2 December 2018

# Philippines 2019 GDP outlook

## Likely to post slowest growth rate since 2015

**Our estimate of 2019 Philippines growth at 6.1% would be its lowest print since 2015, reflecting recent monetary policy adjustments and elevated inflation in 1H19. We expect a recovery in the second half of 2019. The Philippines is transitioning to an investment-led growth phase with capital formation and government spending to drive domestic demand. This carries a cost: a protracted current account deficit.**

Bangko Sentral ng Pilipinas (BSP) may still need to hike rates (by 50bp) in light of continued Fed tightening and despite domestic inflation sliding back to within target. We cannot rule out a more dovish stance if two drivers point to significant moderation.

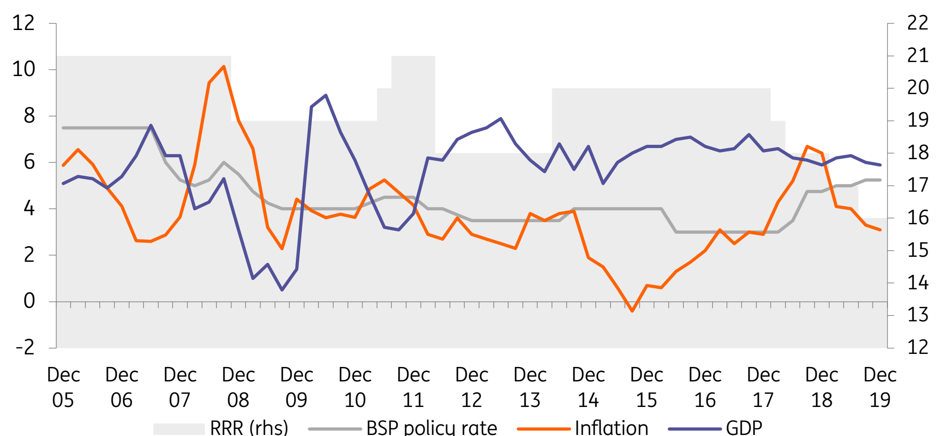
The Peso could well face depreciation pressure as domestic demand driven growth foments current account deficits. Possible BSP policy rate adjustments and financial account inflows are expected to moderate any PHP weakness.

### GDP to slow on BSP rate hikes and inflation

Philippines growth in 2019 could post its lowest print since 2015. Recent monetary policy adjustments are expected to sap economic growth momentum, with GDP averaging 6.1% in 2019 and decelerating from 2018's projected 6.2%. In response to above-target inflation in 2018, the BSP unloaded an aggressive 175bp rate hike salvo which will continue to weigh on overall growth momentum in 2019. Elevated borrowing costs will sap both consumption and investment momentum and this will be a key theme throughout 2019. Meanwhile, inflation is expected to trend lower and eventually fall within target by 2H, after monetary and non-monetary policy measures feed into the economy.

For the first half of 2019, growth will be boosted by election-related spending although a five-month ban on public spending could well offset this positive. Post-election, decelerating inflation will partially restore lost purchasing power while also helping to lead financing costs lower. This should lead to a slightly faster pace of growth in 2H as household spending, business investment and government spending accelerate from the first half.

**Fig 1 BSP policy, inflation and GDP: High rates and growth don't mix (%)**




Source: Bloomberg

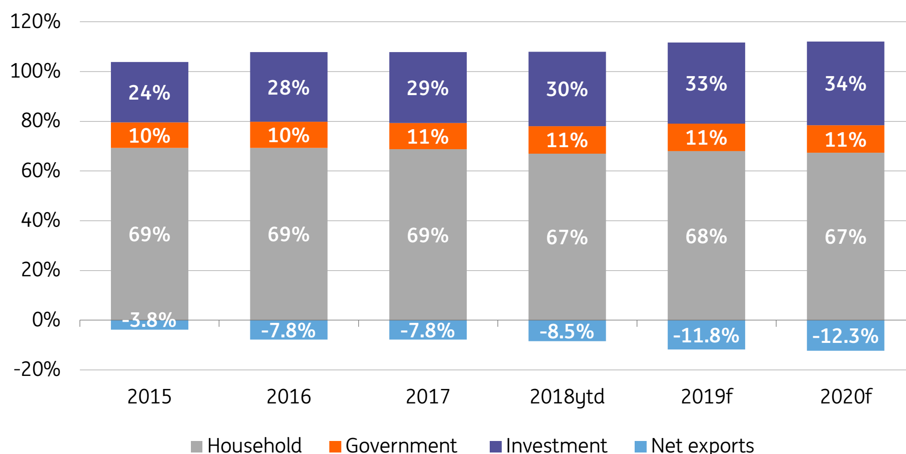
*Prognosis: Elevated borrowing costs to sap momentum, recover slightly in 2H as inflation slows*

