

The Philippine Economy: Moving Ahead in 2015

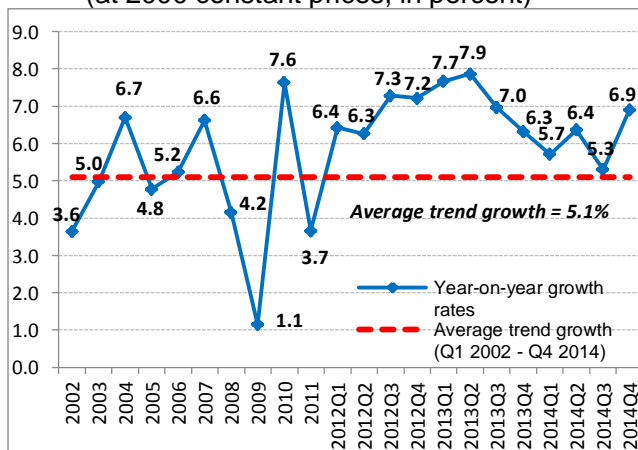
By Faith Christian Q. Cacnio¹

There are two things that people are accustomed to do when one year ends and another begins. One is to look back at the year that was and the other is to look forward to the coming year. This article reflects that custom. It highlights some of the important developments that characterized the Philippine economy in 2014 and it provides a brief overview of what could be expected in 2015, including the risks and challenges that may lie ahead.

A review of 2014

Recent years have seen the Philippine economy emerge as one of the strongest in Southeast Asia. Between 2012 and 2013, the country's economy grew at an average rate of 7.0 percent, higher than that of other economies in the region except China. The Philippines sustained its growth momentum in 2014 expanding at a rate of 6.1 percent (Figure 1). While this figure is at the lower end of the growth target of the national government for 2014 (i.e., 6.0 – 7.0 percent), the Philippines is still one of the best-performing economies in the region for year (Table 1).

Figure 1: Real GDP Growth
 (at 2000 constant prices, in percent)



Source: Philippine Statistics Authority.

Table 1: Real GDP Growth in Selected Asian Countries (in percent)

| | 2012 | 2013 | 2014 |
|-------------|------|------|------|
| Philippines | 6.8 | 7.2 | 6.1 |
| Malaysia | 5.6 | 4.7 | 6.0 |
| Indonesia | 6.3 | 5.8 | 5.0 |
| Thailand | 6.5 | 2.9 | 0.7 |
| Singapore | 2.5 | 3.9 | 2.8 |
| India | 4.7 | 5.0 | 6.9* |
| Korea | 2.3 | 3.0 | 3.3 |
| Taiwan | 1.5 | 2.1 | 3.5 |
| China | 7.7 | 7.7 | 7.4 |
| Vietnam | 5.2 | 5.4 | 6.0 |

*In 2015, India changed the base year it uses in computing real GDP from 2004–2005 to 2011–2012. Thus, GDP growth for 2014 was revised from 5.1 percent to 6.9 percent.

Sources: IMF, NSCB, and Bloomberg.

On the demand side, the key drivers of growth in 2014 were the robust expansion in private consumption, sustained fixed capital investments and the marked improvement of external trade. Consumer spending benefitted from higher employment, particularly on the services and industry sectors, and from the steady stream of remittances from overseas Filipinos. Investments in fixed capital formation (e.g., construction and durable equipment) have also contributed to the growth in 2014.

Meanwhile, positive developments in the global manufacturing sector led to a 12.1 percent growth of Philippine exports. Government spending, which helped boost aggregate demand in 2013, was restrained in the first quarters of 2014. The slowdown in public spending proved to be transitory and was traced to the implementation of reforms in public financial management. By the last quarter of 2014, the national government ramped-up its spending which contributed to the impressive growth posted in the last quarter of 2014. On the production side, economic expansion was mainly driven by the growth in the services and industry sectors.

¹ Ms. Cacnio is a Bank Officer V at the Department of Economic Research.

The growth in these sectors indicates that economic growth has primarily been private sector-led which translates to increased economic activity in sectors that offer better job opportunities.² The services sector, which accounts for more than half of the increase in GDP, continued to be buoyed by the strong growth in the Information Technology and Business Process Management (IT-BPM) industry. In 2014, the total revenue of the IT-BPM industry was estimated at US\$18 billion with employment of more than a million. Growth in the industry sector was propelled by the strong growth in the manufacturing and construction sectors.

