# CONSTRAINED RECOVERY

**The health crisis is barely improving in the Philippines. After a particularly severe second wave, the number of new Covid-19 cases seems to have levelled off, albeit at a high level. Yet the full vaccination rate is very low, which means that the tight health restrictions which must be kept in place are weighing on domestic demand and the tourism sector. After contracting by more than 9% in 2020, GDP should rebound moderately in 2021. Even so, the country still has high growth potential thanks to the reforms undertaken over the past decade, which are paying off.**

## A SEVERE RECESSION IN 2020

The Philippines was one of the region's economies that the Covid-19 crisis hit hardest. The introduction of very strict health measures as of mid-March 2020 triggered an abrupt drop-off in business that heavily constrained domestic demand. Investment contracted by 27% and private consumption fell by 8% in 2020. At the same time, tourism revenues (which accounted for nearly 13% of GDP in 2019) plunged by about 80%.

All in all, despite the authorities' massive support (the central bank and the government implemented measures accounting for more than 14% of GDP), real GDP contracted by 9.3%. In comparison, GDP contracted by 3.4% on average in the ASEAN-5 countries.

## THE HEALTH SITUATION IS PROVING HARD TO STABILISE

Growth is expected to rebound in 2021-2022, lifted primarily by the upturn in global demand, ongoing public policy support, and a huge base effect, although downside risks are still very strong.

A sharp rise in the number of Covid-19 cases since mid-March has cut short the economic recovery observed since the end of Q3 2020. After levelling off at 1,500 cases in mid-November, the number of new daily cases rose very rapidly, to nearly 10,000 new cases in early April 2021, which is significantly higher than the 4,500 new cases reported during the first peak in August 2020. After being gradually lifted, health restrictions had to be imposed again nationwide in mid-March. Measures were especially strict in the Manila metropolitan area, home of the nation's capital, which accounts for more than 70% of GDP. Moreover, the country's hospitals and intensive care units have extremely limited capacity.

GDP contracted again in Q1, down 12% quarter-on-quarter (q/q), after Q4 growth of 16% q/q, the only quarter of positive growth in 2020. The rebound in exports of goods and robust public demand (additional measures were announced in March 2021) failed to offset another decline in domestic demand.

The outlook for the rest of 2021 is mixed. On the one hand, the number of new daily cases has declined since mid-June, but remains relatively high (less than 5,500 new cases in early July). On the other, the vaccination rate is still low (only 2.6% of the population had received two doses of the vaccine at 5 July) because the government has encountered numerous supply problems. That said, the vaccination campaign should accelerate during H2 thanks to a large number of doses received via Covax. The government is aiming to vaccinate 65% of the population by 31 December 2021.

Consequently, it could take a long time to absorb the imbalance between the number of new cases and the vaccination rate, which means that health restrictions may have to be extended. This would have a lasting negative impact on domestic demand and the tourism sector.

FORECASTS

| | 2019 | 2020 | 2021e | 2022e |
|---|---|---|---|---|
| Real GDP growth (%) | 5.9 | -9.3 | 5.1 | 6.8 |
| Inflation (CPI, year average, %) | 2.5 | 2.6 | 3.8 | 2.5 |
| Government balance / GDP (%) | -3.5 | -7.5 | -6.0 | -4.5 |
| National government debt / GDP (%) | 39.5 | 54.5 | 55.1 | 55.0 |
| Current account balance / GDP (%) | -0.8 | 3.6 | 1.9 | 1.0 |
| External debt / GDP (%) | 87.8 | 109.8 | 104.4 | 103.5 |
| Forex reserves (USD bn) | 87.8 | 110.1 | 112.1 | 114.1 |
| Forex reserves, in months of imports | 6.9 | 10.1 | 11.1 | 9.8 |

TABLE 1 e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

FULL VACCINATION RATES IN THE ASEAN COUNTRIES

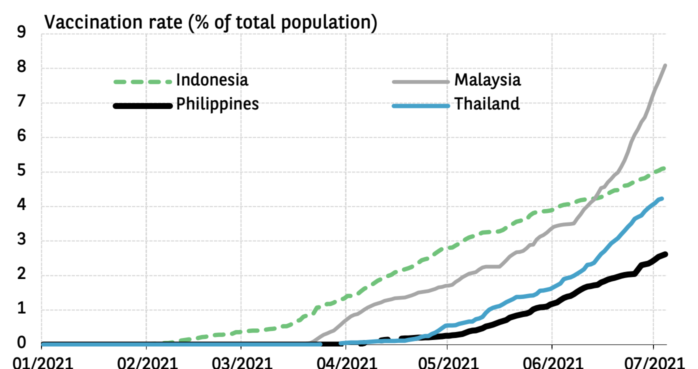


CHART 1 SOURCE: OUR WORLD IN DATA

## SOLID MACROECONOMIC FUNDAMENTALS

Even so, despite the size of the shock and the prospects of a timid recovery in the short term, the country still has solid macroeconomic fundamentals.

