CPBRD

BUDGET BRIEF

NO. 3 | 2022

Macroeconomic Parameters: Implications on the Proposed FY 2023 National Government Budget

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HIGHLIGHTS

- ***DBCC Targets.*** Most of the assumptions adopted for 2021 have not been met which could be attributed to the negative impact of the second wave of the Covid-19 pandemic in the second half of 2021. Real GDP growth of 5.7% in 2021 fell short of the target 6.0-7.0%. Unemployment was still elevated as it exceeded the target by 0.4 percentage point and by 2.7 percentage points compared with pre-pandemic level in 2019 while the inflation rate almost reached the upper end of the target in 2021. Similarly, the gross international reserves (GIR) was below the target as the current account went into a deficit while the annual average price of imported Dubai oil products and foreign exchange rate almost reached the upper end of the targets.

- ***DBCC Revisions***. In the light of the continuing Covid-19 pandemic and the current Russia-Ukraine war, projection for real GDP for FY 2022 has been revised downward while projections for inflation rate, Dubai oil price, and foreign exchange have been revised upwards. Projections for exports and imports remained optimistic as targets have been revised upwards. For 2023, forecast for real GDP growth has been revised upwards while imports are expected to expand below the original target of 8%. The inflation rate, Dubai oil price, and foreign exchange rate are projected to remain elevated.

- ***Forecasts by Other Institutions.*** The latest revised average forecast of multilateral institutions and credit rating agencies (excluding the DBCC) for 2022 stands at **6.6%.** For 2023, however, a moderate GDP growth of **5.9%** has been projected owing to factors such as the increase in policy interest rates, slowdowns in major industrial economies, depreciation of the peso, and inflation caused by sustained elevated global commodity prices due to the prolonged Russia-Ukraine war.

- ***CPBRD Projections.*** With the robust performance of the economy in the first half of 2022, the CPBRD forecasts a full year 2022 real GDP growth of **6.8%**, which is within the range of the government target of 6.5%-7.5%. This is based on expectations of continued strong domestic demand supported by a pick-up in employment and remittance inflows, private investment expansion, large public infrastructure projects, the resumption of face-to-face classes in August 2022, and the positive impacts of the economic reform measures, i.e. amendments to the Public Service Act, Retail Trade Act, and the Foreign Investments Act. For 2023, a more moderate growth is projected at 5.9% which is lower than the government target of 6.5-7.5% and the average **5.9%** growth rate projected by various institutions due to baseline effects and the persistence of downside risks.

- ***Downside risks brought about by economic and geopolitical developments abroad will weigh down on the Philippines' continued recovery.*** The projections could, however, easily turn into a more tempered or even a negative outlook given the following emerging downside risks: a) lingering Russia-Ukraine war resulting to higher global commodity prices that will push inflation and widen current account deficit; b) additional US Federal Reserve's interest rate hikes and war-related volatility in global financial markets that could trigger capital outflows and contribute to the further depreciation of the peso; c) additional increase in BSP's policy interest rates that could dampen demand and increase the cost of money for production purposes; d) sharper-than-expected economic slowdowns in major trading partners, such as the U.S. and China which can affect the country's exports; e) natural disasters and weather-related events; and f) the escalation of the geopolitical conflict between China and Taiwan.

- ***The economy in the second quarter of 2022 showed some signs of weakening.*** While total GDP grew solidly by 7.4% year-on-year in the second quarter of 2022, seasonally adjusted quarter-on-quarter growth declined by 0.1%. While expanding by 9.8% in the first quarter of 2022, manufacturing slowed down to 2.1% growth in the second quarter. The weakness in the manufacturing sector is also reflected in the decline of the demand for exports of goods which contracted by 2.1% in the second quarter of 2022. Quarter-on-quarter, growth of the services sector also declined by 0.4% mainly due to the fall in the output of the transport (-20.3%), human health (-6.5%), and real estate sectors (-2.1%), while household consumption also contracted by 2.7% with the top contributors being transport (22.8%), restaurants and hotels (-10.7%), and food and non-alcoholic beverages (-1.3%).

- ***Double-edged impact of inflation and the weakening peso on budget balance.*** Although an increase in inflation and the depreciation of the peso is estimated by the government to contribute significantly to its revenues, gains may be offset with the increase in the cost of delivering critical public services and infrastructure. A very high inflation fueled by a very weak peso may also constrain overall output growth as production costs increase and real incomes are reduced. Inflation is a regressive and arbitrary tax, the burden of which is typically borne disproportionately by those in the lower income brackets. Note that while the economy grew by 7.8% in the first semester of 2022, unemployment remained elevated at 6% compared to the 5.1% in 2019.

- ***Need for an efficient and effective government spending and debt management.*** While public expenditures can boost the economy, financing it through borrowings will further increase interest rates and inflation. In these uncertain times, the best strategy for the government is to focus spending on productivity enhancing programs and projects specifically in education, public health, and research and development, and at the same time restore fiscal space with revenue-raising and cost saving reforms.

- ***Need for a conducive business environment.*** The agriculture and industry sectors can only take advantage of the benefits of a recovering services sector if and only if existing obstacles to the efficient and fair production of goods and services are reduced. Aside from high cost of raw materials, logistical challenges, shipment delays and port congestion are still cited as major problems of these sectors. More than maintaining fiscal stability, the government's role is to ensure overall governance quality by enacting and implementing institutional and regulatory policies that would help increase productivity, investments and employment.

MACROECONOMIC PARAMETERS: IMPLICATIONS ON THE PROPOSED FY 2023 NATIONAL GOVERNMENT BUDGET

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- The national budget is comprised of public funds used to achieve the economic and social goals of the country. Through the budget, the government can prioritize and put into action its plans, programs and policies within the constraints of its financial capacity. These programs and projects are intended to create the most impact on the production and delivery of goods and services that would ultimately promote the development of the country.

- In determining the required level of budget, the Development and Budget Coordination Committee (DBCC) takes into account a set of macroeconomic assumptions that would make the budget's implementation possible. Based on the 2023 BESF[1], these major macroeconomic parameters are as follows: (i) real GDP growth rate, (ii) inflation rate, (iii) interest rate (364-day Treasury bill rate), (iv) foreign exchange rate, (v) Dubai oil price, and (vi) unemployment rate. Other parameters include the exports and imports of goods, current account balance, and gross international reserves, among others. Any divergence from the expected values of these parameters affect the management of the revenue and disbursements of the government. The following discussion will focus on the recent performance and outlook of these variables to ascertain their likely effect on the viability of the proposed 2023 budget.