The Philippine economy's productive capacity has risen over time. Based on Bangko Sentral ng Pilipinas (BSP) staff estimates, the country's potential output³ grew at an average rate of 5.8 percent for the period 2010 – 2014; an increase from its average growth of 4.8 percent between 2002 and 2009. The improvement in the economy's productive capacity is underpinned by positive developments in the Philippine labor market and higher capital investments. From a negative growth rate of -1.7 percent in 2009, labor productivity rose to 6.1 percent in 2014. The industry sector registered the highest growth in labor productivity in 2014 at 7.2 percent followed by the services sector at 6.5 percent. The increase in labor productivity reflects the improvement in skills of Filipino workers. Moreover, the country's Incremental Capital-Output Ratio (ICOR) declined from an average of 4.2 for the 2002–2009 period to an average of 3.3 for the period 2010–2014. This implies that the production process has become more efficient between the two periods considered.^{4, 5}

² Statement of Secretary Balisacan at the 2014 Year-end Press Briefing, 17 December 2014, NEDA, Pasig City.

³ Potential output refers to the highest level of aggregate output that an economy can produce given its supply of labor and capital and state of technology.

⁴ The Incremental Capital-Output Ratio (ICOR) is estimated as the annual average share of investment-to-GDP over the annual average growth rate of GDP. The higher the ICOR, the less efficient is the production process.

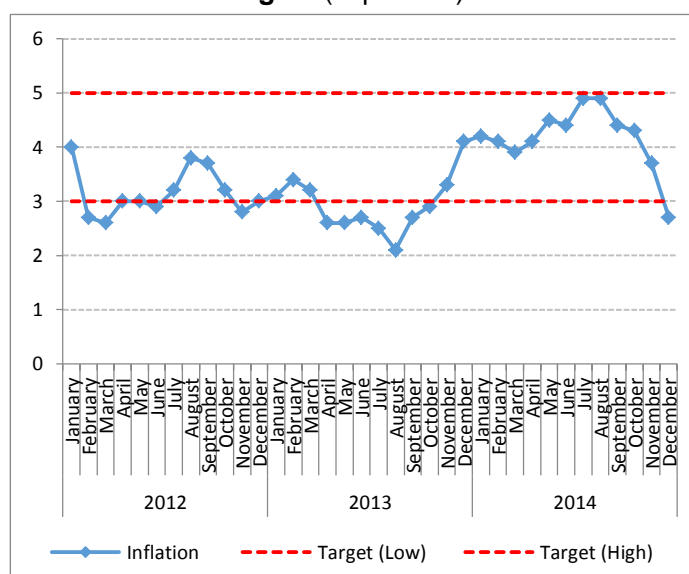
⁵ Glindro, E. and R. Amodia (2014). *Decomposing Sources of Potential Growth in the Philippines*. Unpublished manuscript, Bangko Sentral ng Pilipinas, Manila.

For its part, the BSP continued to deliver on its primary mandate of maintaining price stability conducive to sustainable and inclusive growth in 2014. Average full-year inflation in 2014 stood at 4.1 percent – within the government's inflation target of 3.0 to 5.0 percent for the year (Figure 2). This is the sixth consecutive year that the BSP managed to achieve its inflation targets with average inflation falling within the target range. During the year, the BSP implemented pre-emptive and calibrated monetary tightening measures to ensure that inflation remains within target and inflation expectations are well-anchored. The BSP's monetary policy decisions included increases in reserve requirements, policy rates and SDA rates (Table 2). Reserve requirements were raised twice in the first half of 2014, each by one percentage point. This was done to mitigate the potential risks that strong liquidity and credit growth may pose on financial stability. Between June and September 2014, the BSP raised its policy rates and SDA rates by a total of 50 basis points to temper the rise in inflation and guide market expectations towards the inflation target. Inflation was accelerating on the back of higher food prices, volatile oil prices and strong aggregate demand. Inflation expectations were also settling near the upper-end of the inflation target. Towards the end of the year, inflationary pressures moderated with the easing of international oil and commodity prices and inflation expectations settled within manageable levels. The BSP ensured that each monetary policy decision and the rationale behind them are properly communicated to the market. This is in keeping with the BSP's commitment to transparency and accountability.

