Philippines: Signs point to growth falling short of target in 2023

The Philippines managed to beat its GDP target in 2022 but this year, it could undershoot

Price pressures continue to mount in the Philippines as supply chain constraints disrupt food supplies

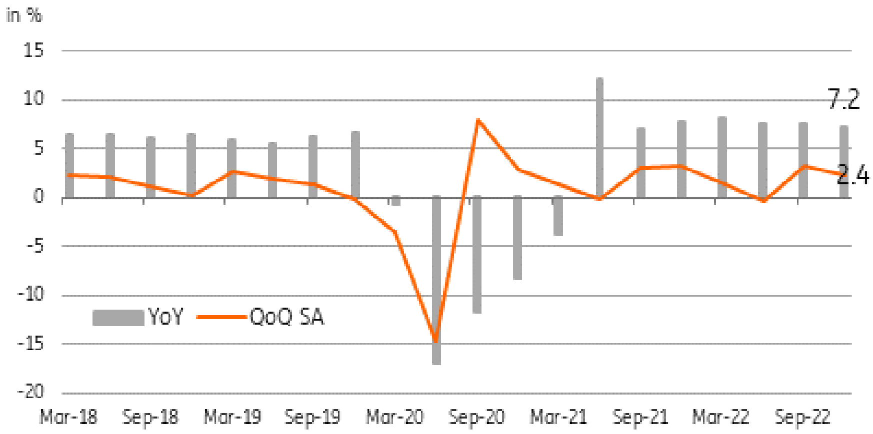
Economy bounced back sharply in 2022 to beat growth target

The Philippines grew by 7.6% year-on-year in 2022 compared to the official growth target of 6.5-7.5% YoY as the economy quickly reopened after more than two years under extensive Covid restrictions. Presidential elections held last May provided a nice boost to economic activity while so-called 'revenge' spending was in full effect.

Spending on items related to the reopening story such as air travel, restaurants and hotels and recreation recorded consecutive quarters of double-digit growth even in the face of multi-year high inflation. Capital formation also managed to expand, although at a more moderated pace, with firms and households taking on loans as uncertainty over the growth outlook eased.

However, the potent mix of resurgent demand, currency depreciation and elevated commodity prices all contributed to a pickup in price pressures. As a result, Bangko Sentral ng Pilipinas (BSP) hiked rates by 350bp in 2022. BSP Governor Felipe Medalla was particularly worried about the peso’s weakness given its impact on inflation but has since softened his stance and recently hinted at a reversal as early as the first quarter of 2023.

2022 GDP surprised on the upside



Source: Philippine Statistics Authority

Key support to growth to fade as households rebuild savings

The Philippines exited heavy-handed Covid restrictions by the second quarter of 2022, unleashing pent-up demand that ultimately lifted GDP growth past target. Lockdowns in the Philippines were extended (more than two years) and may have contributed to the potency of so-called 'revenge' spending.

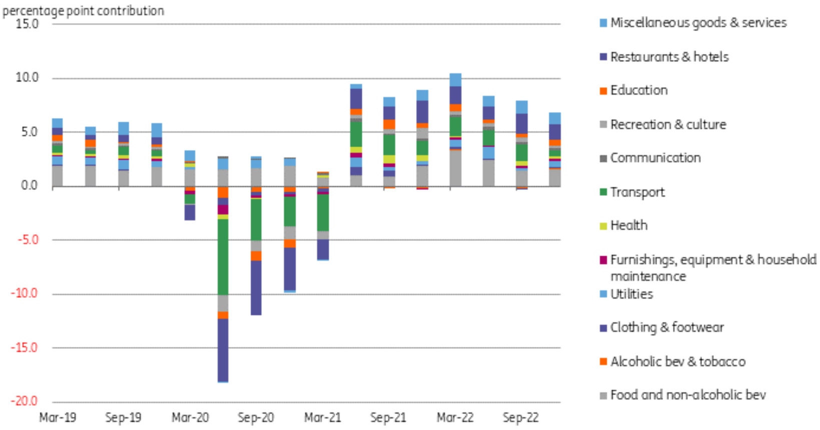
The reopening story was on full display with consumption bolstered by an extended spell of spending on transport (air travel in particular), restaurants and recreation. With mobility restrictions all but removed, spending on items related to revenge spending provided 2.1 percentage points to overall household spending and 1.4 percentage points to the overall 7.2% YoY growth posted in the fourth quarter.

Surprisingly, the extended run of revenge spending was taking place amidst (and to some extent also fuelling) multi-year high inflation which undoubtedly took its toll on household finances. Results from the Bangko Sentral ng Pilipinas' (BSP) consumer expectations survey show fewer households were able to set aside savings in the second and third quarters, possibly to finance the uptick in spending after the lockdowns. This could explain how spending continued amidst surging prices in those quarters.

