imparting the harsh lesson of overspending beyond one's income while proponents of the euro's bias against Southern Europe believe

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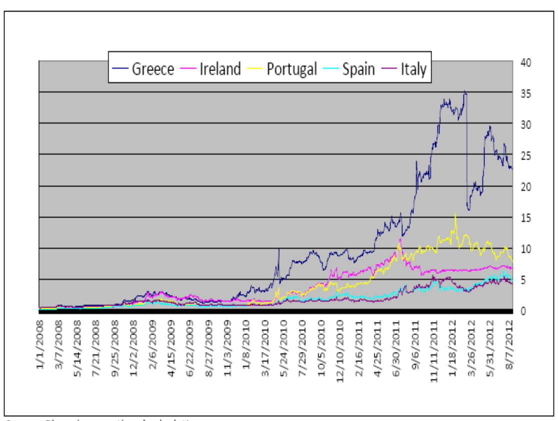
[2] Faris, Stephan, "The Future of Europe: A Stronger Union or a Smaller One?," TIME, 12 August 2011
[3] Charlemagne, "The Future of the European Union (Part 2)." Don't Count on a Hamiltonian Moment: The Economist, 28 May 2012

that peripheral economies have fallen victim to an overvalued exchange rate that is beyond their powers to tinker with.

The depth of the complication and interrelatedness of the European turmoil have prompted serious thoughts about the effectiveness of policies designed to contain them. For example, providing funding and liquidity to crisis-hit countries could have given their domestic banking sectors a breathing room, but could have sunk these countries deeper into a debt quagmire. Likewise, implementing austerity measures to trim sovereign debts could weaken further economic activity and eroding the tax revenues necessary to sustain the operations of governments.

Moving forward and with a risk of recession looming, Eurozone policymakers are indeed at a crossroad and may be forced to take decisive actions to restore normalcy in the region. The market has so far been transparent in punishing weaker countries by requiring them to pay punitive rates in their borrowing activity. Crisis-hit member-countries' debt spreads over Germany have remained elevated.

Figure 1. 10-Year Sovereign Debt Spreads over Germany (in percent)



Source: Bloomberg, authors' calculation

As Europe muddles through and fights to remain buoyant above these problems, it could choose the path of least resistance, which is likely a long and slow adjustment process. A widely-consulted and comprehensive roadmap could be drafted, which may include a methodology for instituting a banking union and greater financial integration, with better and more coordinated fiscal and monetary policy governance and risk sharing. In addition, credible firewalls should be instituted to ring-fence the turmoil and prevent its spread to other member-countries at the very least, and the entire global economic system at worst.

Should the market grow tired of this evolutionary crawl and starts to question the Eurozone's capability to wiggle its way out of this problem, two scenarios could likely emerge.

The first scenario is coated with optimism. The slow and painful process could lead to a revolutionary regime where reform processes are drastically accelerated as policy makers are pushed against the wall by unfortunate events conspiring against them. As market pressures intensify, policymakers could be forced to get their act together and think beyond national interest. The "economic convergence" promised by the Maastricht Treaty[4] but never realized as governments allowed debt to rise and failed to liberalize their labor markets, supervise their banks or harmonize their tax systems could be hastily put into motion.[5] A European superstate could be established by harmonizing taxes and centralizing political power with, say, an elected European Commission and new powers for the European Parliament. Another version of the superstate involves ceding greater power to bigger countries such as Germany as compensation for bailing out crisis-hit member-countries.[6] In principle, this would offer a rapid and effective resolution of the crisis. However, the likelihood of this outcome is low as governments continue to struggle in taking collective decisions. Moreover, nationalist sentiments in crisis-hit countries could be buoyed by the apparent hegemony of Germany, scuttling the objectives of the superstate ideal.

