Economics

DBS Focus

Philippines: Public spending to support growth

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- *The Philippines, after chalking up another year of 6%+ growth, is facing multiple sources of headwind in 2019, but would receive support from the public sector.*
- *Low oil price and inflation will help keep the current account and policy rates in check.*
- *Delay on 2019 budget approval could weigh on investment and consumption.*

GDP growth slowed in 4Q18 to 6.1%, resulting in an annual growth of 6.2%. The 2018 annual growth rate is the lowest in three years, yet the Philippines remains one of the fastest growing economies in the world. Combination of global factors such as slowing global growth and higher oil price contributed to the slowdown. In addition, facing the high inflation environment and pressure to Peso, BSP tightened monetary policy stance and hiked policy rate by 175bps last year, contributing to further domestic demand contraction.

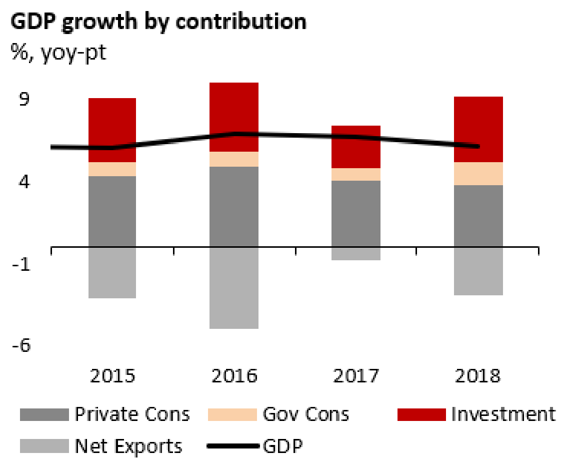
We think growth might pick up slightly this year on the back a recovery of consumption amidst easing inflation. We maintain our growth estimates at 6.5%, vis-à-vis government target of 7%-9% this year.

Government-led growth might continue this year

2018 was a government-led growth, both from consumption and investment sides. Tax reform success in bringing in additional revenue, has created room for government spending to expand (12.9% YoY in 2018 from 7.1% YoY in 2017). This consumption spending increase includes salary adjustment of military and other personnel. Government-led investment related to infrastructure reform, was another driver of growth resulting in higher gross capital formation growth (13.9% YoY in 2018 from 9.4% in 2017).

The biggest drag to growth was consumption, which account for more than 60% of GDP, and weaker trade sectors. Higher inflation has dampened household consumption growth (5.6% in 2018 from 5.9% in 2017). However, **it seemed that the slowdown in consumption may have reached its bottom** as inflation eased and is expected to ease further this year. Consumption growth have shown an uptick in the quarterly number (5.4% YoY in 4Q18 from 5.2% in 3Q18).

As oil price has come down significantly and impact of higher excise taxes will finally wear off, inflation will ease further this year. Lower inflation and the upcoming midterm election to some extent will support consumption pickup this year. Midterm election will elect 12 out of 24 senates and around 18,000 national and regional posts.



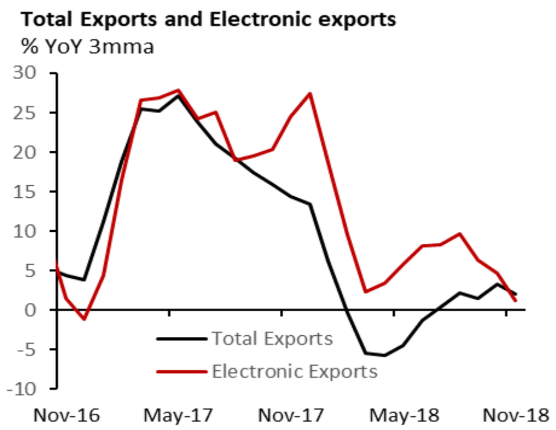
Source: CEIC, DBS Group Research

Main risks to growth outlook: trade, investment and consumption

Unlike our cautious optimism on consumption growth, **we are wary of trade sector being a drag on growth again this year**. Lower oil price might curb imports growth further. In fact, imports growth has come down significantly in 4Q18 at 11.8% YoY from 17.9% YoY in 3Q18 as oil price (Brent) declined by 35% between these two quarters. Yet, imports related to constructions and infrastructure might stay elevated as the government continue to prioritize on infrastructure development.

