MACROECONOMIC AND DEBT SUSTAINABILITY ASSESSMENT

A. Summary

1. The Gross Domestic Product (GDP) is projected to increase by 6.4% in 2015.[1] Growth is being driven by private consumption and investment, coupled with a recovery in exports. However, continued weakness in budget execution is a key downside risk to this outlook. While private consumption remains the dominant growth driver, the contribution of fixed investment is also increasing. The Government has implemented measures to address spending bottlenecks. However, progress thus far has been modest due to procedural delays and absorptive capacities especially at the local level. The share of services to domestic output has risen over the years to 58% of GDP in 2014 and the sector accounts for over half of total employment**.** The sector is led by retail trading, business process outsourcing, tourism, finance, and real estate. The current remains in surplus, driven by business process outsourcing, and remittances from overseas workers. On the external front, disruptive asset price shifts associated with asynchronous monetary policies in advanced economies is a risk.

2. The debt profile of the Philippines has improved significantly, reflecting the fiscal consolidation which has been a centerpiece of the current administration. Public debt has declined to 39% of GDP from almost 70% in 2013. The most recent International Monetary Fund (IMF) debt sustainability assessment found that public debt in the Philippines is sustainable.[2] Public debt appears to be resilient to shocks including interest rates, growth, and the current account. However, a one-time real depreciation in the exchange rate of 30% in 2014 would raise the external debt-to-GDP ratio by 12 percentage points.

3. The financial system has continued to post strong performance. Philippine banks have achieved strong profits, and despite double digit credit expansion in recent years, Non-Performing Loans (NPLs) are at a historically low level of about 2%. Banks and other supervised financial institutions remain well-capitalized. Risk exposures emanate from the highly concentrated nature of their loan portfolios, and their large portfolios of long-tenor fixed-rate government securities. Loan portfolios, while small, are concentrated to a small number of top-tier listed companies, including affiliated organizations.[3]

B. Macroeconomic Overview

4. **Recent growth performance has been robust.** GDP rose by 6.1% in 2014, the third consecutive year of GDP growth exceeding 6%. Growth was driven by private consumption and investment, coupled with a recovery in exports. Improvements in domestic employment and remittances have supported private consumption**.** One million new jobs were generated in the 12 months to January 2015, and the unemployment rate fell to 6.6% from 7.5% in January 2014. While private consumption remains the dominant growth driver, the contribution of fixed investment is also increasing. Fixed investment has increased by an annual average of nearly 10% yearly since 2010. However, as a share of GDP, fixed investment remains modest at 20.5% in 2014, and lags behind peer economies in Asia.

[1] ADB. 2015. Asian Development Outlook. Manila.
[2] IMF. 2014. Article IV Consultation. Washington DC.
[3] The IMF estimates that the average leverage ratio of listed companies was 100% in 2012, but that this leverage is not evenly distributed with firms with leverage ratios above 200% accounting for one-third of all corporate debt.

5. **Government spending recovering in the fourth quarter of 2014.** Fiscal consolidation in the past years has helped created fiscal space for development expenditures. National government debt has fallen to 45.4% of GDP, the lowest in over a decade. The share of external borrowing has declined from 50.7% in 2000 to 33.4% of total debt in 2014, of which 35% are from multilateral and bilateral lenders and the remainder from debt issuances. However, spending was sluggish due in part to the Supreme Court ruling against certain government funds along with capacity constraints and procurement problems. Subdued spending and higher revenues cut the fiscal deficit to 0.6% of GDP in 2014, well under the ceiling of 2.0% and narrower than the deficit of 1.4% in 2013. Revenue rose by 11.2% compared to 2013, helped by more stringent tax administration. Expenditures excluding interest increased by 6.7% but fell short of targets by 13%.

6. **Higher domestic demand offsets weakness in merchandise exports.** Merchandise exports declined by 0.2% year on year in the first quarter of 2015, though recovering in March. Exports to Japan (top market, 20.7% share in total exports) and China (10.3% share) declined, partly cushioned by brisk shipments to other key markets like US (16.2% share) and European Union (12.1% share). From the production side, services contributed nearly 60% of GDP growth, and manufacturing one-third. The service sector was led by retail trading, business process outsourcing, tourism, finance, and real estate. Damage inflicted by super typhoon Haiyan late in 2013 and other storms in 2014 hurt agricultural production for much of last year.