- ***Macroeconomic Assumptions/Targets in the BESF 2023***. The estimated values of the macroeconomic parameters considered in formulating the national budget are recorded in the Budget of Expenditures and Sources of Financing (BESF). Table 1 shows some of the parameters used in the 2023 BESF which include the actual values of the parameters in the previous fiscal year, latest available data and adjusted targets during the current fiscal year, and the projections of these parameters for the following fiscal year.

- It can be observed that most of the assumptions adopted for 2021 have not been met which could be attributed to the negative impact of the second wave of the Covid-19 pandemic specifically with the spread of the Delta variant in the second half of 2021. Note that although quarantine rules that were in place last year allowed the mobility of more authorized persons out of residence (APOR) in critical and essential industries than those covered in the list issued in

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[1] *https://www.dbm.gov.ph/wp-content/uploads/BESF/BESF2023/A1.pdf*

March 2020, a travel ban on foreigners from 10 countries with high cases of the Delta virus[2] and domestic travel from ECQ to MECQ and GCQ areas was still in place.

- Real GDP growth of 5.7% in 2021 fell short of the target 6.0-7.0%. Unemployment was still elevated in 2021 as the actual value exceeded the target by 0.4 percentage point and by 2.7 percentage points compared with pre-pandemic level in 2019 while the inflation rate almost reached the upper end of the target in 2021. Similarly, the gross international reserves (GIR) was below the target as the current account went into a deficit with imports exceeding exports compared to that recorded in 2020 as well as the annual average price of imported Dubai oil products and the annual average foreign exchange rate almost reaching the upper end of the targets.

TABLE I.
SELECTED MACROECONOMIC PARAMETERS IN THE BESF 2023

Particulars	2022 BESF Forecast	Actual	Latest Available	Adjusted	Projections[1]
	2021	2021	2022	2022	2023
Real GDP Growth (%)	6.0-7.0	5.7	7.8 (Jan-Jun '22)	6.5-7.5	6.5-8.0
Inflation Rate, CPI (2018=100)	2.0-4.0	3.9	4.7 (Jan-Jul '22) 6.4 (Jul '22)	Target: 2.0-4.0 Forecast: 4.5-5.5	T 2.0-4.0 F 2.5-4.5
Unemployment Rate (%)	6.7-7.4	7.8	6.05 (Jan-Jun '22)	5.1-6.5	5.7-6.8
364-Day T-bill Rate (%)	2.0-3.0	1.694	2.12 (Jan-Jun '22)	2.5-4.0	3.0-4.5
Foreign Exchange Rate (P:$)	48-53	50.8	52.1 (Jan-Jun '22)	51-53	51-55
Dubai Oil Price (US$/Barrel)	50-70	69.1	102.0 (Jan-Jul '22) 103.9 (Jul '22)	90.0-110.0	80-100
Exports of Goods					
Level (in US$ billion)	52.2	74.7	38.53 (1st Sem '22)	58.0	61.4
Growth Rate (%)	10.0	14.5	7.1	7.0	6.0
Imports of Goods					
Level (in US$ billion)	88.8	117.9	69.2 (1st Sem '22)	127.4	135.0
Growth Rate (%)	12.0	31.3	28.1	18.0	6.0
Current Account Balance					
Level (in US$ billion)	10.0	-6.9	-4.8 (Q1 '22)	-19.1	-20.5
Percent of GDP (%)	2.5	-1.8	-5.0	-4.6	-4.4
Gross International Reserves (in US$ billion)	115.0	**108.8**	98.8 (Jul '22)	105.0	106.0
Equivalent Months of Imports of Goods, Services and Income	11.9	9.6	8.3	8.0	7.6

Note: 1/ Adopted by the Development Budget Coordination Committee (DBCC) on 8 July 2022.
Sources: 2022 BESF, NEDA, PSA, BSP, New Zealand Ministry of Economic Development

- ***DBCC Targets and Revisions***. In recent years, the DBCC has made periodic reviews and updates on its macroeconomic assumptions or targets for the national budget to reflect the impact of the latest economic developments. Citing a review of the "administration's priorities and fiscal strategy, latest economic developments, and external pressures", the DBCC has revised its medium-term macroeconomic assumptions twice since 15 December 2021 – one on 24 May 2022 and another on 8 July 2022. The unpredictability of the outcomes of the continuing

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[2] *https://www.reuters.com/world/asia-pacific/philippines-bar-travel-malaysia-thailand-curb-deltas-spread-2021-07-23/*

Covid-19 pandemic as well as the current Russia-Ukraine war on the Philippine economy has tempered the outlook for most of the macroeconomic parameters.

- Note that considerable adjustments have been made for FY 2022 with downward pressure on the real GDP growth forecast while projections for inflation rate, Dubai oil price, and foreign exchange have been revised upwards. Projections for exports and imports remained optimistic as growth targets have been revised upwards. For 2023, forecast for real GDP growth has been revised upwards while imports are expected to expand below the original target of 8%. The inflation rate, Dubai oil price, and foreign exchange rate are projected to remain elevated.

TABLE 2.
REVISIONS IN THE DBCC'S MACROECONOMIC PARAMETERS FOR 2022-2023

Parameter	Projections[3]					
	2022			2023		
	Dec 2021	May 2022	Jul 2022	Dec 2021	May 2022	Jul 2022
Real GDP Growth	7.0-9.0	7.0-8.0	6.5-7.5	6.0-7.0	6.0-7.0	6.5-8.0
Inflation rate (%)	2.0-4.0	3.7-4.7	4.5-5.5	2.0-4.0	2.0-4.0	2.5-4.5
Dubai Crude Oil (US$/barrel)	60-80	90-110	90-110	60-80	80-100	80-100
Foreign Exchange (P/US$)	48-53	51-53	51-53	48-53	50-53	51-55
Growth of Goods Export (%)	6.0	7.0	7.0	6.0	6.0	6.0
Growth of Goods Import (%)	10.0	15.0	18.0	8.0	6.0	6.0

Source: DBM

- With the latest revisions in the macroeconomic assumptions, a lower GDP growth target of 6.5-7.5% for 2022 and given a 7.8% growth in the first semester of 2022, the economy has to expand by 5.3% to 7.2% in the second half of the year to be able to achieve the full year target.

