PHILIPPINES

For the past few years, the Philippines has been one of ASEAN's economic stars. The economy grew at 6.9% yoy in 2016. Although the 1Q17 growth was only 6.4% yoy on the back of lower government and consumer spending, economy is expected to expand by 6.7% in 2017, due to large-scale infrastructure projects that will give the economy a boost. The performance of exports improved recently, however, robust domestic demand and import intensive infrastructure investments will mean that import growth will continue to outpace exports, leading to an increase in the trade deficit. The current account, however, should continue to post a healthy surplus thanks to foreign remittances.

Inflation climbed to 3.4% in March driven mainly by increasing food and oil prices. Although, it remained within the Filipino central bank's (BSP) target range of 2% to 4%, it was closer to the upper limit of the range, which along with currency depreciation pressures might result in BSP increasing the interest rate near the end of 2017. The success and timeliness of tax reform, is the key risk factor to the overall positive outlook as it will determine whether the government will have the fiscal space to fulfill its infrastructure investment agenda.

Slightly disappointing first quarter

- The GDP growth for the Q117 was 6.4 % yoy, below the government's target range of 6.5% - 7.5%. The main reason for this was weaker government spending which grew at 0.2% yoy following the election year boost in 2016.
- Although government expenditure has slowed I expect it to pick up later this year as the budget for 2017 is 11.6% higher that of 2016. The government outlays should provide momentum to the economy in next couple of years.
- Export growth was strong, growing at 22.3% yoy in 1Q17 compared to 13.7% yoy in 4Q16. Electronic products, mainly semiconductor components, contributed to over half of the export bill.
- Although the remittances reached a record level of USD2.6 bn and the average growth of retail sales was 20% in Q1, the growth in customer spending yoy only reached 5.7%, compared to 6.9% yoy for 2016.
- Growth of gross fixed capital formation was weaker at 11.8% yoy in 1Q17, compared to the robust 23.7% yoy for 2016.The public construction activity which grew 29% yoy in 2016 was driving public spending last year. In the Q1 2017 the growth decelerated to 2% yoy, which is the main reason for the drop in Grossed Fixed Capital Formation (GFCF) expansion.
- The manufacturing activities expanded in the first 3 months of this year.[1] This led to slight increase in capacity utilization from 83.7 in January to 83.8 in March. As the level of capacity utilisation is high, the investments in new production capacity will be vital to ensure the continuance in robust GDP growth in long term.
- The Nikkei ASEAN manufacturing Purchase Managers Index (PMI) for the Philippines in April remained at 53.3 in April far from the 55.7 I saw in December 2016.

[1] Measured by volume of production index

Trade: Strong exports to be outpaced by imports

- Exports expanded in March 2017 by 21% yoy compared with contraction of around 15% yoy in the period year ago. Exports of electronic products grew 19% in March. Growth is expected to be moderately positive as the global economy stabilises in 2017. Imports also accelerated in March registering growth of 24% yoy compared to 11.7% in March 2016. The general components of Philippines' imports remain the same as in 2016; intermediate products, capital goods, and raw materials. Import growth is expected to continue outpacing exports due to the anticipated large infrastructure outlays, leading to a widening of the trade deficit.
  - The current account surplus as a percentage of GDP shrunk in 2016 to 0.2% from 2.9% in 2015. Despite a worsening balance of trade, the current account was supported by the strength of remittances, which continued to expand against global headwinds, last year.

Inflation pressures and weakening peso might result in rate hike

- Headline inflation reached 3.4% yoy in March 2017 and stayed at the same level in April. This was mainly driven by increasing food prices, which grew 4.2% yoy in April, as a result of weather shocks disrupting the food market. Core inflation stood at 3% in April.
- The exchange rate was fluctuating 50 pesos to a USD since the beginning of the year. Due to supply chain dynamics, the currency needs to move in step with regional currencies thus expect the weakening of PHP in 2017.However, because of feasibility of using outflows buffers, in form of, bond yields (Debt to GDP relatively at about 40 %), policy rate (vigorous domestic demand) and FX reserves, the depreciation expected to be minor.
- Although inflation stayed within BSP target range of 2%-4%, BSP is nonethless expected to increase the interests to 3.25 near the end of the year to support the peso. The reasons would be that planed infrastructure investments are highly import intensive so weaker currency will increase the overall cost of program.