7. **Manufacturing continued to expand.** Manufacturing posted an 8% average yearly growth over the past five years. Buoyant domestic demand and rising export orders for manufactured products underpinned this growth. Food processing, about 40% of all manufacturing, is a key driver, though increases have been seen as well in a range of industries such as chemicals, furniture and fixtures, and transport and communication equipment. The share of services to domestic output has risen over the years to 58% of GDP in 2014 and the sector accounts for over half of total employment. In contrast, industry's share of GDP fell from 42% in 1980 to 31% in 2014 (manufacturing at 20.5% of GDP). Share of agriculture to GDP has also declined to 11% from 22% over the same period, though still accounts for a third of all jobs. Manufacturing currently accounts for 8% of total employment.

8. **Inflation eased on lower fuel prices and modest increases in food prices.** Inflation declined to an average 2.3% over the period January to April 2015 from 4.1% in the same period in prior year. As inflation stayed within the central bank's 2%–4% target, monetary authorities have maintained the policy rates since raising them last year by a cumulative 50 bps to 4% and 6% for the overnight borrowing and lending rates, respectively. The Central Bank also raised the reserve requirement in 2014, helping temper liquidity (M3) growth to 9.4% year on year in March 2015.

9. **The current account has been in surplus since 2003.** The current account surplus, equivalent to 4.4% of GDP in 2014, has improved slightly from 4.2% of GDP in 2013. Services exports, mainly business process outsourcing (BPO), coupled with remittances from overseas workers underpin the current account. The BPO sector continues to grow rapidly. Export revenues from the BPO sector grew three-fold from $6.3 billion in 2008 to $18.1 billion in 2014, while employment grew from 355,000 to 1,000,000 (2.7% of total employment) over the same period. Prospects remain favorable considering the diversification to high growth segments, including financial services, insurance, human resources, logistics, engineering, and healthcare. The expansion of investments to other regions, outside of Metro Manila, also bode well. Net outflows of portfolio investment during the period however put the balance of payments in deficit equivalent to 1% of GDP.

10. **Remittances from overseas Filipinos have moderated.** Remittances rose by 6.3% in full year 2014 and by 2.1% in the first two months of 2015, easing from a 7% average yearly growth from 2009 to 2013. Slowdown was attributed to slower economic growth in key host countries including Europe.

C. Debt Sustainability Analysis[4]

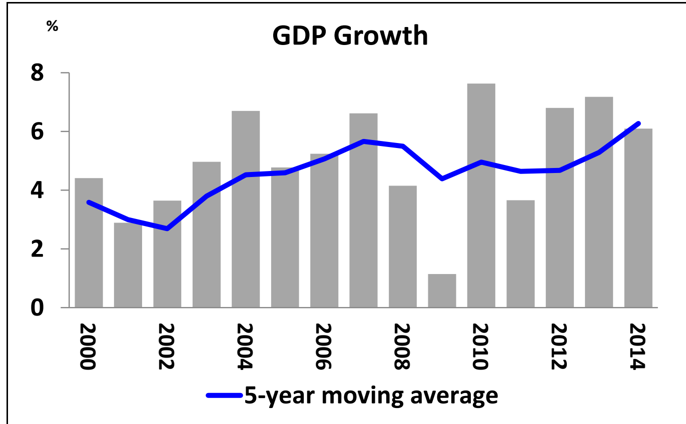
11. The debt profile of the Philippines has improved significantly, reflecting the fiscal consolidation which has been a centerpiece of the current administration. Public debt has declined to 39% of GDP from almost 70% in 2013. Public debt denominated in foreign now represents less than half of the total general government debt, and is continuing to decline. In addition, the government has made significant progress in lengthening the average tenor of peso-denominated public debt. From less than 10% in 2009, Peso-denominated public debt with a maturity of 10 years has increased to 42% in 2013. Public debt with floating interest rates represents only 7.5 percent of total public debt. As a direct consequence, the Philippines was upgraded to investment grade status by three major global rating agencies during 2013, with a further upgrade by one agency in early 2014.