The second scenario is the worst-case scenario of the Eurozone's disintegration and the euro's demise. On the optimistic side, a

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[4] The Maastricht Treaty (formally, the Treaty on European Union or TEU) was signed on 7 February 1992 created the European Union and led to the creation of the single European currency, the euro. The Maastricht criteria (also known as the convergence criteria) are the criteria for European Union member states to enter the third stage of European Economic and Monetary Union (EMU) and adopt the euro as their currency. The criteria cover inflation rate, government finance, exchange rate and long-term interest rates.
[5] Lister, Tim, "The Future of Europe: 3 Scenarios," CNN, 15 June 2012
[6] The Economist, "The Future of European Union. The Choice," 26 May 2012

break-up would allow individual countries to restore control over monetary policy. Countries such as Germany will not be forced to bailout and create moral hazard over the profligacy of other countries, while countries in the periphery could reclaim exchange rate flexibility that was given up in joining the euro.[7] But this scenario may prove overly optimistic. Others argue that even if in the event of a euro break-up, banks and firms across the world would all scamper to exit and square their euro positions, which would make it difficult for them to find those willing to take the other side of the transactions.[8] Furthermore, this will throw the global financial system into a complete chaos that could outstrip the jitters experienced after Lehman Brothers collapsed in September 2008. Under a condition of a severe risk aversion, share prices will plummet across the world, demand for safe-haven financial instruments will be heightened and the primacy of the US dollar as a reserve currency will be cemented further. In Eurozone itself, every country is expected to take a hit. The German government has reportedly estimated that the German economy would shrink 10 percent if the euro were to break up.[9]

The appropriate policy response to the euro crisis is equally a function of savviness and commitment among European political leaders to make bold decisions that transcend national boundaries as well the creativity of monetary policymakers to implement timely macroeconomic adjustment. However, as the debate continues, its repercussions particularly if push comes into shove, will surely be felt thousands of miles away – reaching the shores of emerging market economies, the Philippines included.

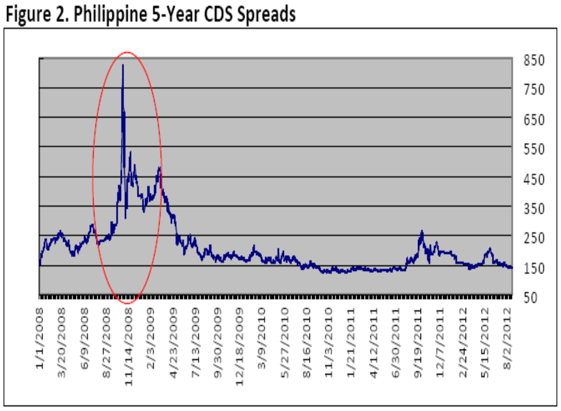
Possible Spillovers to the Philippine Economy

The potential impact of the European debt turmoil on the Philippine economy could pass through possible spillover channels such as in (1) financial markets, (2) the trade in goods and services, and (3) financial flows.

1. Financial markets channel

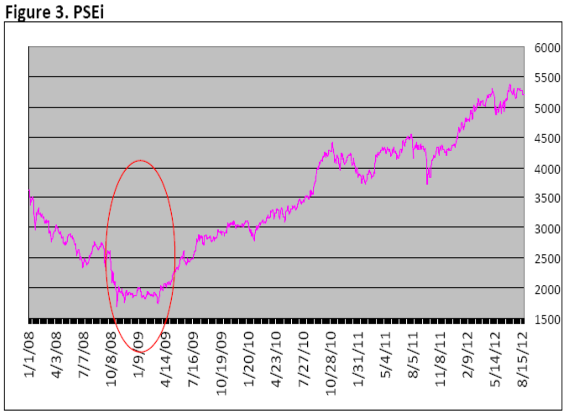
The further deterioration of the European debt crisis would have an immediate impact on investor risk perception. Increased risk aversion across the global financial markets and fears of another financial meltdown could put a squeeze on credit markets and global liquidity which could possibly trigger capital flight. Credit Default Swap (CDS) spreads may widen as investors seek protection given the escalating tension in the Eurozone, Philippine debt papers could be sold off, and the Philippine Stock Exchange index (PSEi) could revert to sub-5000 level as investors take refuge in perceived safe haven financial instruments.

