Philippines

Stopped in mid flight

The coronavirus crisis has hit a fast-growing economy, which expanded by more than 6% year-on-year in H2 2019 and looked set to continue at the same pace in 2020. The pandemic and the very strict lockdown imposed by the Duterte government will cause all the engines of growth to seize up: production will stop in the country's economic centre, the fall in domestic demand will be exacerbated by reductions in remittances from workers abroad and losses in the informal economy, tourism will collapse and exports of goods and services will follow suit. This is a substantial shock, but the strong macroeconomic fundamentals and the modest level of government debt give the authorities scope to introduce support measures.

The Philippines has enjoyed solid economic growth in recent years, driven by robust domestic demand and an expansion of the export base. Between 2012 and 2019, real GDP growth averaged 6.5% per year. It slowed to 5.5% year-on-year (y/y) in H1 2019 primarily due to a dip in investment, but then rebounded in H2 2019, reaching 6.2% y/y. This trend was set to continue into 2020 before it was brutally interrupted by the shock from the coronavirus epidemic.

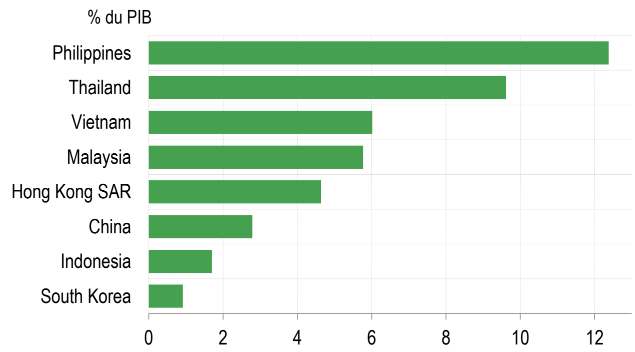
The government imposed very strict lockdown measures in mid-March. The whole of the island of Luzon and its capital Manila were placed into quarantine for at least a month. As a result, economic activity is at a standstill in this region, which is home to 56 million people (53% of the country's population) and accounts for 73% of GDP (with Manila accounting for 36%). The health crisis will also have repercussions for sectors dependent on international demand, particularly tourism as well as remittances from workers abroad, which represent a significant source of support for domestic household consumption. As a result, all the private-sector engines of the Philippines' growth will be significantly weakened from March onwards. The economy could go into recession in S1 2020, before recovering gradually once the epidemic has passed its peak. The stimulus measures introduced by the authorities will be key in determining the pace of this recovery. We project real GDP growth at only 2% in 2020, the slowest rate since the crisis of 2009. Economic growth is then expected to bounce back to 6% in 2021, slightly below the Philippines' potential growth rate (Table 1).

1- Forecasts

	2018	2019	2020e	2021e
Real GDP growth (%)	6.2	5.9	2.0	6.0
Inflation (CPI, year average, %)	5.2	2.5	2.2	2.8
Government balance / GDP (%)	-3.2	-3.5	-4.5	-3.5
Current account balance / GDP (%)	-2.6	-0.1	-0.5	-1.2

e: BNP Paribas Group Economic Research estimates and forecasts

2- Contribution of the tourism sector to the economy



Source: WTTC, BNP Paribas

The main engines of growth have seized up

Private consumption accounts for 68% of GDP and has been the main driver of economic growth in recent years. In 2019, it rose by 5.8%, supported by the decline in inflation (from 5.9% y/y in Q4 2018 to 1.5% in Q4 2019), the strength of the labour market (the unemployment rate has continued to fall and reached 5.1%) and the strength of remittances from abroad (which reached USD 30 billion, or 8% of GDP). The lockdown in the country has produced a twin-pronged shock to consumption: firstly, households are limiting their purchases to essential goods, and secondly, they are suffering from lower incomes due to the interruption of production activity. In addition to the deterioration of the formal labour market, there will be losses in the informal sector and the probable reduction in remittances from workers abroad. The informal economy of the Philippines has shrunk over recent years but remains substantial: it still probably represents around two-thirds of employment and 30% of GDP. Household incomes are therefore likely to be lastingly weakened. As a result, after falling during the lockdown period in March and the early part of Q2 2020, private consumption growth is likely to recover only very gradually over the following quarters.

Activity in the tourist industry is likely to be at a standstill for several months. This sector plays a crucial role in the economy, estimated at 12% of GDP, which is the largest economic contribution of any major Asian country (Figure 2). Tourist receipts in the current account balance account for 7% of total foreign currency receipts (or nearly 3% of GDP).