**Nicholas Mapa**
Senior Economist, Philippines
Manila +63 2 479 8855
nicholas.antonio.mapa@asia.ing.com

## Evolving GDP game plan: PHL moves to investment-led growth, but at a cost

Household spending has consistently provided a stable base for growth and we expect it to do so again in 2019, albeit with a twist. Economic growth is now more broad-based and its reliance on household spending is easing. The past two years have seen a stark acceleration in government spending, up 10.3% since 2017, while investments have posted 16.9% average annual expansion since 2015. In particular, gross domestic capital formation has contributed 4.31ppt to the average 6.5% growth in GDP since 2015. Over 2010 to 2014 it contributed 2.26ppt to the average 6.2% growth. We expect investments to be sustained as borrowing costs eventually moderate by 2H19 and with growth expected to remain above 6% into the medium term. Furthermore, should investment pledges and ODA-funded infrastructure projects materialize in-line with the country's "build build build" programme, we could see investments accelerate further and contribute more to GDP growth.

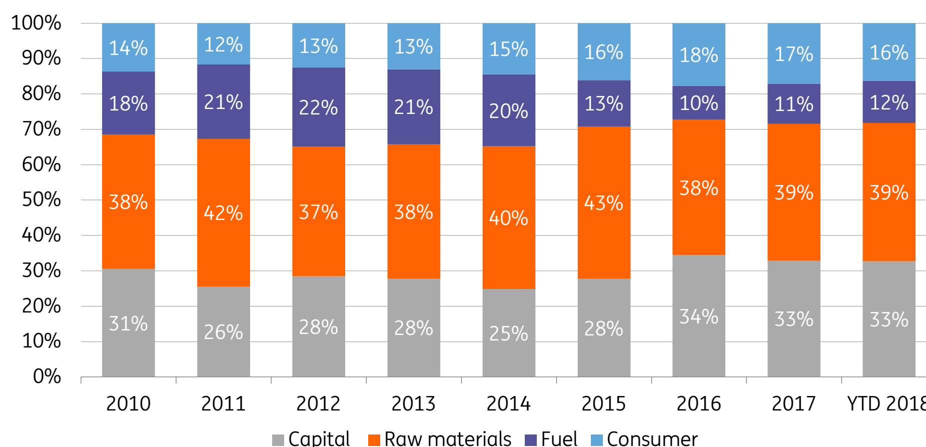
**Fig 2 Percentage contribution to GDP**




Source: Bloomberg

The cost of this strong domestic demand and the shift to a more investment-intensive growth strategy is in wider trade and current account deficits. Previously, the consumption-heavy growth strategy called for a "steady diet" of consumer goods and erratic flows of capital goods and raw materials. With the economy evolving, capital machinery and construction materials are in high demand. These have been flooding Manila ports to feed the voracious investment appetite. Capital goods now account for 33% of economic activity, up from 28% in 2015. The net effect is a swelling trade deficit with imports outpacing exports - since 2015 inbound shipments are up an average 14.4% pa while outbound flows have grown at only 3.1% pa. While the rest of the economy has flourished, the export sector remains outside the new Philippines growth story.

**Fig 3 Contribution to total import requirements shifting to capital goods**




Source: Bloomberg

*Prognosis: Structure of the economy shifting to investment-driven growth, trade gap and current account deficit to remain wide*

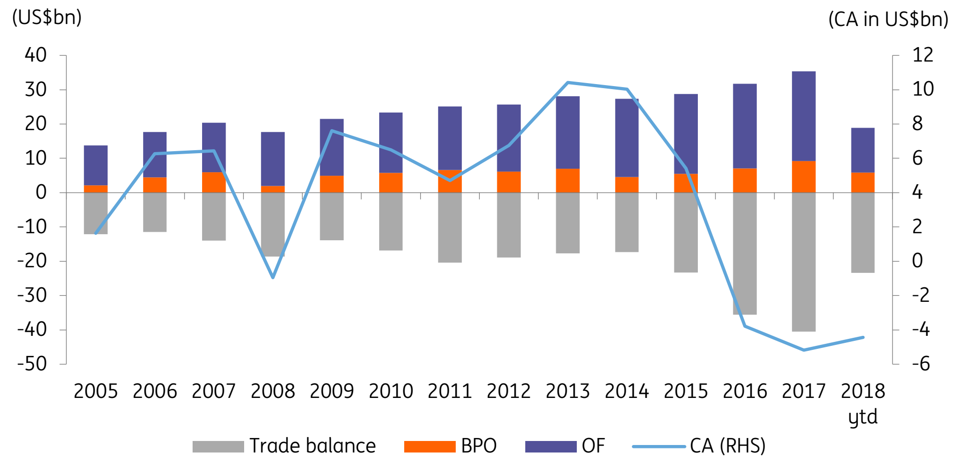
## Three main threats and opportunities: the make or break