Figure 2. Philippine 5-Year CDS Spreads



Source: Bloomberg

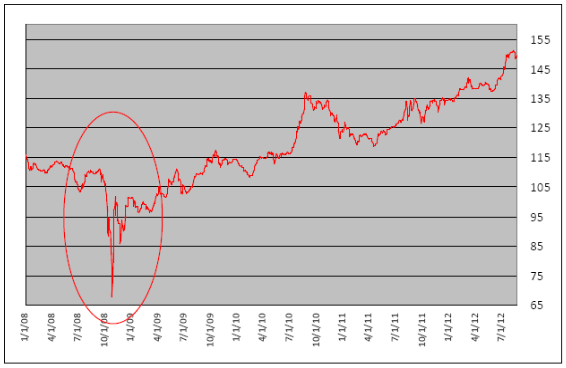
Figure 3. PSEi



Source: Bloomberg

[7] Lister, Tim, "The Future of Europe: 3 Scenarios," CNN, 15 June 2012
[8] Worrachate, Anchalee, "Euro Exit Risk Prompts JPMorgan to Establish Contingency Plans," Bloomberg, 25 July 2012
[9] Porter, Eduardo, "Why Germany Will Pay Up to Save the Euro," The New York Times, 26 June 2012

Figure 4. ROP31 Prices[1]



[1]Refer to US$-denominated Republic of the Philippines (ROP) bonds maturing in January 2031.
Source: Bloomberg

Banking system

While the country's banking system is not insulated from contagion risk, reforms implemented over the years have fortified its resilience against external shocks. These reforms ensure a sustained credit growth that support economic activity without fomenting asset price misalignments; promote higher capitalization of banks without undermining their profitability; and enhance financial sector flexibility without curtailing market discipline. In addition, the financial regulatory framework has complemented monetary policy in the pursuit of macroeconomic stability. In the event of a financial market squeeze emanating from a worst-case European crisis scenario, the BSP could revisit the liquidity-enhancing measures it implemented at the height of the recent global financial turmoil.

2. Trade in goods and services channels

Trade in goods channel

The Philippines is exposed to the European turmoil through a possible decline in Philippine exports. In 2011, the country's export to Europe amounted US$6.4 billion, representing 13.2 percent of total Philippine exports. For the first semester of 2012, the country's exports to Europe amounted to US$3.5 billion, representing 13.2 percent of total Philippine export of US$26.8 billion. Given the prolonged decline of consumer spending in Europe, Philippine exports to Europe is expected to remain sluggish.

Table 2. Philippine Export Destinations (As share to total) [1/]

	2000	2010	2011	Jan-Jun 2012
US	29.8	14.7	14.8	15.3
Europe	18.4	14.8	13.2	13.2
Asia:	48.1	66.0	53.3	67.4
Japan	14.7	15.2	18.5	17.8
China	1.9	14.9	12.7	12.8
NIEs[2/]	23.8	30.4	25.3	26.0
ASEAN[3/]	7.5	8.2	9.1	9.9
South Asia[4/]	1.4	1.0	1.0	0.9

[1/] Based on NSO data
[2/] includes Hongkong, South Korea, Singapore and Taiwan
[3/] includes Brunei Darussalam, Cambodia, Indonesia, Malaysia, Myanmar, Thailand and Vietnam
[4/] includes India and others
Source: BSP

Nevertheless, the growing inter-Asia trade provides a buffer for Philippine exports. The substantial growth and industrialization in Asian economies present opportunities for the Philippines to expand its trade and investment in the region. The continued robust economic growth and closer integration of Asian economies offer diversification and broaden the market for Philippine exports. However, inter- and intra-regional trade, as well as other trade transactions with the rest of the world, could be adversely affected by the second-round effects of a worst-case European crisis. That is, trade-related transactions, such as trade credit and refinancing, could be severely curtailed by weaker global economic conditions and heightened risk aversion of both borrowers (on the demand side) and creditors (on the supply side).

Trade in services channel

Overseas Filipino (OF) remittances

OF remittances from Europe remain significant. In 2011, OF remittances originating from Europe stood at US$3.3 billion, constituting 16.6 percent of total OF remittances. For the first seven months of 2012, OF remittances from Europe amounted to US$1.9 billion, accounting for 15.9 percent of total OF remittances. The economic downturn in Europe as well as the weaker euro relative to the Philippine peso could decrease euro-denominated remittances (both in value and volume). However, the geographical diversification of deployment of Filipino workers, as manifested in the continued resilience of OF remittances from US and the Middle East and the growing

OF remittances from Asia, acts as a buffer against a sluggish European economy.