External vulnerability remained very low in 2020 and could diminish even further: the peso has strengthened against the dollar, foreign reserves are rising, the current account balance has been positive (3.6% of GDP) for the first time since 2015. The downturn in imports and relatively resilient remittances from migrant workers have largely offset the decline in exports. The current account surplus is expected to shrink in the quarters ahead as imports pick up, in keeping with the

rebound in economic growth. Ultimately, however, the economy's competitiveness should further strengthen exports (notably in the services sector).

After declining in 2019-2020, foreign direct investment (FDI) should rise again, bolstered by new government measures. According to the OECD, despite regular reforms since 2016, the Philippines still had one of the most restrictive frameworks for FDI of the ASEAN countries in 2019 (concerning the authorised thresholds for foreign stakes, filtering/authorisation mechanisms, restrictions on hiring non-residents for key positions, and other operating restrictions). This observation applies to virtually all sectors, including infrastructure projects that are being promoted by the government (such as maritime transport, road transport, and landline/mobile telecommunications).

The Corporate Recovery and Tax Incentives for Enterprises (CREATE) bill, passed in March 2021, should help improve the business climate and facilitate private investment projects with both resident and non-resident investors. Among its incentives, the bill proposes to reduce the corporate tax rate, which is currently one of the highest in the ASEAN countries, from 30% to 25%, and to make the tax cut retroactive to July 2020. Foreign companies would then benefit from a 1-point tax cut annually until the rate comes to 20% in 2027. Meanwhile, local small and mid-sized enterprises (SME) would benefit immediately from a tax rate of only 20%. Several other draft bills are also being discussed.

Similarly, the corporate tax reforms launched over the past decade have paid off. In early 2020, the government had sufficient fiscal manoeuvring room to provide massive support to the economy and the health system.

The public deficit rose significantly in 2020, to 7.5% of GDP from 3.5% in 2019, and will remain high in 2021-2022. Nonetheless, it should narrow gradually with the halting of support measures and the rebound in the economy. New measures to improve tax collection were also set up in 2020. They aim to offset the short-term increase in spending due to the Covid-19 crisis, and the medium-term shortfall in fiscal revenues due to the corporate tax cuts introduced by the CREATE bill. Fiscal consolidation could take time, however, and the presidential election scheduled for 2022 introduces some uncertainty concerning the economic policy that will be pursued by the next government.

The public debt rose to nearly 55% of GDP in 2020, from less than 40% in 2019, and it is expected to swell further in 2021-2022. The year 2020 "erased" more than 10 years of fiscal consolidation (public debt was 52% of GDP in 2009), but the debt profile is much more favourable today (longer maturities, a large share of the debt issued in the local market, and a sharp decline in the share of foreign currency debt). To help the government cover its financing needs, the central bank also announced that it would maintain the securities purchasing programme introduced in early 2020 at least through the end of 2021.

Lastly, the country still has very high growth potential, estimated at 6.5% a year, and this potential has not eroded despite the amplitude of the shock. With a diversified economy, a young population and ongoing reform efforts in 2020, productivity will get a boost in the medium to long term. Moreover, the unemployment rate has declined continuously from 2005 to year-end 2019, signalling a stronger labour market, even though the working age population is still growing.

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**Hélène DROUOT**
helene.drouot@bnpparibas.com

FOREIGN DIRECT INVESTMENT INFLOWS

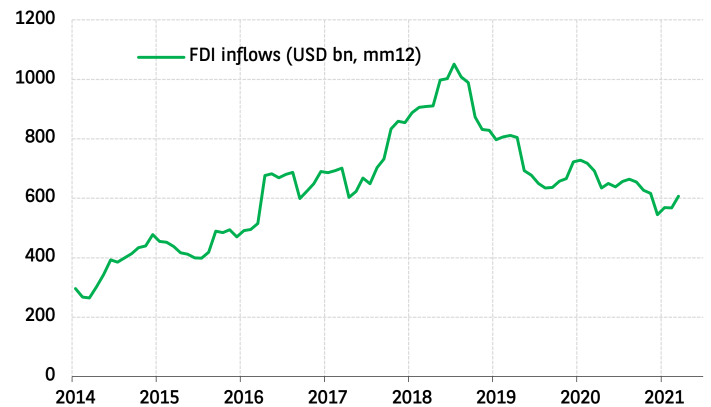


CHART 2 SOURCE: CENTRAL BANK