These threats and opportunities in 2019 will largely determine whether the Philippines is able to outpace its growth path in 2019 and beyond or if it will slip below forecast. The timing of actions such as the BSP's planned RRR reduction and projected dollar-denominated bond issuances, will be crucial in keeping the economy on an even keel.

### 1. The current account: Fast and furious vs slow and steady

The swelling trade deficit, on the back of strong import growth, has yielded an equally sharp increase in demand for foreign currency. Traditional "structural" sources of foreign currency, namely Overseas Filipino (OF) remittances (up 2.5% YoY as of 3Q18) and services exports (up 55% YoY as of 1H18), have not been able to match the speed and heft of the "fast and furious" pace of the swelling trade deficit (up 70.5% YoY as of 3Q18). The net effect has been a series of months of net dollar outflows (current account deficits). These are more likely to be the norm with the shift to investment-led growth. With imports expected to continue to surge while exports and structural flows chug along at a lacklustre pace, current account deficits may be here to stay. We do not a see any substantial recovery in the export sector in the near term.

**Fig 4 Current account, trade balance and structural flows: Fast and furious (imports) vs slow and steady (OFW)**



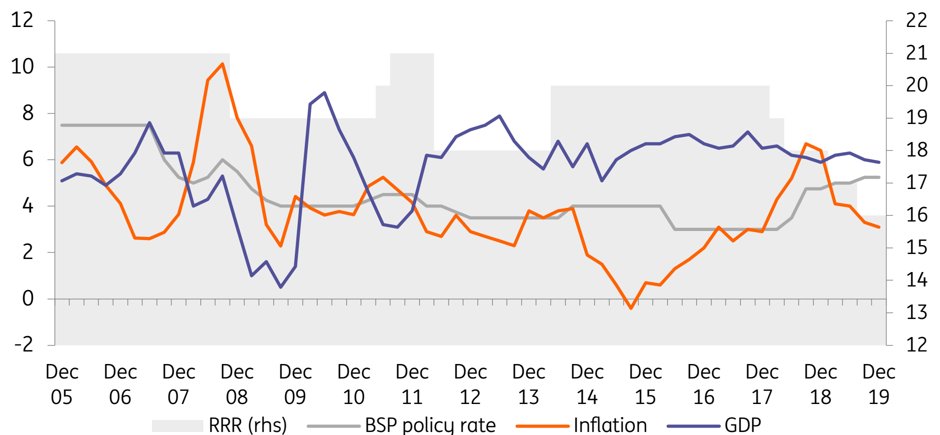

Source: Bloomberg

*Prognosis: Current account remains in deficit as trade gap moves past structural flows*

## 2. BSP to retain hawkish bias but resume cuts to RRR

Despite inflation being expected to revert to target by 2H19, the BSP is likely to retain its current hawkish stance and carry out a modest 50bp worth of hikes. The US Fed “dot diagram” suggests 3 hikes in 2019. BSP will likely be mindful to safeguard against inflationary pressures and look to maintain a healthy differential with the Fed funds rate. On the other hand, BSP Governor Espenilla will likely resume his quest to slash the RRR by another 200bp (with 100bp in each of 1Q and 3Q) to help alleviate tight onshore liquidity conditions. At October 2018 annual money supply posted its lowest expansion in almost 3 years, at 8.2%.