Fiscal deficit to widen; foreign reserves are solid

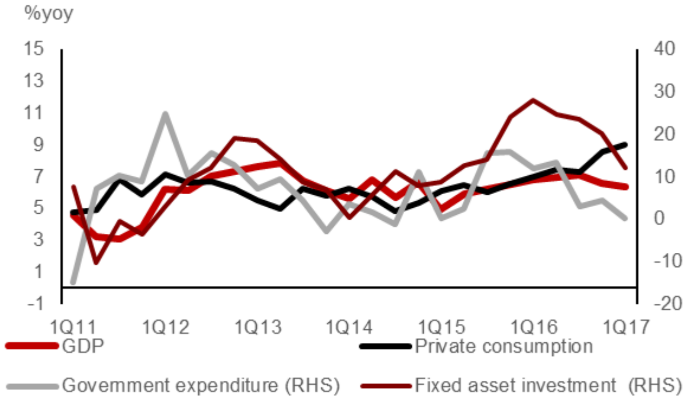
- In the 2016 deficit widened 2.4% of GDP compared to 0.9% in 2016. However, it remained within the 2016 government target of 2% - 2.7%. The deficit was mainly financed domestically. The target for this and next year was raised to 3% of GDP as increase in infrastructure, education, and health spending is planned.
- The deficit in Q117 shrank compared to Q116 as the revenues form taxes grew 12.3% qoq.
- In April 2017, reserves increased to USD 81.8 billion (a USD1 billion surge compared to March) driven by strong dollar inflows. They now cover 5.4 times Philippines' short term external obligations.

Risks and Other Issues

- The tax legislation which is now expected to be passed in October 2016 is facing a challenge getting past congress. It assumes income tax cuts and an increase in tax on fuels and automobiles, that will eventually lead to an increased tax revenues providing the fiscal space needed for infrastructure development. A tax amnesty has also been proposed to boost revenues, similar to the Indonesian case.
- Protectionist sentiment within the US administration may result in a clampdown of outsourcing which could affect the economy of the Philippines where many multinational companies have back-office operations. Moreover, 33.2% of all remittances in 2016 came from the US.

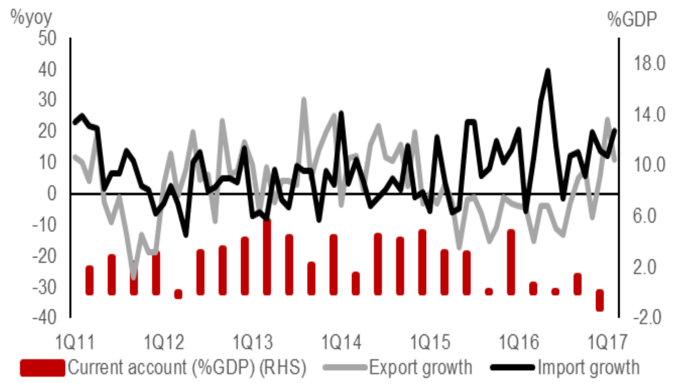
Private consumption and government expenditure on infrastructure are driving domestic demand