The peso averaged ₱44.40/US\$1 for the period 2 January - 29 December 2014, depreciating by 4.4 percent from its ₱42.45/US\$1 average in 2013. Global market uncertainties, particularly on the potential spillover effects of the US Fed tapering of its quantitative easing policy,⁶ have brought depreciation pressures on the Philippine peso.

⁶ Quantitative easing is a monetary policy that central banks adopt to stimulate the economy when standard monetary policy becomes ineffective (i.e., when short-term interest rates are near the zero lower bound). It

Figure 2: Actual Inflation vs. Inflation Targets (in percent)



Source: Bangko Sentral ng Pilipinas.

Table 2: Monetary Policy Decisions

| Date | Monetary Policy Decision | | | |
|------|--------------------------|-----------------|---------------------|----------------|
| | RRP rate | SDA rate | Reserve Requirement | |
| 2014 | Feb 6 | Maintain | Maintain | Maintain |
| | Mar 27 | Maintain | Maintain | Raise by 1 ppt |
| | May 8 | Maintain | Maintain | Raise by 1 ppt |
| | Jun 19 | Maintain | Raise by 25 bps | Maintain |
| | Jul 31 | Raise by 25 bps | Maintain | Maintain |
| | Sep 11 | Raise by 25 bps | Raise by 25 bps | Maintain |
| | Oct 23 | Maintain | Maintain | Maintain |
| | Dec 11 | Maintain | Maintain | Maintain |

Source: Bangko Sentral ng Pilipinas.

The US Fed is gradually moving towards the normalization of interest rate given that its economic recovery is gaining traction and its jobs market is posting growth. In October 2014, the US Fed ended its bond-buying

entails the purchase of specified amounts of financial assets (commonly of longer-term maturities) from the commercial banks and private institutions which raises their prices, lower long-term yields and increase the money supply in the economy. Japan was the first country to have used quantitative easing in the early 2000s to fight deflationary pressures in its economy. The US undertook three rounds of quantitative easing beginning in 2008 to tide its economy over the repercussions of the 2008 financial crisis. By the time the US Fed ended its bond-buying program in October 2014, it has accumulated US\$4.5 trillion worth of Treasury bonds and mortgage-backed securities.

program that was started in 2012. Diverging growth prospects in major economies (e.g., US, Japan, Euro area) have likewise contributed to the weakening of the peso. On one hand, market optimism over the US economy has resulted in the strengthening of the dollar. On the other hand, apprehensions over fragilities in the economies of Japan and the Euro area have dampening effects on the demand for the peso.

During the first nine months of 2014, the country's BOP position recorded a US\$3.4 billion deficit, a reversal from the US\$3.8 billion surplus recorded in 2013. The deficit was attributed to the significant increase in net outflows in the financial account brought about by large net outflows in portfolio investments and in other investments. Positive developments in the US economy and anticipations of interest rate adjustments by the US Fed have led to capital outflows in emerging markets like the Philippines. Meanwhile, the current account remained in surplus at US\$6.8 billion supported by strong remittance flows and receipts from the BPO industries and the export sector. As of end-December 2014, the country's gross international reserves (GIR) stood at US\$79.8 billion. This GIR level can cover 10.2 months' worth of imports of goods and payments of services and income. It is also equivalent to 8.4 times the country's short-term external debt based on original maturity and 6 times based on residual maturity. This implies that the economy has sufficient buffer against potential external shocks.

In 2014, the BSP continued to safeguard the stability of the Philippine banking system. Having a sound and stable banking system is vital in sustaining the growth momentum of the country. Banks play the important role of ensuring that financial resources in the economy are channeled to productive uses. The robust expansion in bank lending has been cited as an important factor underpinning the domestic economy's growth momentum in 2014. Bank lending reached a total amount of ₱4.4 trillion in December 2014, growing by 16.8 percent. Loans for production activities, which accounts for four-fifths of banks' aggregate loan portfolio, likewise grew at double-digit levels (i.e., 15.4 percent) primarily driven by growth in lending