**Fig 5 BSP policy, RRR and inflation: Timing for RRR cut is crucial to avoid inflationary build-up (%)**




Source: Bloomberg

*Prognosis: BSP to hike by 50bp while cutting RRR by 200bp*

**An alternative scenario: BSP cuts policy rates sooner so to give the economy a break**

We now consider the possibility that BSP looks to unwind its aggressive 175bp 2018 rate hikes sooner rather than later, particularly if inflation moves comfortably within the target band and if the Fed eases off on its rate hike cycle (something we see as more likely, given recent dovish commentary from Fed officials). With growth struggling and liquidity conditions tight, we might see the BSP deliver a two-pronged easing by slashing RRR in 1Q and 3Q while cutting its policy rates in 2Q and 4Q. This dual-easing strategy would help the Philippines to regain some growth momentum by the end of 2019, with a recovery in business investment and the government sustaining its "build build build" initiative. A BSP policy rate cut in 2019 would be a possibility as BSP shifts tack with inflation under control and with BSP looking to give the economy a much needed break.

*Alternative prognosis: BSP cuts RRR by 200bp, slashes rates to boost growth*

### 3. Peso to remain pressured while liquidity conditions to improve

Given expectations of a protracted current account deficit and BSP's likely 200bp RRR cut, the PHP will face moderate to mild depreciation pressure in 2019. The structural factors that have led to US$ outflow, coupled with an infusion of peso liquidity, should all drive PHP weakness. Meanwhile, the projected rate hikes by the BSP (50bp cumulative) are expected to limit this depreciation, as will financial account inflows in the form of foreign direct investment (FDI) and possible $-denominated bond issuance. Domestic liquidity conditions are expected to improve after the BSP releases up to PHP200bn via RRR reductions, with inflation trending back to within the target range.

*Prognosis: PHP to face moderated depreciation pressure, liquidity conditions to improve*

**An alternative scenario: Peso faces less severe depreciation pressure**

Despite the current domestic outlook, changes in sentiment stem mostly from the geopolitical scene and can dictate the direction of financial flows. A continued breakthrough between Presidents Trump and Xi in light of the recent positive turnout at the G20 meeting would be positive for emerging markets and could ease pressure on the Peso - portfolio flows have the potential to then flood the region. Further weakness in oil prices as the supply glut grows could also translate into a less severe current account deficit. Lastly, recent dovish communications from the Fed might lead to a less aggressive rate hike cycle which would then also lead to reduced depreciation pressure on the Peso in 2019.

## How the sectors will play out

The prevailing themes discussed above, coupled with a still volatile geopolitical environment, will influence how the major sectors perform in 2019.

### Household consumption: the "go-to guy"

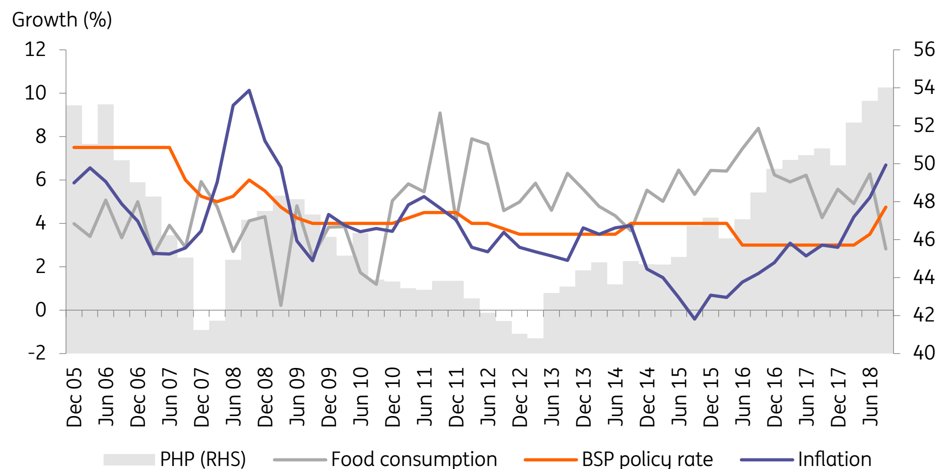
**Positives:** OF remittance, BPO receipts, election spending and decelerating inflation by 2H boost household spending.

**Negatives:** 175bp BSP hike in 2018 saps purchasing power, 1H19 inflation above target.

Delivering 67% of total GDP growth, household consumption will remain the major source of growth for the Philippines although we don't expect it to have the same "punch" of previous quarters. Higher borrowing costs and still elevated inflation in 1H19

should sap purchasing power. The combination of high rates and high inflation slowed consumption growth to 5.2% YoY in 3Q18, the weakest in 16 quarters. Meanwhile, slightly slower inflation by 2H, election spending, steady OF remittance flows and BPO receipts might provide some lift.