Figure 1: GDP growth by domestic demand



Source: CEIC

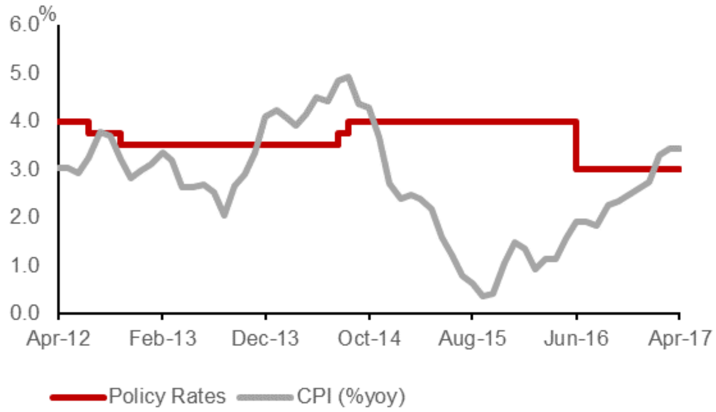
Figure 2: Trade growth and current account balance



Source: CEIC

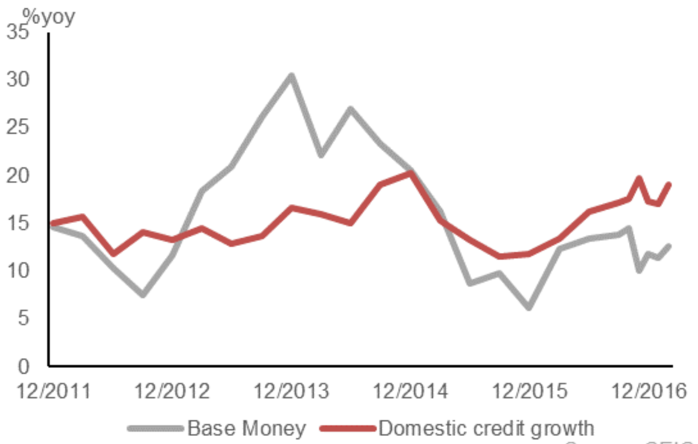
Increasing inflation and weakening peso might convince BSP to increase interest rate in second half of 2017

Figure 3: Inflation and policy rates



Source: CEIC

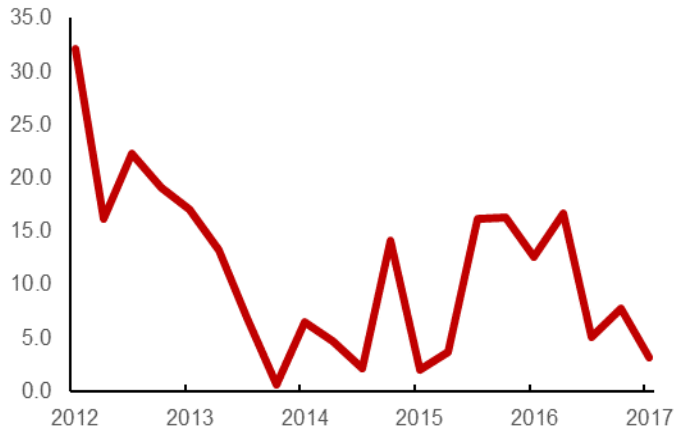
Figure 4: Base money and credit growth



Source: CEIC

Growth of government spending decelerated due to tapering off of election related spending