The latest BSP survey, however, shows an increase in savings rates by the fourth quarter (now at 30.5%), suggesting that households could now be building up savings after splurging over the past few months. We could see this trend continue in 2023 as households attempt to bring back savings to pre-Covid levels.

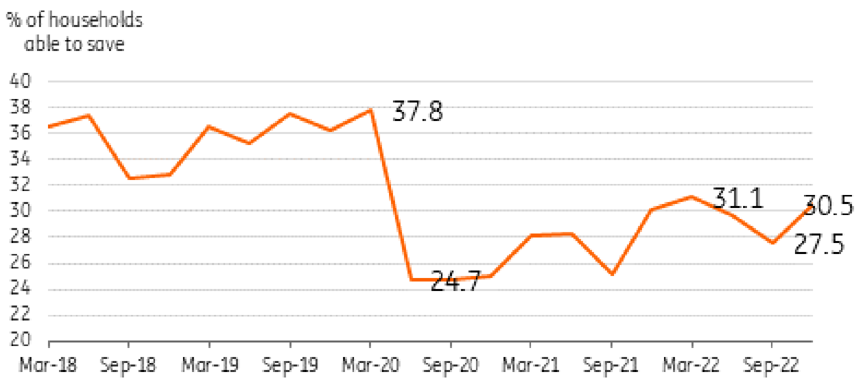
With households possibly refocusing on rebuilding savings we could finally see a moderation in consumption. Softer household spending suggests that economic growth will be missing key support this year, which is our central reason for expecting full-year GDP growth to settle at roughly 5% YoY.

Reopening story helps drive uptick in growth



Source: Philippine Statistics Authority

Savings rate: Households attempting to build back savings after splurge?



Source: Bangko Sentral ng Pilipinas

This time it's different: inflation to be sticky in 2023

Inflation revisited multi-year highs in 2022 fuelled by surging commodity prices and resurgent domestic demand. BSP Governor Medalla believes that inflation is "normalising" and should be within target by the second half of the year. We believe, however, that inflation will be "sticky" given pervasive price pressures across several items in the CPI basket.

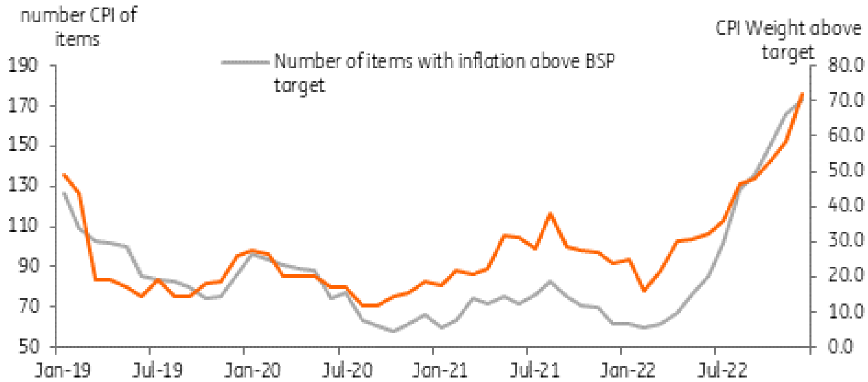
Governor Medalla believes that Philippine inflation episodes are driven mainly by supply-side shocks and that headline inflation should gradually trend lower once base effects kick in. Previous shocks in the Philippines (like in 2018) ended quickly, with inflation reverting to target after supply issues were addressed but we believe the 2022-2023 inflation episode is different.

Global energy prices remained elevated as we start 2023 which should continue to have a material impact on Philippine inflation given the country's reliance on imported energy. Pricey energy imports will likely result in additional wage and transport fare adjustments this year.

Supply chain challenges for basic food items may be another reason for price pressures remaining elevated in 2023. Domestic production appears to be challenged and vulnerable to shocks such as storms, disease and flooding. A key driver of inflation back in 2021 was the shortage of pork due to African Swine Fever while December 2022 inflation was driven by the surging cost of onions induced by crop damage from storms. In early 2023, the price of eggs is on the uptrend caused this time by the spread of Avian flu in the country. President Marcos has taken on the role of Agriculture secretary for the time being and we are unsure of whether his agency would be able to address the supply chain vulnerabilities in the near term.

On top of these challenges, inflation could also be stickier in 2023 as price pressures are spread across the CPI basket with more items now registering inflation above target. More alarming, items with inflation above the BSP's target account for a significant 72% of the CPI basket. This suggests that inflation is now more broad-based and pervasive which would result in inflation being sticky, a development that could crimp consumption even more so this year. Inflation is likely to remain above target this year (5.5% YoY) and only revert to target by 2024.