**Fig 6 Food inflation, food consumption and BSP policy - Rate hikes and inflation sap consumption momentum**




Source: Bloomberg

*Outlook: Positive with decelerating trend*

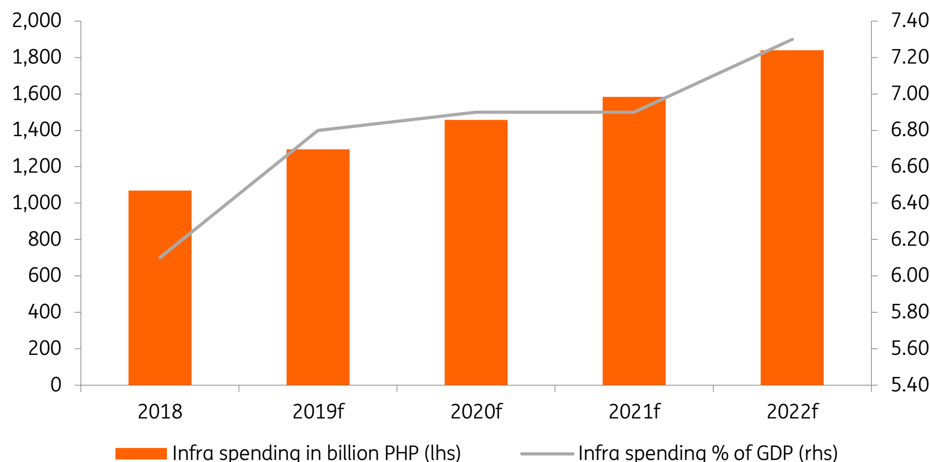
### Capital formation: if you build it they will come

**Positives:** Annual public construction growth remains in double digits. Corporates continue to invest, as evidenced in strong capital goods imports.

**Negatives:** BSP's 175bp rate hike to sap some momentum from private investment due to higher financing costs.

The government's aggressive infrastructure programme dubbed "build build build" has included a possibly Quixotic move to bring Philippine infrastructure closer to par with the region. Public construction has grown at 21.0% pa over the last two years.

**Fig 7 Infrastructure spending targets until 2022**

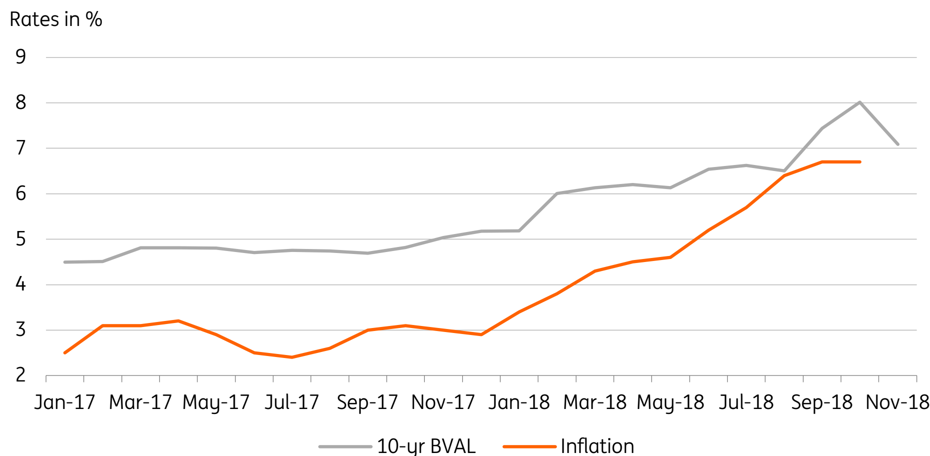



Source: Bloomberg

Outside construction, investment in durable equipment apart from road vehicles has expanded by 14.5% since 2017, highlighting both corporate and government demand

for increased capacity for the long term. These capital outlays for machinery are reflected directly in the 16.4% growth in capital goods imports for the year. With financing costs expected to dip in coming months as inflation normalises, we can expect business investment to pick up again towards the second half of 2019.