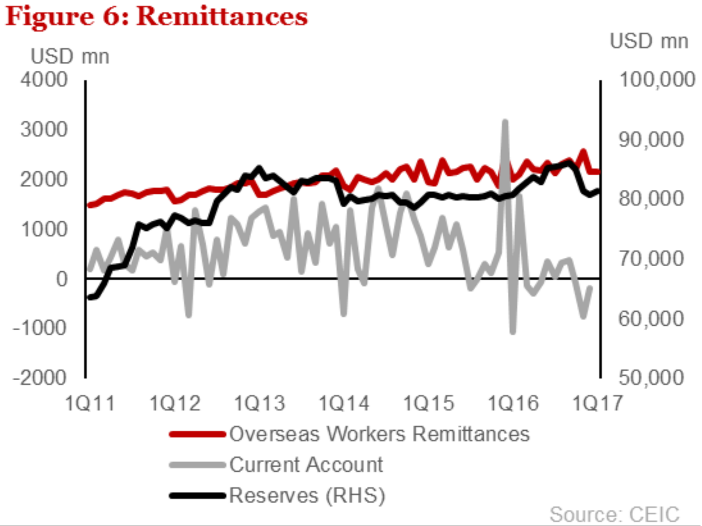
Figure 5: Government spedning



Source: CEIC

Strong flow of remittances has supported the current account which nevertheless turn negative recently.

Figure 6: Remittances



Source: CEIC

Annual Data	2016					
Nominal GDP (USD bn)	304.6					
GDP per capita (USD)	2,952.0					
Population (mn)	101.0					

	2013	2014	2015	2016	2017F	2018F
Real GDP growth (%yoy)	7.1	6.2	5.9	6.9	6.7	6.7
Real consumption growth (%yoy)	5.5	4.9	6.6	7.3	7.0	6.7
- Public consumption (%yoy)	5.0	3.3	7.8	8.4	9.5	6.4
- Private consumption (%yoy)	5.6	5.5	6.3	7.0	6.8	6.8
Gross capital formation growth (%yoy)	27.9	5.2	15.1	23.7	14.5	9.9
Nominal export growth (%yoy)	9.0	9.0	-5.1	2.6	8.0	-
Nominal import growth (%yoy)	0.5	3.1	3.6	12.2	13.0	-
Trade balance (USD bn)	-10.6	-12.8	-17.5	-27.0	-29.0	-
- % of GDP (%)	-3.9	-4.5	-6.0	-8.9	-	-
Current account balance (USD bn)	11.4	10.8	7.7	0.6	0.4	0.9
- % of GDP (%)	4.2	3.8	2.9	0.2	0.1	0.2
Reserves, end of period (USD bn)	83.2	79.5	80.7	80.7	78.0	77.0
- foreign reserves to months of imports	11.6	9.9	10.1	-	-	-
- short term debt (% of total reserves)	20.3	20.4	-	-	-	-
Fiscal balance (% of GDP)	-1.4	-0.6	-0.9	-2.4	-3.0	-3.0
Retail Price Index growth, average (%yoy)	2.7	2.7	1.2	2.3	-	-
Industrial Production Index growth, average (%yoy)	5.4	6.3	-4.4	9.4	5.8	-
Narrow money (M1) growth, average (%yoy)	21.2	19.2	13.4	16.8	-	-
Broad money (M2) growth, average (%yoy)	24.1	23.1	8.2	13.0	-	-
Domestic credit to private sector (% of GDP)	35.8	39.2	41.9	14.9	15.4	-
Consumer Price Index (CPI), end of period (%yoy)	4.1	2.7	1.5	2.6	-	-
Consumer Price Index (CPI), average (%yoy)	2.9	4.2	1.4	1.8	2.5	3.0
Policy rates, (end of period %)	3.50	4.00	4.00	3.00	3.25	3.50
Exchange rate vs USD, end period	44.41	44.62	47.17	47.49	51.00	52.00
5Y government bond yield (%)	2.13	3.00	2.54	4.74	-	-

Quarterly data	2Q15	3Q15	2Q16	3Q16	4Q16	1Q17
GDP (%yoy)	5.9	6.2	6.5	7.1	6.6	6.4
CPI, average (%yoy)	1.7	0.6	1.0	2.0	2.5	3.2
Policy rates, end of period (%)	4.00	4.00	3.00	3.00	3.00	3.00
Exchange rate vs. USD, end period	47.17	46.11	46.96	47.06	49.10	49.99
5Y government bond yield (%)	3.98	3.31	2.90	2.94	4.74	4.26

SOURCE: CEIC, IMF estimates, Oxford Economics, Philippines Bureau of the Treasury

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