TABLE 3.
GDP GROWTH RATE ESTIMATES OF VARIOUS INSTITUTIONS, 2022-2023

Institution	Forecast as of	Direction of Change from previous forecast	2022	2023
Development Budget Coordinating Committee	July 2022	↓	6.5-7.5	6.5-8.0
Oxford Economics	May 2022	↑	7.3	-
Moody's Analytics	June 2022	↑	7.2	5.4
DBS Bank Ltd.	August 2022	↓	7.0	6.3
IHS Markit	February 2022	-	7.0	-
ASEAN+3 Macroeconomic Research Office	July 2022	↑	6.9	6.5
FocusEconomics	June 2022	↑	6.9	6.1
Goldman Sachs	March 2022	↓	6.9	6.3
International Monetary Fund	July 2022	↑	6.7	5.0
ANZ Research	June 2022	↑	6.7	-
Fitch Solutions	August 2022	↑	6.6	-
Standard and Poor's	June 2022	-	6.6	6.9
Maybank	August 2022	↓	6.5	6.2
Asian Development Bank	July 2022	↑	6.5	6.3
Fitch Ratings	July 2022	↓	6.5	6.3
HSBC	June 2022	↑	6.5	5.6
BPI	August 2022	↓	6.3	-
Nomura Securities	August 2022	↓	6.3	3.6
BDO Unibank Inc.	May 2022	-	6.2	-
Institute of International Finance	May 2022	↓	6.1	-
World Bank	June 2022	↓	5.7	5.6

Source: Institutions' respective websites, news articles

[3] *https://www.dbm.gov.ph/index.php/253-dbcc-matters/macroeconomic-assumptions-and-fiscal-targets*

- ***Forecasts by Other Institutions.*** Multilateral institutions, credit rating agencies, and other research organizations have also released their outlook on the Philippine economy. Revisions are also done based on emerging data coming from newly released national accounts data for the first and second quarter of 2022 (2022Q1 and 2022Q2) by the Philippine Statistics Authority (PSA). The average forecast of multilateral institutions and credit rating agencies (excluding the DBCC) for 2022 stands at **6.6%** which is now within the newly revised government GDP growth assumption as of July 2022. Most of these institutions have revised upwards their 2022 growth forecast for the Philippine economy citing positive developments in the first half of the year such as the relaxation of the Covid-19 mobility restrictions in the country, the expansion of the Covid-19 vaccination program, and a rebound in investment and household consumption.

- For 2023, however, a moderate GDP growth of 5.9% has been projected owing to factors such as the increase in policy interest rates, slowdowns in major industrial economies, depreciation of the peso, and inflation caused by sustained elevated global commodity prices due to the prolonged Russia-Ukraine war.

- ***CPBRD Projections.*** The CPBRD estimated last year that the Philippine economy will grow by 5.8% in 2022 with the primary assumption that the economic recovery would be slow and protracted given the magnitude and uncertainty brought about by the Covid-19 crisis. However, latest data from the PSA with real GDP growing by 8.3% in the first quarter and 7.4% in the second quarter showed significant improvement from last year and thus served as the basis for the upward revision. In view thereof, the CPBRD forecasts a full year 2022 real GDP growth of **6.8%**, a full percentage point higher than previously projected a year ago, and which is now within the range of the government target of 6.5%-7.5%. This is based on expectations of continued strong domestic demand supported by a pick-up in employment and remittance inflows, private investment expansion, and large public infrastructure projects. Also, the scheduled resumption of face-to-face classes in all levels in August 2022 will likely increase economic activities. NEDA in May 2022 estimated that the economy is losing about P12 billion in productive output a week, including activities around schools due to the closure of learning institutions[4]. Further, the CPBRD is likewise hopeful that the positive ramifications of the economic reform measures, most especially the amendments to the Public Service Act, Retail Trade Act, and the Foreign Investments Act, all recently enacted in the 18th Congress would already start to kick in.

- ***However, downside risks brought about by economic and geopolitical developments abroad will weigh down on the Philippines' continued recovery.*** This projection could, however, easily turn into a more tempered or even a negative outlook given the following emerging downside risks: a) larger than expected spillovers from the lingering Russia-Ukraine war including higher global commodity prices especially on food and fuel resulting to higher inflation and widening current account deficit; b) faster than expected monetary tightening in the United States with additional Federal Reserve's interest rate hikes and war-related volatility

[4] *https://business.inquirer.net/347908/adb-warns-of-slower-economic-growth-job-losses-due-to-prolonged-school-closures*

in global financial markets that could trigger capital outflows and contributing to the further depreciation of the peso; c) additional increase in BSP's policy interest rates that could dampen demand and increase the cost of money for production purposes; d) sharper-than-expected economic slowdowns in major trading partners, such as the U.S. and China which can affect the country's exports; e) natural disasters and weather-related events; and f) the escalation of the geopolitical conflict between China and Taiwan which may again disrupt supply chains. Nikkei Asia estimates that a total of US$2.61 trillion (equivalent to 3% of global GDP) will evaporate if sanctions were imposed on China in case of a Taiwan emergency.

- For 2023, the CPBRD estimates a **5.7%** growth which is still lower than the government target of 6.5-7.5% and the average **5.9%** growth rate projected by various institutions. A more moderate growth is projected in 2023 due to baseline effects and the persistence of the abovementioned downside risks.

Performance and Prospects of Selected Macroeconomic Parameters and Implications on the National Budget

TABLE 4.
BUDGET SENSITIVITY TO MACROECONOMIC PARAMETERS, 2022-2023
(IN BILLION PESOS)

Indicator	Change	2022			2023		
		Revenues	Disburse-ments	Budget Balance[1/]	Revenues	Disburse-ments	Budget Balance[1/]
Peso-to-US$ exchange rate	P 1 depreciation	9.7	2.1	7.6	10.0	2.4	7.6
Treasury Bill Rate (All Maturities)	1 percentage point increase	1.1	5.7	(4.6)	1.0	5.0	(4.0)
Treasury Bond Rate (All Maturities)	1 percentage point increase	1.8	9.0	(7.2)	1.3	6.4	(5.1)
LIBOR (180-Day)	1 percentage point increase	-	10.5	(10.5)	-	12.7	(12.7)
Inflation Rate	1 percentage point increase	24.7	-	24.7	30.4	-	30.4
Real GDP Growth Rate	1 percentage point increase	28.2	-	28.2	33.7	-	33.7
Growth Rate of Imports	1 percentage point increase	7.6	-	7.6	6.5	-	6.5