Broad-based price pressures to make inflation sticky in 2023



Source: Philippine Statistics Authority

BSP Governor sweepstakes and slowing investment momentum

BSP Governor Medalla took over as central bank governor at the height of market volatility in 2022. After a flurry of moves, including an off-cycle rate increase, Medalla was able to steady the Philippine peso by maintaining his preferred 100bp interest rate differential with the Fed funds rate. We believe Medalla will continue to match Federal Reserve rate hikes this year and we have the BSP's terminal rate at 6% by June. The bigger question we are now faced with is who will be replacing Governor Medalla when his term expires by June. Medalla is not eligible for reappointment as he will reach the maximum tenure as a member of the Monetary Board by June.

The choice of replacement for Governor Medalla could spell the difference between a rapid normalisation of policy rates versus a more hawkish stance that could keep the policy rate at restrictive levels for 2023.

And although we are confident that the policy rate will be nudged higher to 6% by mid-year, we believe any expectations for policy rates after July are dependent on who will take over as head of the NSP.

In the meantime, borrowing costs remain at multi-year highs and appear to have taken their toll on capital formation. Outlays for both construction and durable equipment have slowed and registered the slowest pace of expansion recorded in the past six quarters. Meanwhile, the BSP reported that commercial banks have tightened credit standards for firms in the past quarter to safeguard against default risk.

Higher borrowing costs and tighter credit conditions may be the two reasons for the slowdown in investment momentum and something that could weigh on growth momentum even more in 2023.

Tax cut + high debt levels = tight fiscal space

The Marcos administration inherited a hefty debt stock (Php13.5Tr) after the previous administration dealt with the economic fallout from the Covid-19 pandemic. Currently, the debt-to-GDP ratio stands at 63.5% and the fiscal consolidation plans call for this ratio to fall below 60% by 2025, three full years from now.

The official strategy to implement the fiscal authorities' consolidation hinges on "outgrowing the debt". Despite the tight fiscal space, Marcos opted to push through with the scheduled 2023 income tax reduction despite suggestions from the previous president to defer the tax reduction. Perhaps Marcos believes the reduction in income taxes would spur economic growth that could compensate for the revenue impact from the tax cut.

The Republic Act 10963 lowered personal income taxes for several income brackets beginning in January 2023. The new tax rates would result in an average increase in disposable income of 2.5% which fiscal authorities are banking on to support consumption at the cost of foregone income tax revenues.

The projected increase in disposable income, however, will fall short of our expectations for inflation, which we expect to average 5.4% YoY this year. Meanwhile, elevated debt levels coupled with the loss of income tax revenue suggest that the fiscal purse strings will remain tight this year. The limited fiscal space and its impact on government spending could be an additional factor that could weigh on overall growth prospects in 2023.

	Annual salary	Old tax	New tax	"Savings"	Monthly savings	% increase in takehome pay
Not over 250,000	PHP 250,000	PHP 0	PHP 0	PHP 0	PHP 0	0.0%
Over 250k but not over 400k	PHP 400,000	PHP 30,000	PHP 22,500	PHP 7,500	PHP 625	1.9%
Over 400k but not over 800k	PHP 800,000	PHP 130,000	PHP 102,500	PHP 27,500	PHP 2,292	3.4%
800k but not over 2 million	PHP 2,000,000	PHP 490,000	PHP 402,500	PHP 87,500	PHP 7,292	4.4%
2 million but not over 8 million	PHP 8,000,000	PHP 2,410,000	PHP 2,202,500	PHP 207,500	PHP 17,292	2.6%
Over 8 million	PHP 10,000,000	PHP 3,110,000	PHP 2,902,500	PHP 207,500	PHP 17,292	2.1%

Source: Bureau of the Treasury

Signs point to growth falling short of target in 2023

After beating their growth target for 2022, the Philippine economic team headed by Secretary of Finance Diokno pegged the 2023 growth aspiration at 6.5%. Meanwhile, President Marcos believes early signs point to GDP growth settling even higher, at 7% YoY.

We believe, however, that although the 2022 GDP result surprised on the upside, fading revenge spending, sticky inflation, uncertainty over interest rates and tight fiscal purse strings all point to the Philippines missing its growth target this year.

Elevated inflation and households opting to rebuild savings could mean that consumption will moderate while high borrowing costs have already begun to cap the upside to capital formation. Lastly, the relatively tight fiscal space, exacerbated by the income tax this year, points to only a modest pace of government spending in 2023 and a limited ability for the government to support growth.

Lastly, one additional factor that could slow growth even further this year is the projected global downturn and its impact on Philippine exports. And although exports remain a modest portion of the Philippine economy, the potential slowdown of overseas remittances may be sizable enough to pose yet another challenge to domestic consumption.

Given all these challenges, we are expecting Philippine 2023 GDP growth to slip below the government target of 6.5% YoY. However, given all the multiple challenges faced by the economy, we believe our 5% YoY growth forecast can be considered quite respectable against the backdrop of a likely global recession.