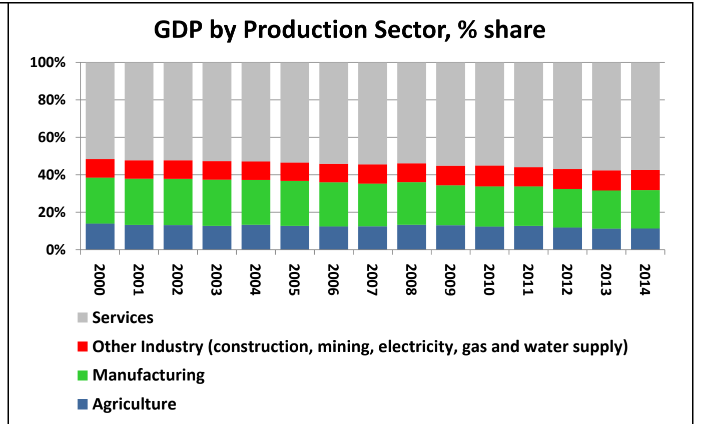
12. The most recent IMF debt sustainability assessment found that public debt in the Philippines is sustainable. Under baseline assumptions, the IMF expects public debt to decline to approximately 27 percent of GDP by 2019 from 39 percent in 2013. This projected decline is due primarily to the government's stated policy of maintaining a national budget deficit at 2% of GDP, which implies an annual primary surplus of over 1 percent of GDP.[5] The government's gross financing needs are expected to remain in the range of 4−6% of GDP, representing a relatively high 335 of general government tax revenue.

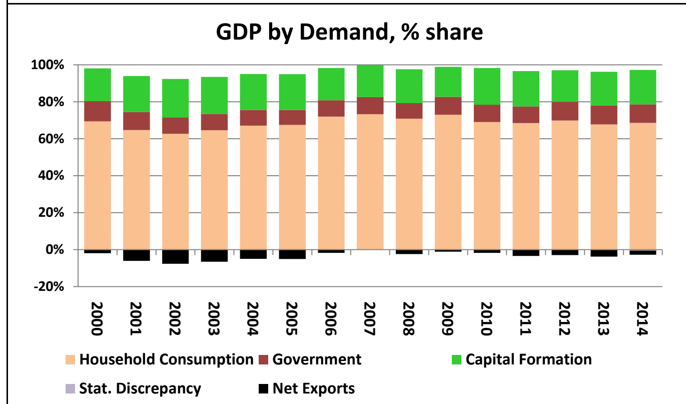
13. The IMF considerers the baseline scenario conservative. The reduction in public debt over the past 10 years is due primarily to primary surpluses, high output growth, and exchange rate appreciation. Thus, if the assumptions in the baseline scenario are set to historical averages over 2004−2013, would debt levels and gross financing needs decline even faster. The IMF also considered the outlook for economy-wide external debt to be positive. Public debt appears to be resilient to shocks including interest rates, growth, and the current account. However, a one-time real depreciation in the exchange rate of 30% in 2014 would raise the external debt-to-GDP ratio by 12 percentage points.

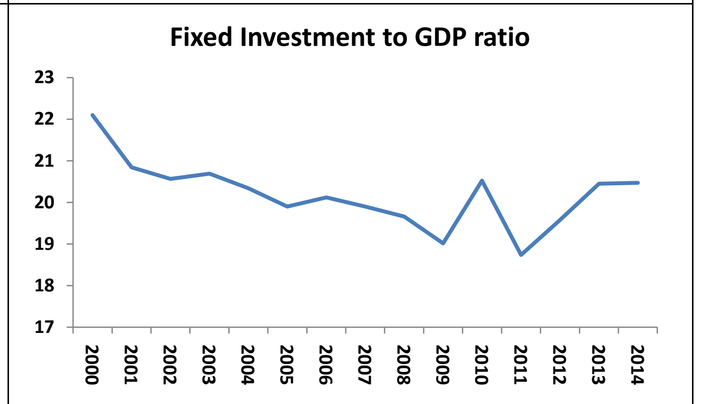
[4] This assessment is based on the most recent debt sustainability assessment prepared by the International Monetary Fund.

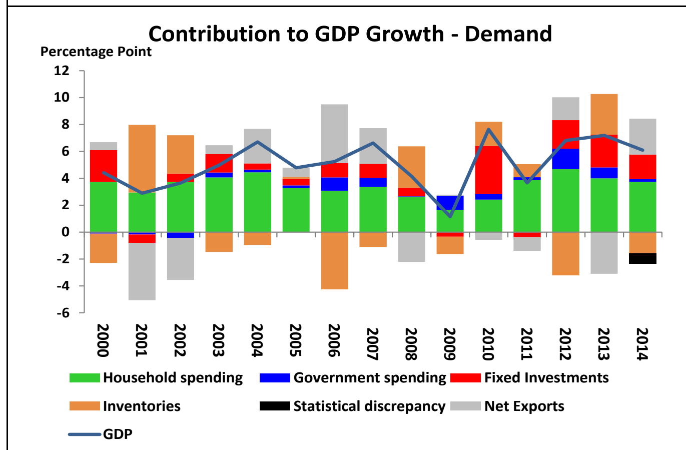
[5] This exceeds the debt stabilizing primary deficit of 0.6% of GDP, based on the assumption of 6% real GDP growth, and 3.5% inflation in the medium term.