Table 3. Overseas Filipino Remittances (US$ million)

	2007	2008	2009	2010	2011	Jan-Jul 2012	Jan-Jul 2011
US	7,564.9	7,825.6	7,323.7	7,862.2	8,481.2	5,177.6	4,779.9
Europe	2,351.7	2,658.7	3,061.6	3,180.5	3,348.1	1,901.4	1,996.0
Middle East	2,172.4	2,502.6	2,665.0	2,964.2	3.215.8	1,818.0	1,741.2
Asia:	1,543.2	1,884.0	2,078.2	2,363.2	2,568.6	1,651.5	1,482.3
Japan	401.6	575.2	773.6	883.0	913.6	580.6	540.6
China	8.2	4.7	12.9	21.6	22.5	42.1	12.7
NIEs[1/]	1,048.4	1,205.8	1,178.3	1,330.6	1,470.4	924.1	843.6
ASEAN[2/]	71.6	96.5	109.4	121.5	155.1	100.2	81.0
South Asia[3/]	1.2	1.5	3.0	4.8	4.5	2.4	2.7

Table 4. Overseas Filipino Remittances (As share to total)

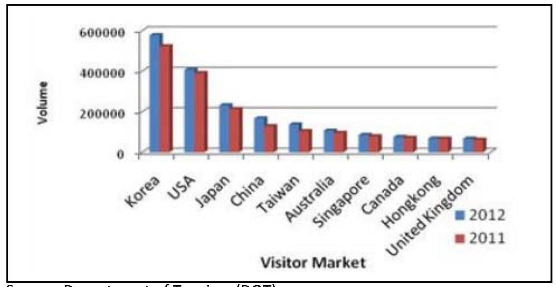
	2007	2008	2009	2010	2011	Jan-Jul 2012	Jan-Jul 2011
US	52.4	47.6	42.2	41.9	42.2	43.4	41.1
Europe	16.3	16.2	17.6	17.0	16.6	15.9	17.6
Middle East	15.0	15.2	15.4	15.8	16.0	15.2	15.3
Asia:	10.7	11.5	12.0	12.6	12.8	13.8	13.1
Japan	2.8	3.5	4.5	4.7	4.5	4.9	4.8
China	0.1	0.0	0.1	0.1	0.1	0.4	0.1
NIEs	7.3	7.3	6.8	7.1	7.3	8.0	7.7
ASEAN[2/]	0.5	0.6	0.6	0.7	0.8	0.8	0.7
South Asia[3/]	0.0	0.0	0.0	0.0	0.0	0.0	0.0

1/ includes Hong Kong, South Korea, Taiwan and Singapore
2/ includes Brunei Darussalam, Cambodia, Indonesia, Malaysia, Myanmar, Thailand and Vietnam
3/ includes India and others
Source: BSP

Tourism receipts

Tourist arrivals for the period January to July 2012 showed that visitors from Europe, mostly from the United Kingdom, were among the top 10 tourist markets of the country. The prolonged anemic economic activity in Europe could increase unemployment and reduce disposable income in the region. This could lead to a possible deferment in travel plans among European tourists. In addition, the relatively weaker euro vis-a-vis an appreciating peso could trim down euro purchasing power and would make travel to the country more expensive. These could lead to an eventual decline in the county's tourist receipts from Europe. Nevertheless, the robust and growing tourist arrivals from neighboring Asian countries, particularly South Korea, Japan, China, Taiwan and Singapore, could provide a cushion from the declining tourism receipts from European visitors.

Figure 5. Top Ten Visitor Markets (January to July 2012 vs. 2011)

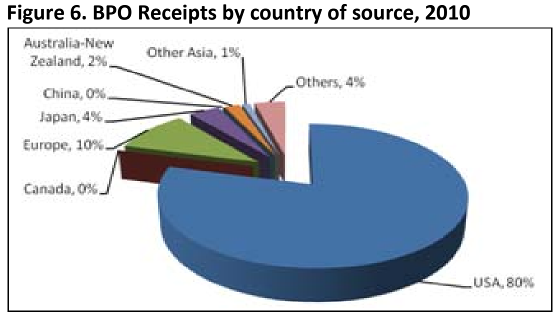


Source: Department of Tourism (DOT)

Business process outsourcing (BPO)