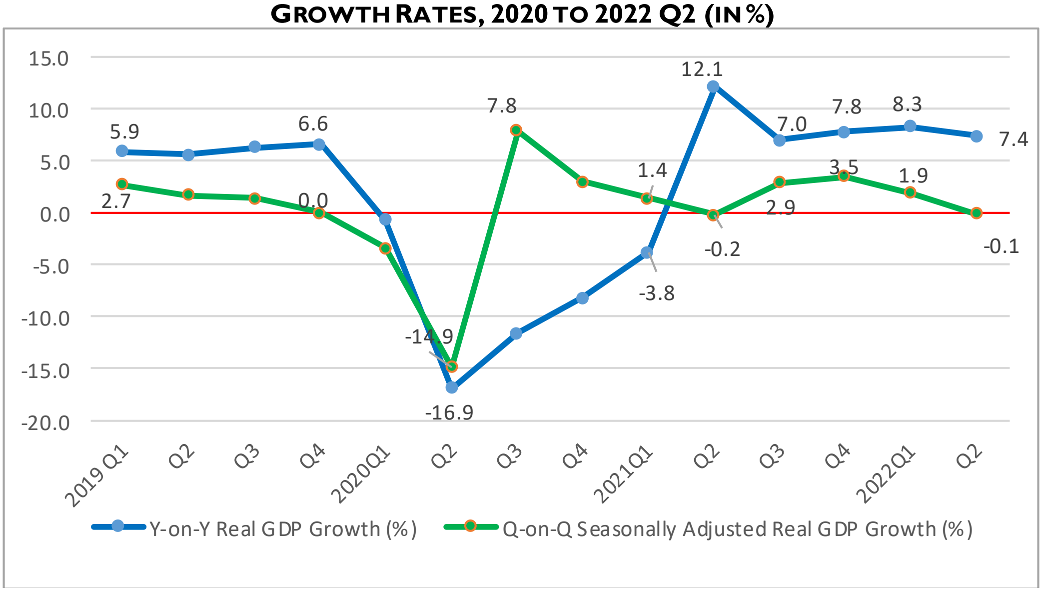
Note: 1/A negative figure in the budget balance means an increase in the deficit.
Sources: DOF and BTr in BESF 2022 and 2023

- ***Impact of Macroeconomic Variables on the Philippine Budget.*** An overview of the relationship of macroeconomic variables with the budget specifically in the case of the Philippines is presented in the annual budget sensitivity analysis included in the BESF. Using a sensitivity analysis model, the Department of Finance (DOF) and the Bureau of the Treasury (BTr) estimated the possible impact of selected macroeconomic variables on the government's revenues, expenditures, and budget deficit. The DOF's sensitivity analysis for the 2023 budget is given in Table 4. The nominal exchange rate, inflation rate, real GDP growth rate and the growth rate of imports are expected to positively contribute to the budget balance. Note that the GDP growth rate has the highest impact on the budget deficit among the macroeconomic variables considered in formulating both the 2022 and 2023 budgets. The estimates for 2022 showed that a one percentage point decrease in GDP growth rate compared to the target is seen to increase the budget deficit by P28.2 billion holding all other variables constant. Given the low-end GDP growth target of 7.0% for 2022 in the 2022 BESF and the revised 6.5% percent target this year—implying a 0.5 percentage point change, the deficit could increase by about P14.1 billion holding all other variables constant. For 2023, the DOF and the BTr expect that a percentage point increase in the GDP growth rate compared to the target will increase revenues by P33.7 billion and improve the budget balance by an equivalent amount.

Gross Domestic Product (GDP)

- ❑ The **Gross Domestic Product (GDP)** is generally utilized as an indicator of economic activity. A higher GDP suggests an expansion of the economy's production capacity which usually means that more jobs are created and more incomes are received. A higher GDP largely results in a larger tax base and accordingly, higher revenue collections from the domestic market which could be made available to the government to finance public services and development programs and projects or to increase the fiscal space, depending on the government's policy (DBM, 2012).

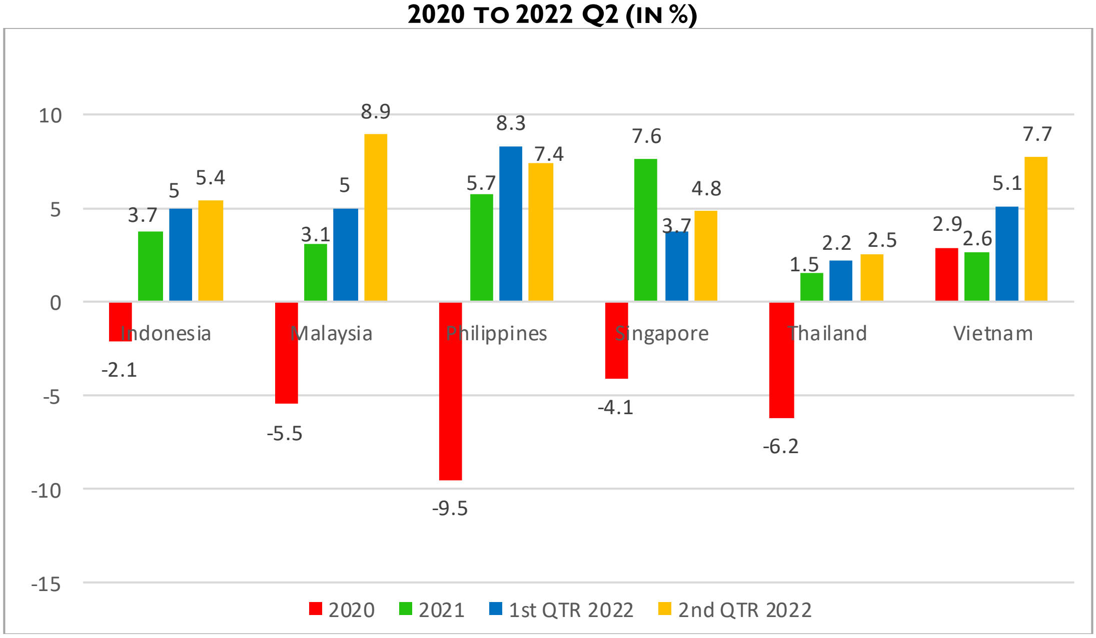
CHART I.
GDP YEAR-ON-YEAR AND SEASONALLY ADJUSTED QUARTER-ON-QUARTER GROWTH RATES, 2020 TO 2022 Q2 (IN %)



Source: PSA

- ***GDP growth will likely contribute to budget balance as the Philippine economy recovered its growth momentum pre-pandemic.*** Since the second quarter of 2021, real GDP expanded robustly, recording growth of more than 7% year-on-year (Chart 1). In fact, growing by 8.3% and 7.4% in the 1st and 2nd quarter of 2022, respectively, GDP in the first half of 2022 amounting to P9.61 trillion exceeded the GDP of P9.45 trillion recorded in the same period in 2019 prior to the Covid-19 pandemic. The strong performance of the economy in the first half of the year has been attributed to a wider Covid-19 vaccination coverage, with adolescents among those getting inoculated, and relatively mild health impacts from the Omicron variant which spurred a restart in expanded operations for most private businesses and have allowed the government to relax mobility restrictions starting in the first quarter of the year ushering domestic and inbound (foreign) tourism to resume in February 2022.

CHART 2.
GDP GROWTH RATES OF MAJOR ASEAN ECONOMIES
2020 TO 2022 Q2 (IN %)



Source: Statistical agencies of ASEAN member states.