As risks to imports subside, we see more risk towards exports. Exports slowdown is not unique to the Philippines. Other countries in the regions were experiencing the same deceleration. For Philippines, as electronic account for more than 50% of total exports, trade war and slower global demand have had a significant impact on exports. Electronic manufacturing exports growth fell to -1.62% YoY in Nov18 from a monthly average of 24.4% in 2017.

As global electronics demand softens, we think it is crucial for Philippines to diversify its exports basket from heavy reliance on electronics.



Source: CEIC, DBS Group Research

Philippines trade deficit to China has widened lately while its trade balance to the US had improved. The widening deficit toward China (from -USD8.3bn in 2017 to -USD11.4bn in 2018, data until Nov) were mostly related to domestic infrastructure development. Big ticket items are iron and steel and machineries which relates to infrastructure development.

Trade diversion from the US to countries outside of China has benefited the Philippines trade balance with the US as shown in higher trade surplus (USD2.6bn in 2018 from USD2.2bn in 2017), on account of higher electronics exports (34% of total exports to the US).

Source: CEIC, DBS Group Research

Delay of the 2019 budget could hurt investment sentiments. A significant part of investment has been government spending and investment. Budget is currently still under review and if reenacted, only a proportion of personal services, maintenance and operating expense, as well as capital outlays of regular programs and ongoing (multi years) projects included in 2018 budget will be allowed by law.

This means new infrastructure projects not allocated in 2018 budget will be affected, while the ongoing projects would be allowed for disbursement up to certain percentage of the proposed budget.

The new projects at risks include Metro Manila Subway (P1.5bn), Mindanao Railway Project (P2.9bn) and Philippine National Railway Phase-1 project (P14bn). Even pre-construction work for these new projects might be delayed until the budget bill is passed hence delaying overall project disbursement. Given the new cash-based systems, undisbursed budget – including due to delayed implementation – will be returned and could not be disbursed.

In addition, there is additional risk of delay due to prohibition of public fund disbursement during election period (13 Jan to 12 Jun) as stipulated by the Omnibus Election Code. A special provision allowing for infrastructure projects is included in the proposed budget. If this special provision is not approved, infrastructure projects can only start after 12 June 2019.

Investment might be affected, with the mildest scenario where budget along with the special provision is approved in February. The worst-case scenario, in which new infrastructure projects are being disbursed after 12 June, seemed unlikely.

Budget delay could also impact consumption:

- **Salary increases**: 2019 budget proposes salary increases for civil servants, military and uniformed personnel (roughly P122bn). In addition, the 4th tranche of the Salary Standardization Law for civilian employees including teachers might be put on hold as well.

- **Social services**: Several social spending might be delayed as well. This includes the unconditional cash transfer program as well as fuel subsidies for jeepney drivers (public transportation).

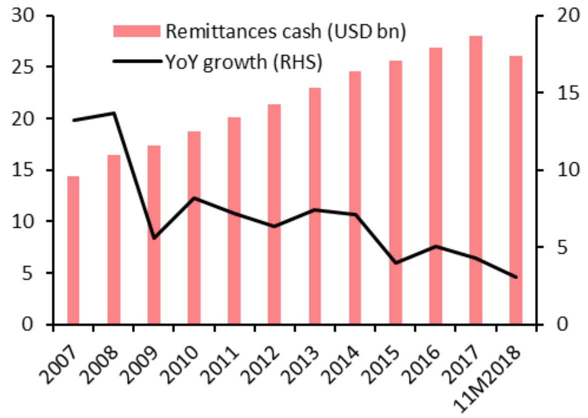
In the 2019 budget, 10 million poor households would get additional P100/month of unconditional cash transfers to compensate the impact of higher excises tax due to tax reform, from P200/month in 2018 budget (33.3% lower).

Although the difference in subsidy according to 2018 and 2018 budget is only around 1% of PSA's poverty line (P9,063month), the impact might be significant as it would affect more than 40% of poor (using World Bank 2015 poverty number). Delay budget would have a higher impact on Jeepney drivers as they will only receive P833/month, or 51% lower than P1,709/month in 2019 budget.

The impact to consumption (assuming budget approval in February) would be minimum and might be compensated by the increase in consumption due to easing inflation.

Another potential headwind to consumption is deceleration of remittance flows. There are two reasons that could lead to further decline in remittance flows. First, it has decelerated continuously since 2008 and might continue to decelerate further. Second, the US has recently ban H-2A visa (temporary non-agricultural and seasonal workers) and H-2B visa (construction and healthcare) from Jan19 to Jan20.

OF Remittances
USD bn, % YoY



Source: CEIC, DBS Group Research

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Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).