In 2010, about 10 percent of total receipts from the BPO industry came from Europe. The weak economic activity in Europe could trigger reduced inflows from the BPO industry. However, the continued robust outsourcing receipts from the US could compensate for this potential reduction.[10]

Figure 6. BPO Receipts by country of source, 2010



Source: BSP

3. Financial flows channel

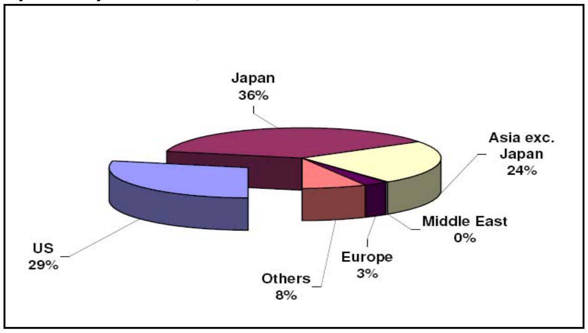
Investments

Investments (both portfolio and direct) may be curtailed by higher risk aversion among investors should the European turmoil deepen. While direct investments coming from Europe accounted for only 3 percent in 2011, gross portfolio investments from Europe remain significant at around 40 percent. Meanwhile, the direct exposure of Philippine banks to European entities

[10] On 30 July 2012, the Business Processing Association of the Philippines (BPAP) announced in its website that it welcomed the rejection of an anti-outsourcing bill by the United States Senate. The vote was 56-42. Sixty votes were necessary to end the effort to kill the bill. If passed, the bill would have eliminated tax breaks for companies outsourcing services and manufacturing jobs to other countries, and provide a 20% tax deduction on costs associated with closing outsourced operations and transferring jobs to the US. (http://www.bpap.org/media-room/500-bpap-welcomes-us-senate-rejection-of-anti-outsourcing-bill)

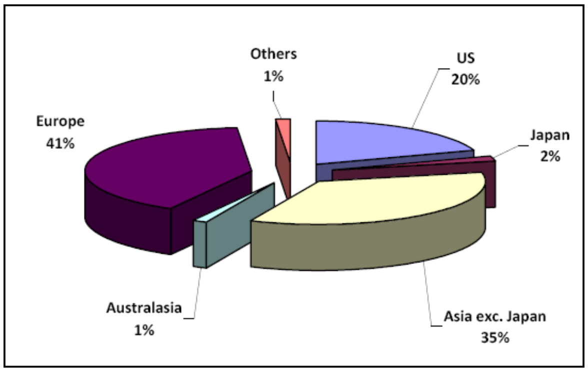
(i.e., sovereign, financial institutions and corporates) remains minimal (representing 1.5 percent of the total banking system assets as of end-February 2012) and was concentrated on the core countries in the EU which currently retained a high credit score despite the European crisis.

Figure 7. Gross Foreign Direct Investments by country of source, 2011



Source: BSP

Figure 8. Gross Foreign Placements of Portfolio Investments by country of source, 2011



Source: BSP

Policy Options for the BSP

Over the years, reforms have strengthened the financial sector against external shocks. But the economy is not totally immune from vulnerabilities. Thus, the BSP stands ready to implement appropriate responses as and when the euro crisis deepens further. For example, macroprudential measures and liquidity-enhancing initiatives could compliment monetary policy in the BSP's defense against risks to financial stability and financial market squeeze.

Structural reforms (such as diversifying trade and investment, enhancing financial policies and deepening the financial system) could also be pursued to improve the Philippine economy's absorptive capacity. These reforms, however, are not designed for short-term and shot-in-the-arm benefits but may take time before their benefits are felt. Thus, this would require close coordination and commitment among the various stakeholders – the BSP; the instrumentalities of the National Government; the investors, exporters and market players; and the public.

Furthermore, intensifying surveillance as well as close coordination with other central banks for information sharing could help the BSP be better prepared to deal with possible adverse implications of the Eurozone crisis. Equally important is the constant and clear communication by the BSP to manage market expectations and allay market risk aversion.

The threat of contagion from the European turmoil still looms. Europe is an important trading and financial partner of the Philippines. If this region deteriorates and its financial markets become dysfunctional, exports, OF remittances and investments to the Philippines will be reduced. Thus, it is in the country's interest to assist in the resolution of the European crisis.

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