- Among the ASEAN 6, the Philippine economy registered the highest growth in the first semester of 2022 with an average growth of 7.8% followed by Malaysia (7.0%) and Vietnam (6.4%) (Chart 2). This is in contrast with the situation in 2020 wherein the Philippines suffered the most from the effects of the Covid-19 pandemic during its peak, registering the highest GDP decline of 9.5% in 2020. Note that the Vietnamese economy has remained resilient all throughout the Covid-19 pandemic as it managed to expand even in a time of crisis.

TABLE 5.
GROSS NATIONAL INCOME AND GROSS DOMESTIC PRODUCT AT CONSTANT 2018 PRICES GROWTH RATES (%)

	2020-2021				2021 - 2022	
	Q1	Q2	Q3	Q4	Q1	Q2
Expenditure						
Household final consumption expenditure	-4.8	7.3	7.1	7.5	10.0	8.6
Government final consumption expenditure	16.1	-4.2	13.8	7.8	3.6	11.1
Gross capital formation	-13.9	83.7	20.8	14.2	20.4	20.5
A. Gross fixed capital formation	-18.2	39.7	16.0	10.8	11.8	13.2
1. Construction	-25.2	35.3	24.9	15.8	14.7	15.7
2. Durable equipment	-11.0	94.5	6.2	5.5	9.9	11.7
3. Breeding stocks and orchard development	-3.2	-2.7	-2.2	-5.0	3.5	-0.8
4. Intellectual property products	1.1	10.7	18.4	18.7	10.5	6.0
B. Changes in inventories	-	-	-	-	-	-
C. Valuables	-18.1	29.2	-35.1	56.0	-40.3	-16.9
Exports of goods and services	-8.4	28.6	9.1	7.7	10.4	4.3
A. Exports of goods	2.8	35.9	9.0	5.4	5.8	-2.1
B. Exports of services	-20.0	20.2	9.4	12.2	16.6	12.6
Less : Imports of goods and services	-7.5	40.3	12.7	14.3	15.4	13.6
A. Imports of goods	-0.4	48.4	16.5	14.8	12.3	11.3
B. Imports of services	-33.6	1.0	-6.0	11.8	32.5	29.9
Industry						
Agriculture, forestry, and fishing	-1.3	0.0	-1.7	1.4	0.2	0.2
Industry	-4.2	21.3	8.7	9.6	10.5	6.3
1. Mining and quarrying	2.0	4.2	4.0	10.7	20.3	-7.3
2. Manufacturing	0.8	22.4	7.0	7.3	9.8	2.1
3. Electricity, steam, water & waste mgt	1.1	9.5	3.0	4.3	5.6	5.4
4. Construction	-22.6	27.4	18.0	18.6	14.7	19.0
Services	-4.0	9.9	7.7	8.0	8.3	9.1
1. Wholesale and retail trade; repair of motor vehicles and motorcycles	-3.4	5.4	6.5	7.1	7.0	9.7
2. Transportation and storage	-19.9	24.3	15.5	18.7	26.3	27.1
3. Accommodation and food service activities	-22.5	56.7	12.4	20.2	20.3	29.9
4. Information and communication	6.6	12.6	8.6	8.7	7.4	10.7
5. Financial and insurance activities	4.3	5.2	3.9	5.4	7.7	4.2
6. Real estate and ownership of dwellings	-11.7	16.8	3.9	3.4	5.9	3.9
7. Professional and business services	-3.6	9.7	10.6	7.2	8.3	7.7
8. Public administration and defense; compulsory social activities	7.5	5.1	5.4	5.0	0.8	9.1
9. Education	0.3	12.5	13.6	7.3	8.5	5.3
10. Human health and social work activities	13.0	14.0	16.1	13.6	1.4	1.8
11. Other services	-38.7	37.6	19.6	29.6	22.7	39.5
Gross Domestic Product	-3.8	12.1	7.0	7.8	8.2	7.4
Net primary income from the rest of the world	-75.9	-55.7	-52.4	16.0	105.4	64.8
Gross National Income	-10.5	6.8	2.8	8.1	10.6	9.3

Source: PSA

- **On the supply side**, growth accelerated mostly in the services sector during the second quarter of 2022, which includes the following subsectors: wholesale and retail (9.7%); transportation and storage (27.1%); accommodation and food service activities (29.9%), information and communication (10.7%), and public administration and defense (9.1%). Moreover, construction in the industry sector grew faster at 19.0% compared to 14.7% in the first quarter.

- **On the demand side,** the expenditure categories which grew faster are as follows: household consumption (8.6%); government expenditure (11.1%); and investment or the gross capital formation (20.5%) specifically in construction (15.7%) and durable equipment (11.7%).

- ***The economy in the second quarter of 2022, however, showed some signs of weakening.*** While total GDP grew solidly by 7.4% year-on-year in the second quarter of 2022, seasonally adjusted quarter-on-quarter growth declined by 0.1% (Chart 1). Note that after expanding by 9.8% in the first quarter of 2022, manufacturing slowed down to 2.1% growth in the second quarter. Manufacturing has the biggest share to the total GDP of almost 20%, more than the wholesale and retail trade sector (16.7%) and financial and insurance activities (10.5%). The weakness in the manufacturing sector is also reflected in the decline of the demand for exports of goods which contracted by 2.1% in the second quarter of 2022. Quarter-on-quarter, growth of the services sector also declined by 0.4% mainly due to the fall in the output of the transport (-20.3%), human health (-6.5%), and real estate sectors (-2.1%). Quarter-on-quarter household consumption also contracted by 2.7% with the top contributors being transport (22.8%), restaurants and hotels (-10.7%), and food and non-alcoholic beverages (-1.3%).

- ***Recovery of the agriculture, forestry and fishing (AFF) sector remains difficult as the frequency and severity of natural disasters and weather-related events due to climate change adversely impact total production.*** For the first time since the 2nd quarter of 2018, the livestock subsector posted a growth of 2.3% in the second quarter of 2022. This is good news to the sector which has been decimated by the African Swine Flu (ASF) since 2019. The Department of Agriculture reported that around 700,000 hogs have been added to the inventory from January 2021 to January 2022[5]. Major crops such as rice, corn and coconut also posted growths of 0.7%, 10.2%, and 2.0%, respectively, in the second quarter of 2022.