to the trade, transportation, storage and communication, electricity, gas and water, real estate, renting, and business services, manufacturing and financial intermediation sectors. While lending continued to grow, universal and commercial banks (U/KBs) managed to maintain the quality of their loans. The NPLs of U/KBs stood at 2.0 percent as of September 2014, the lowest since December 2009. With low NPLs, the capital adequacy ratios (CARs) of U/KBs under the BASEL 3 Framework was at 16.0 percent on solo basis while it was 16.7 percent on consolidated basis at the end of the second quarter of 2014. The CAR of banks is well-above the BSP's standard of 10.0 percent and the BIS's standard of 8.0 percent. The relatively high capital adequacy ratios of banks imply that they are sufficiently capitalized to weather possible financial risks that may arise. In 2014, the Philippine banking sector was the only one among 69 assessed jurisdictions that was given positive outlook by Moody's, an international credit rating agency. This is the third straight year that the Philippines received such positive outlook. This is an affirmation of the confidence that market agents bestow upon Philippine banks.

The BSP recognizes the many risks and uncertainties that continuously arise due to the evolving nature of banking systems. Thus, in 2014, the BSP enacted a number of regulatory reforms to further enhance the risk management practices in the Philippine banking system and have the adequate capital buffers to address potential shocks. These reforms include: i) implementation of real estate stress test (REST) limit for U/KBs and TBs on their aggregate real estate exposures; ii) approval of enhanced regulation on credit risk management of banks and quasi-banks; iii) approval of guidelines for determining so-called "D-SIBs" or banks which are deemed systematically important within the domestic banking industry; and iv) increase in the minimum capital requirement for all bank categories, on top of the capital requirement under Basel 3.⁷ The BSP also endorsed Republic Act No. 10641 which allows for the full entry of foreign banks in the

Philippines. With the Monetary Board approval of the Implementing Rules and Regulations (IRR), additional foreign banks can now apply to operate in the Philippines either as a branch or a wholly-owned subsidiary. The entry of more foreign banks provides economic benefits for the Philippines. Foreign banks can serve as channels of foreign direct investments into the country and facilitate the transfer of technology and know-how.⁸ These contributions are expected to further strengthen the Philippine banking system as it prepares for greater integration and competition under the ASEAN Banking Sector framework.^{9, 10}

The BSP is also cognizant of the importance of providing marginalized and low-income households with timely and affordable financial services. Towards this end, the BSP undertakes efforts to strengthen the enabling environment for financial inclusion. These initiatives are in the areas of policy, regulation and supervision, financial education and consumer protection, data and measurement, advocacy programs and strategic international linkages. The BSP spearheads inter-agency working groups that serve as a platform to improve coordination and maximize linkages toward financial inclusion. The commitment of the BSP to advance financial inclusion in the country has been recognized internationally. In 2014, the Economist Intelligence Unit named the Philippines as the top country in Asia and the third in the world with the most

⁷ Tetangco, Amando, Jr. "Keeping the House in Order amid Mounting Uncertainties." Top of the Citi, Makati City. 29 October 2014. Speech.

⁸ The entry of foreign banks provides the economy with greater stability and efficiency and improves regulation and governance (IMF, 2006). Studies have shown that, in developing countries, increasing the number of foreign banks leads to lower overhead expenses of domestic banks (Claessens, Demirguc-Kunt and Huizinga, 2001). Moreover, foreign banks tend to maintain higher loan growth rates than domestic banks even during times of adverse economic conditions (De Haas and Lelyveld, 2002 and 2003; Goldberg, Dages and Kinney, 2000).

⁹ Tetangco, Amando, Jr. "The Philippine Economy Going Forward." Manila Polo Club, Makati City. 8 January 2014. Speech.

¹⁰ The ASEAN Banking Integration Framework aims to liberalize the region's banking market by 2020. It will allow ASEAN banks to enter and operate in banking markets in other member countries, eliminate discrimination against ASEAN banks operating in member countries, and create a consistent banking environment throughout the region (ADB, 2013).

conducive environment for financial inclusion. The BSP also received the Maya Declaration award for its initiatives towards greater financial inclusion.¹¹

Going forward in 2015

The national government targets a GDP growth rate of 7.0–8.0 percent in 2015 while inflation is set at 2.0–4.0 percent.¹² Consensus forecast from international institutions (e.g., IMF, World Bank, ADB) and other market analysts, however, projects a lower GDP growth rate for the Philippines. Nonetheless, the lower forecast does not weaken expectations of a robust growth for the Philippines in 2015. Moreover, the country began 2015 with another credit rating upgrade. On 11 December 2014, Moody's Investors Service raised the country's rating a notch above minimum investment grade.