Investment growth slowed markedly in 2019 (to 1.5% from 12.9% in 2018), as a result of delays in the implementation of the budget and interruptions to several public infrastructure projects, and also due to a tightening of credit conditions at the start of the year and weaker global demand prospects. Investment growth started to recover in H2 2019, particularly thanks to the resumption of construction projects, but this improvement has been stopped in its tracks by the outbreak of the virus. Despite a loosening of monetary policy, private investment is likely to remain depressed in the short term, due to the losses incurred by corporates during the health crisis and the deterioration of confidence. However, investment in public infrastructure projects is likely to recover more rapidly after the lockdown, driven by the government's "Build, build, build" programme (which projects infrastructure development spending to reach 7% of GDP in 2022, up from 3% in 2015).

Growth in exports of goods and services also started to slow in 2019 (to 3.2% in real terms, from 13.4% in 2018). Import growth fell even more sharply, and the contribution of net exports to real GDP growth was slightly positive, after four years in negative territory. In 2020, both exports and imports of goods and services are likely to contract, given the slowdown in domestic demand, the fall in world industrial production (on which sales of electronic goods and IT services from the Philippines depend), international trade and tourism.

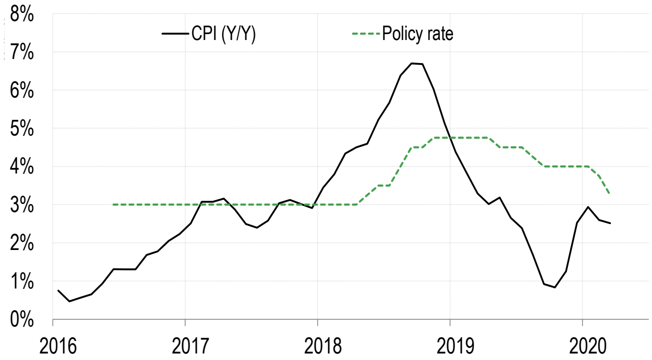
The central bank has room to act

The reduction in inflationary pressures has given the central bank (*Bangko Sentral ng Pilipinas*, or BSP) the room to ease its policy stance. Monetary policy is based on inflation-targeting, with a targeted range from 2% to 4%. Inflation has been below the 3% mark since June 2019. After a temporary uptick in December-January, it is likely to continue to weaken in the short term, due to low oil prices and weaker consumption. The BSP began to relax its monetary policy in Q2 2019, cutting its policy rate by 50 basis points (bp) between May 2019 and January 2020. Since the onset of the pandemic, it has quickened the pace of rate cuts. The policy rate was cut by 25 bp on 6 February and then a further 50bp on 19 March, taking it to 3.25% (Figure 3). Further cuts are likely in Q2 2020.

The central bank has also introduced measures to support liquidity in the banking sector and stimulate credit. Reserve requirement ratios have been lowered by 200 bp (to 12% for big banks) and prudential rules have been relaxed (such as reporting and provisioning rules). Banks have been encouraged to support their customers (reducing fees, extending repayment delays, etc.). The authorities enjoy some room to manoeuvre on the credit front as corporate debt levels are moderate (credit to the private sector represents less than 50% of GDP) and the banking sector is solid. In fact, banks have levels of liquidity and equity that are sufficiently comfortable to absorb an increase in non-performing loans (estimated at 2% of total loans in 2019). Yet, the banks will probably face episodes of stress and record a deterioration of profits in the short term. Their main sources of vulnerability come from the concentration of their portfolios on a few large local conglomerates as well as their exposure to the real estate market (which accounts for nearly 20% of total loans). Their exposure to currency risk is limited, as banks on the whole do not post currency mismatches in their balance sheets, and foreign-currency loans only account for about 10% of total loans.

Currency risk itself is limited, with the peso (PHP) supported by the spread between domestic and global interest rates, the Philippines' good macroeconomic fundamentals and the recent improvement in the current account deficit (only 0.1% of GDP in 2019). The peso appreciated slightly against the USD in 2019, and then has barely depreciated since the beginning of the health crisis in spite capital outflows. In contrast, and in line with world market trends, the Philippines' stock market suffered a very sharp correction in March (falling by 22%).

3- The central bank will cut interest rates further



Source : Central Bank, CEIC

Fiscal slippage under control

The government's initial stimulus package was small (PHP 27 billion, or 0.15% of GDP), coming on top of the public investment plan introduced in 2016. However, in response to the worsening health crisis and the growing shock to economic activity and household income, the government declared a state of emergency at the end of March and stepped up its support measures. It aims to support the healthcare sector, the most vulnerable workers and households, SMEs as well as the tourism and agriculture sectors. The budget deficit is expected to exceed 4% of GDP in 2020 (up from an initial target of 3.2%). Public finances are sufficiently solid to absorb the shock: government debt is low, it declined from 45% of GDP in 2015 to 42% in 2019, and two-thirds of it is in securities issued on the domestic market. The BSP has already announced that it will purchase government bonds for PHP 300 billion (1.6% of GDP). Therefore, the government should be in a position to cover its financing requirements in the short term, despite the correction in international bond markets (the EMBI spread on the Philippines' sovereign bonds widened from 67 bp to 280 bp in Q1 2020).

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