**Fig 8 10-year BVAL and inflation**




Source: Bloomberg

*Outlook: Business investment to struggle in 1H but to recover in 2H as borrowing costs slide*

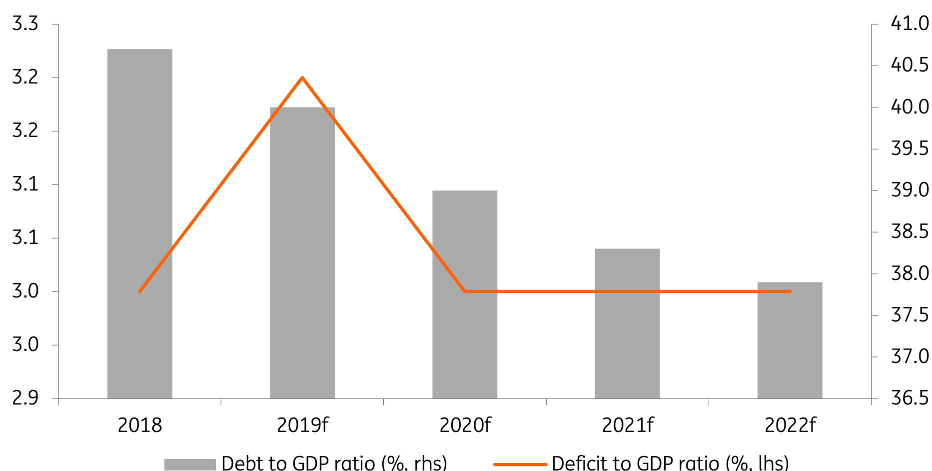
### Government spending: Priming that pump

**Positives:** Budget deficit to increase to 3.2% of GDP in 2019, with infrastructure spending up 6.8%.

**Negatives:** Tight liquidity conditions in 1H19 might cause borrowing costs to rise quickly.

The current administration targets a deficit to GDP ratio of 3.2% in 2019 as the government looks to offset slowing consumption momentum. The ban on election spending will be a drag on 1H19 GDP but we look for outlays to restore double digit growth that has averaged 11% over the past 2 years. The government also aims to push infrastructure outlays with accelerated spending targets up until 2022. Tight onshore liquidity conditions might exert upward pressure on borrowing costs ahead of the projected BSP RRR cuts and thus the timing of government borrowings will be crucial so as to avoid crowding out the private sector.

**Fig 9 Debt-to-GDP ratio**




Source: Company data

*Outlook: Sustained double-digit expansion in public spending but unlikely to match the 15% posted in 2018*

**Trade balance: Import binge continues while exports trail**

**Positives:** The bulk of imports are capital goods and raw materials for construction.

**Negatives:** Exports continue to struggle despite protracted weakness in PHP. Slower global growth might limit export demand.

The trade gap has ballooned to near-record proportions in 2018. All subsectors of the import portfolio have been registering double-digit growth while exports have struggled despite the Peso's protracted depreciation. The silver lining in the widening trade deficit is that capital goods and construction materials account for 46% of the total import bill – something which should benefit productive capacity once these infrastructure projects and machinery are in place. Meanwhile, the export sector continues to struggle despite the weakness of the PHP, highlighting the need to find other means to improve competitiveness. Non-electronics exports have contracted by 11% YTD in 2018.

**Fig 10 Current account, imports and exports**

Source: Bloomberg

*Outlook: Sustained double-digit expansion in imports while exports struggle despite PHP weakness*

**Fig 11 ING Philippines economic forecasts**

| | 2019F | | | | 2020F | | | |
|---|---|---|---|---|---|---|---|---|
| | 1Q | 2Q | 3Q | 4Q | 1Q | 2Q | 3Q | 4Q |
| Real GDP (%YoY) | 6.2 | 6.3 | 6.0 | 5.9 | 6.3 | 6.1 | 6.6 | 6.6 |
| CPI (2012=100; avg. YoY) | 4.1 | 4.0 | 3.3 | 3.1 | 3.3 | 3.5 | 3.8 | 3.8 |
| BSP Key Rate, o/n (%, yr-end) | 4.75 | 5.0 | 5.0 | 5.25 | 5.25 | 5.0 | 5.0 | 4.75 |
| BSP reserve requirement ratio | 17 | 17 | 16 | 16 | 16 | 15 | 14 | 14 |
| 10-yr yield BVAL (%) | 6.9 | 6.6 | 6.5 | 6.1 | 6 | 5.8 | 5.7 | 5.4 |
| 3-month yield BVAL (%) | 5.5 | 5.3 | 5.3 | 5.2 | 5.0 | 5.0 | 4.9 | 4.7 |
| Exch Rate (PHP/US$), yr-end) | 53.74 | 53.93 | 54.18 | 54.45 | 55.00 | 54.64 | 54.61 | 54.89 |

Source: ING estimates

## Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. (**"ING"**) solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies). The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is subject to limited regulation by the Financial Conduct Authority (FCA). ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit https://www.ing.com.