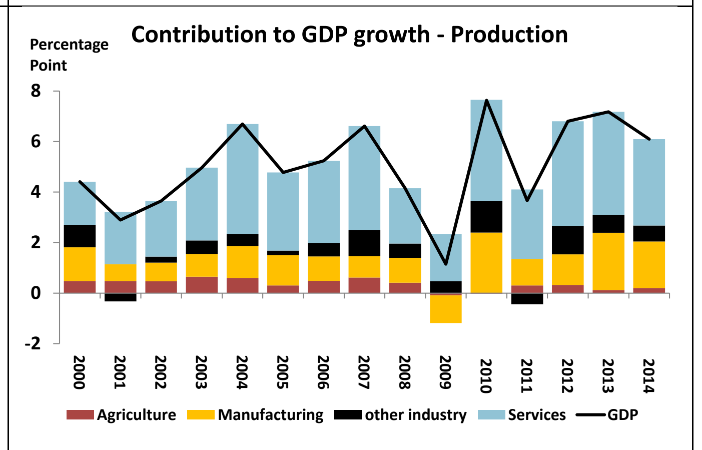

GDP Growth
%
8
6
4
2
0
2000
2002
2004
2006
2008
2010
2012
2014
5-year moving average

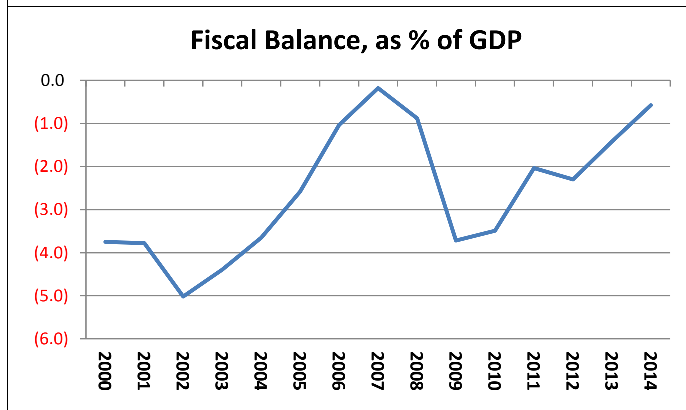

GDP by Production Sector, % share
100%
80%
60%
40%
20%
0%
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
Services
Other Industry (construction, mining, electricity, gas and water supply)
Manufacturing
Agriculture

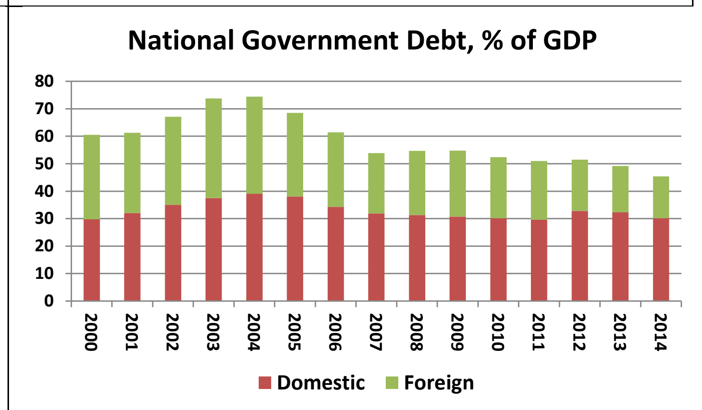

GDP by Demand, % share
100%
80%
60%
40%
20%
0%
-20%
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
Household Consumption
Government
Capital Formation
Stat. Discrepancy
Net Exports


Fixed Investment to GDP ratio
23
22
21
20
19
18
17
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014


Contribution to GDP Growth - Demand
Percentage Point
12
10
8
6
4
2
0
-2
-4
-6
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
Household spending
Government spending
Fixed Investments
Inventories
Statistical discrepancy
Net Exports
GDP


Contribution to GDP growth - Production
Percentage Point
8
6
4
2
0
-2
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
Agriculture
Manufacturing
other industry
Services
GDP


Fiscal Balance, as % of GDP
0.0
(1.0)
(2.0)
(3.0)
(4.0)
(5.0)
(6.0)
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014


National Government Debt, % of GDP
80
70
60
50
40
30
20
10
0
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
Domestic
Foreign