The road towards sustained growth in 2015 is, nevertheless, paved with challenges and risks, particularly in the global front. Global economic recovery remains fragile with uneven growth across regions. Economic growth in the US is gaining some solid ground with improvements in its jobs market and the housing sector. However, positive developments in the US are not enough to anchor global growth. The euro area continues to experience stagnant growth with high unemployment and disinflationary pressures while Japan is struggling to get its economy out of a slump. The divergence in economic prospects leads to differing monetary policy stances. The US Fed and the Bank of England (BOE) are set to gradually increase their interest rates in the latter part of 2015 while the European Central Bank (ECB) and the Bank of Japan are pursuing quantitative easing programs. Moreover, central banks are mindful of the potential global deflationary pressures emanating from the slowdown of China's economy. For the Philippines, the main risk that an asynchronous monetary environment poses is

the volatility in capital flows and financial markets.

The decline in petroleum prices beginning in the second half of 2014 has mixed implications for different economies. For oil-importing countries, the sharp deceleration of oil prices can result in higher economic growth while it can temper the growth prospects of oil-exporting countries. The net effect on global growth, however, is positive.

Notwithstanding the uncertainties in the global economy, growth of the Philippine economy is expected to be supported by favorable domestic conditions. On the demand side, household consumption will most likely retain its vigor in 2015, buoyed by better employment opportunities and OF remittances. Investment is anticipated to receive a boost from higher capital expenditures of the production sector. Industries are investing to upgrade their capital and durable equipment in preparation for stiffer competition under the ASEAN Economic Community. Government spending is foreseen to increase in 2015 with the national government's commitment to catch-up with its infrastructure program. Infrastructure investments (e.g. reconstruction of disaster-hit areas, major Public-Private Partnership (PPP) projects) are targeted to equal 4.0 percent of GDP in 2015 and further increasing to 5.0 percent in 2016. There is also optimism over Philippine exports despite lingering concerns over uneven global growth.

On the supply side, the agriculture and fisheries sector is expected to perform better in 2015 on the back of higher rice and corn yields and improving fisheries, livestock and poultry sectors. The industry sector will continue to be driven by growth in manufacturing and construction. Manufacturing will be fuelled by both domestic and export demand. Domestic demand will benefit from rising employment in the economy, OF remittances and the rise in election-related spending. Private construction will remain buoyant with strong demand for residential projects and office space. The BPO industry will continue to be a key contributor to the growth in the services sector.

¹¹ The Maya Declaration is the first global set of specific, measurable commitments made by policy makers from developing and emerging countries to unlock the economic and social potential of the poor through financial inclusion.

¹² Based on DBCC-approved macroeconomic assumptions as of 7 January 2015.

The economic progress that the country has attained, thus far, was not without any difficulties and challenges. The national government undertook structural reforms to address weaknesses in the system and to strengthen the different sectors of the economy. The BSP, for its part, liberalized bank branching and allowed more competition from foreign banks.¹³ The telecommunications and oil industries were also deregulated and water services were privatized. All these reforms helped improve governance and institution building as well as encourage market competition. In 2015, the national government, guided by the strategies and initiatives it identified in the Philippine Development Plan 2011-2016 Midterm Update, remains committed in achieving a balanced, sustainable and inclusive growth.

Conclusion

Amidst the challenges and risks that lie ahead, the Philippine economy is expected to sustain its robust growth in 2015 supported by strong macroeconomic fundamentals and continued investor confidence. The BSP will remain vigilant of these risks and stand ready to employ appropriate measures to mitigate them. It will continue to pursue price stability conducive to sustainable and inclusive growth. Moreover, it will safeguard the stability of the banking sector while ensuring that financial

resources are channeled to the productive sectors of the economy.

¹³ These were among a set of reforms initiated by the BSP, the focus of which were on upgrading the regulatory framework over banks; strengthening the framework for monetary policy formulation; providing a mechanism for banks to improve the quality of their assets and loans and enhancing their risk management system; ensuring fiscal sustainability; promoting innovation and competition; encouraging private sector participation; and inspiring business activity, among others.