- However, the crop sector has been heavily affected by weather events, of which, the most severe was Typhoon Odette that devastated the entire Visayas region and Northern Mindanao in late December 2021. PSA data recorded that GVA in sugarcane production including muscovado sugar-making in the farm dramatically contracted by 10.1% in the first quarter and 50.1% in the second quarter of 2022 as Typhoon Odette destroyed standing crops. Note that the Visayas region has the biggest hectarage for sugarcane production and supplies 65% of the country's sugar output[6]. This could have explained the current shortage of milled sugar in the

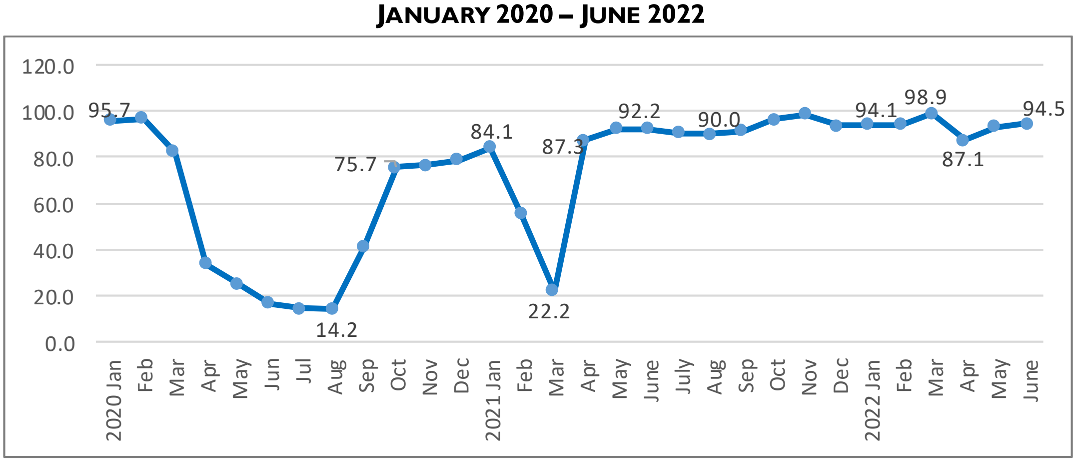
[5] *https://www.da.gov.ph/pork-supply-stabilizes-as-da-continues-to-pursue-strategies-against-asf/*
[6] *https://www.sra.gov.ph/the-philippine-sugarcane-industry-challenges-and-opportunities/*

market resulting in prices fetching P100/kilo in early August 2022 from only P55/kilo a year ago.

- The performance of the agriculture sector has also been adversely affected by the surge in the cost of inputs which are mostly imported. The changes in the prices of imports of agriculture-related inputs showed a huge jump from their 2018 prices as represented by the following implicit price indexes in the first and second quarters of 2022: mineral fuel and lubricants (for boats, farm machineries, and transport) – (211.6 and 150.4); chemical products which include fertilizers (136.4 and 120.8); and feeding stuff (172.5 and 195.8).

- ***The growth of the industry sector will be moderated for the rest of the year if downside risks persist.*** As disruptions in the supply chain caused by the Covid-19 pandemic and the Russia-Ukraine war resulted in high world commodity and fuel prices, the cost of domestic production and operations shot up especially for the highly raw material import-dependent manufacturing sector. Moreover, the cost of importation has also been exacerbated by the depreciation of the peso due to tighter global financing conditions as the U.S. Federal Reserve hiked policy interest rates to rein in inflation. As a result, manufacturing which makes up around 60% of total GVA in the industry sector grew by only 2.1% in the second quarter of 2022 compared with 9.8% in the first quarter. Note that based on the PSA report on the Monthly Integrated Survey of Selected Industries (MISSI), while the monthly volume of production indexes from January to June 2022 are higher than during the peak of the Covid-19 pandemic in 2020 and 2021, they have not reached the level of production in 2018 (Chart 3). Corroborating the apparent weakness of the manufacturing sector is data released by the IHS Markit of the S&P Global wherein the Purchasing Manager's Index (PMI) for July 2022 is only 49. A PMI reading of over 50 indicates growth or expansion while a reading under 50 suggests contraction. Adding to the woes of the sector is the apparent weakening of the external demand for the country's manufactured goods as exports of goods contracted by 2.1% - the first time after five consecutive positive quarterly growth rates.

CHART 3.
VOLUME OF PRODUCTION INDEX GROWTH RATES FOR MANUFACTURING (2018=100)
JANUARY 2020 – JUNE 2022



Source: PSA

- ***The industry's recovery would now, therefore, depend on improving domestic demand.*** A source of growth in the industry sector is the construction subsector which has registered five consecutive quarters of double-digit growth rates year-on-year where the value of output for the first semester of 2022 is 17.3% higher than that recorded during the same period last year. Food and beverage products which comprise more than 50% of the output of manufacturing sector would benefit tremendously with further reopening of the economy specifically with the resumption of the face-to-face classes in August 2022. Still confronted with high input prices, the industry sector's plight could be alleviated by government rationalizing the importation of the necessary raw materials which historically is not sufficiently produced domestically (i.e. sugar, onion, etc.).

- ***An optimistic outlook is seen for the services sector.*** The first half of 2022 showed a full recovery as the GVA of the services sector amounting to P5.81 trillion has surpassed the pre-pandemic level of P5.72 trillion or by 1.7% during the same period in 2019. The sector's output is also 8.7% larger than the P5.3 trillion recorded in the 1st semester of 2020 owing in part to election spending.[7] The wholesale and retail trade, transportation, and accommodation and food service industries which posted substantial growth rates of 9.7%, 27.1%, and 29.9%, respectively, in the second quarter of 2022 will likely benefit from further reopening of the economy including the resumption of face-to-face classes in August 2022.

TABLE 6.
HOUSEHOLD FINAL CONSUMPTION EXPENDITURE AT CONSTANT 2018 PRICES
PERCENT SHARES AND GROWTH RATES, 2021-2Q 2022

Purpose	Percent Shares						Growth Rates (%)					
	2021				2022		2021				2022	
	Q1	Q2	Q3	Q4	Q1	Q2	Q1	Q2	Q3	Q4	Q1	Q2
Food and non-alcoholic beverages	36.2	41.1	36.3	39.6	36.2	40.0	2.4	2.8	2.9	5.3	10.0	5.8
Alcoholic beverages, tobacco	1.5	1.5	1.5	1.7	1.4	1.4	-12.1	0.7	-7.0	-9.7	6.5	2.2
Clothing and footwear	1.6	1.7	2.1	1.9	1.6	1.6	-14.6	46.7	27.9	8.6	7.9	4.5
Housing, water, electricity, gas and other fuels	12.8	15.6	13.4	11.3	12.3	15.3	-0.1	6.6	3.2	2.7	5.9	7.0
Furnishings, household equipment & routine household maintenance	2.8	2.7	3.1	2.7	2.7	2.7	-6.6	16.7	7.9	-1.0	8.4	8.5
Health	4.7	4.1	5.6	4.1	4.3	3.7	6.8	15.6	16.3	16.8	1.1	-2.4
Transport	8.5	6.0	8.4	7.0	9.0	7.0	-28.1	19.2	17.3	14.8	16.0	25.7
Communication	3.4	3.6	2.8	3.1	3.3	3.7	6.8	13.7	7.5	8.2	7.0	10.3
Recreation and culture	1.5	0.9	1.1	1.7	1.6	1.2	-34.5	14.1	21.6	39.4	16.3	35.0
Education	5.6	5.2	5.9	5.0	5.7	5.1	1.7	11.2	14.4	8.8	11.5	7.2
Restaurants and hotels	7.5	4.0	5.4	6.6	8.1	4.9	-18.2	21.7	12.5	22.0	19.8	32.3
Miscellaneous goods and services	13.9	13.4	14.5	15.3	13.7	13.3	-0.2	3.5	6.5	6.8	8.6	7.5
Household Final Consumption Expenditure	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**-4.8**	**7.3**	**7.1**	**7.5**	**10.0**	**8.6**

Source: PSA

[7] *https://www.manilatimes.net/2022/04/29/business/top-business/experts-share-views-on-ph-economy/1841630*

- ***On the demand side, household consumption may continue to improve.*** Household expenditures has expanded since the second quarter of 2021 or for the past five consecutive quarters (Table 6). The recovery in private spending are in sectors that benefited the most from the easing of restrictive community quarantines and, incidentally, those which rely mainly on person-to-person contact. On average, household consumption has grown by 9.3% y-o-y in the first semester of 2022 with all subsectors posting positive rates except for health expenditures (-0.6% in the 1st semester) mainly due to a sharp decline in severe cases of Covid-19 with the rollout of the nationwide vaccination program. Moreover, as world prices of oil seem to stabilize recently below US$100 per barrel despite the ongoing Russia-Ukraine war and as the government makes steps to address supply-side constraints to arrest further rise in inflation, household consumption is poised to expand this year and the following year.

- Higher consumer spending could also be sustained with external sources of income. Note that around 12% of Filipino households have a family member/s who works overseas[8]. Historically, higher remittances translate to a rise in household consumption levels which is the main driver of GDP on the demand side. Based on data from the BSP, overseas Filipinos' cash remittances at US$14.6 billion went up by 6.6% from January to June 2022 compared to the same period last year and even higher than the pre-pandemic level in 2019 by 4.8%.

TABLE 7.
GROSS FIXED CAPITAL FORMATION IN CONSTRUCTION, 2021-2Q 2022
AT CONSTANT 2018 PRICES

Institutional Sector	Percent Share						Growth Rates					
	2021				2022		2021				2022	
	Q1	Q2	Q3	Q4	Q1	Q2	Q1	Q2	Q3	Q4	Q1	Q2
General government	31.9	49.7	33.8	36.6	26.3	52.7	24.9	43.2	54.6	20.7	-5.4	22.7
Financial and non-financial corporations	38.9	25.3	34.9	30.3	25.4	25.4	-44.3	-23.9	-10.8	5.0	27.7	16.2
Households and NPISHs*	29.2	24.9	31.3	33.2	21.8	21.8	-23.8	324.6	64.2	21.7	19.2	1.4
Gross Fixed Capital Formation in Construction	100.0	100.0	100.0	100.0	100.0	100.0	-25.2	35.3	24.9	15.8	14.7	15.7

*Note: * Non-profit institutions serving households*
Source: PSA

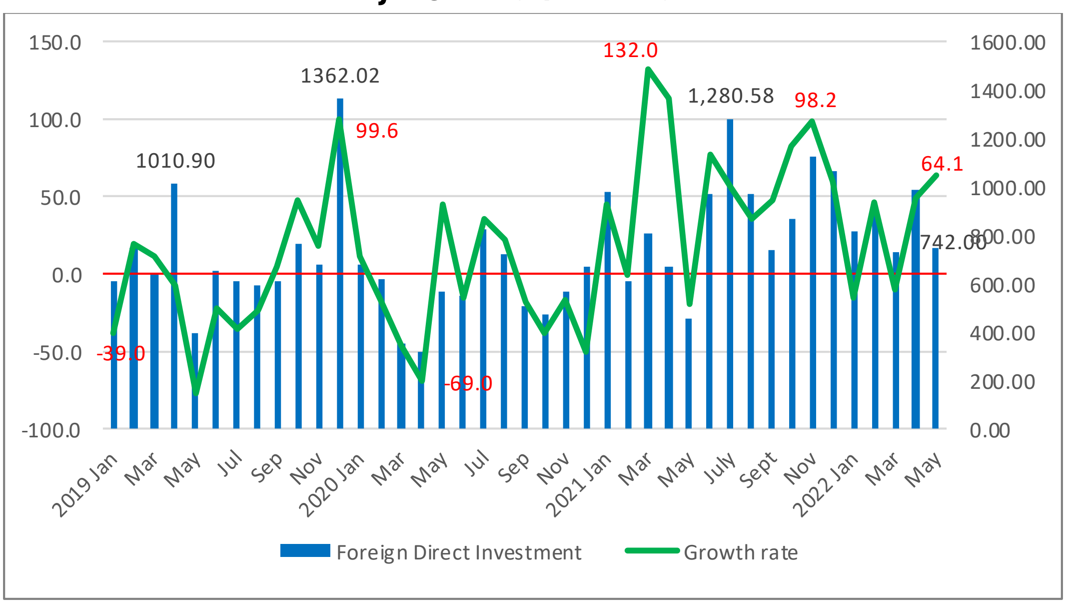
- ***Investments show signs of recovery.*** Investments measured in terms of **gross capital formation** recorded double-digit growth rates for five consecutive quarters since the second quarter of 2021 (Table 7). In fact, the gross capital formation of P2.41 trillion in the first semester of 2022 grew substantially by 20.6% compared to the same period a year ago. This is just P16.77 billion shy of the P2.43 trillion registered in the first half of 2019. The growth in the first half of 2022 comes from the expansion in both investments in construction (15.8%) and durable equipment (10.8%). Public investments in construction grew by 22.7% in the second quarter after contracting by 5.4% in the first quarter. Public construction will likely get a boost during the remaining months of the current year and by next year particularly from

[8] *https://psa.gov.ph/content/12-percent-filipino-households-have-ofw-member-results-2018-national-migration-survey*

infrastructure projects as lawmakers signify their intent to pass the 2023 National Budget by October 2022[9]. The new administration assured investors that projects started by the previous administration will not be suspended and that infrastructure spending would be sustained at 5% to 6% of GDP. The Marcos administration is said to focus on building and upgrading the country's ageing railway system as well as investing in projects related to renewable energy.[10]

- ***Although generally increasing since 2021, foreign direct investment (FDI) levels remain highly volatile.*** On a positive note, FDI levels in general, starting January 2021, remain above the levels recorded not only during the peak of the pandemic in 2020 but also before the pandemic hit in 2019. FDI in 2021 is 54.2% and 21.3% bigger than in 2020 and 2019, respectively, while it grew by 18.8% higher from January to May 2022 compared with the same period last year. The bulk of foreign investments came from Japan (31.6%), ASEAN (27.2%), the US (17.1%), Kuwait (6.3%), and the EU (4%). FDI performance in the coming months, however, will be determined by a weak external environment due to increasing risks such as rising domestic and international interest rates which could impede credit growth and consumption amid accelerating inflation. Moreover, a weak U.S. and Chinese economy, both major trading partners of the Philippines, could also weigh on plans to establish and expand export-oriented businesses in the country.

CHART 4.
FOREIGN DIRECT INVESTMENT (IN MILLION US$) AND GROWTH RATE (%), JANUARY 2019-APRIL 2022



Source: Bangko Sentral ng Pilipinas

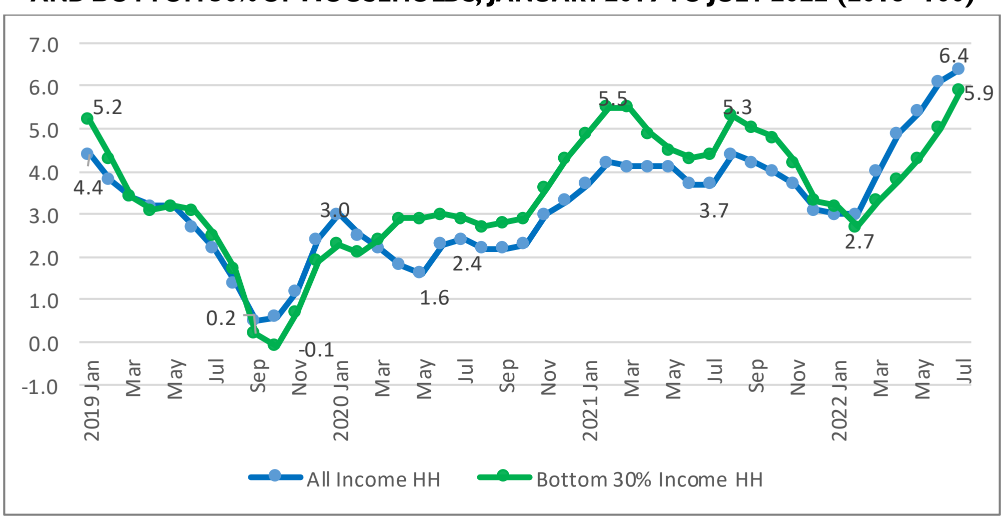
[9] *https://newsinfo.inquirer.net/1647675/house-leaders-confident-proposed-2023-budget-to-be-passed-before-october-recess*
[10] *https://www.reuters.com/world/asia-pacific/philippines-marcos-vows-farm-tax-overhauls-address-nation-2022-07-25/*

Inflation Rate

- **The inflation rate** refers to the annual rate of change in the general price level often measured by the Consumer Price Index. The inflation rate has a dual impact on the government budget. When the inflation rate rises, government revenues mainly from domestic-based taxes also rise due to the increase in the prices of taxable products. Simultaneously, however, government disbursements could swell because of higher cost requirements for maintenance and other operating expenditures such as supplies and materials, transportation services and capital outlays. The inflation rate, thus, serves as an indicator of the possible level of expansion in an agency's budget to cover price escalation (DBM 2012)[11].

- ***Inflation rates will remain elevated.*** The headline inflation rate in the Philippines sustained its upward trend peaking at 6.4% in July 2022 from 6.1% in June 2022 – much higher than the 3.7% inflation logged in July 2021 (Chart 5). This is also the highest recorded inflation since October 2018. The average inflation from January to July 2022, thus, stood at 4.7%. Note that starting in February 2022, the monthly inflation rates for all income households were higher than those of the bottom 30% of income households. The main contributors to the spike in July's prices were food and non-alcoholic beverages at 6.9%, transport index with 18.1%, and restaurants and accommodation services with 3.4%. Food inflation at the national level rose to 7.1% in July 2022 from 4.2% a year ago and from 6.4% in June 2022. By food group, the increase in the inflation for sugar, confectionery and desserts at 17.6%; meat and other parts of slaughtered land animals at 9.9%; fish and other seafood at 9.2% contributed largely to the acceleration in the food inflation during the month of July.

CHART 5.
MONTHLY INFLATION RATES FOR THE ALL INCOME HOUSEHOLDS AND BOTTOM 30% OF HOUSEHOLDS, JANUARY 2019 TO JULY 2022 (2018=100)



Source: PSA

[11] Note that since government spending is bounded by the amounts appropriated in the General Appropriations Act, inflation rate may not significantly affect the amount of government spending but can affect the level and quality of government services.

- With the prolonged impact of the Russia-Ukraine war on disrupting global supply chains and the continuous depreciation of the peso against the US dollar which makes the necessary raw material inputs and oil products expensive, inflation rates are expected to increase further in the coming months. The resumption of classes in August 2022 will put additional pressure on the limited supply of goods and services which may fuel another round of price increases. For full year 2022, the CPBRD projects that annual inflation will reach 5.0% on average while a 4.5% inflation is expected in 2023.

- The overall impact of a higher inflation rate may contribute positively to the budget balance. The DOF's sensitivity analysis model for 2022 indicates that a 1% point increase in inflation rate increases government revenues by P24.7 billion in 2022 and P30.4 billion in 2023 resulting to an improvement in the budget balance by the same respective amounts holding all other variables constant (Table 4). However, a very high inflation rate caused by supply-side constraints may curb overall output growth as production costs increase and real incomes are reduced. Inflation is a regressive and arbitrary tax, the burden of which is typically borne disproportionately by those in the lower income brackets. And although government revenues may increase as prices of taxable products increase, gains may be offset with the increase in the cost of delivering critical public services and infrastructure.

Employment

- A high **employment rate** means more people are employed and consequently results in a larger tax base and therefore, revenue collection. On the other hand, a high unemployment rate which usually happens when economic activities contract or the economy in a recession results in a lower tax collection.

- ***Unemployment and underemployment rates have declined indicating favorable prospects for higher tax collection.*** Average annual unemployment rate in 2021 was at 7.8%, around 2.5 percentage points below the rate registered in 2020 during the peak of the pandemic (Chart 6). Moreover, from January to June 2022, unemployment rate further declined to 6.1% on average while underemployment similarly improved at 14.3% from a high of 16.2% in 2020 when strict community lockdowns were implemented due to the pandemic (Chart 7). A study by NEDA in 2021 estimated that the resulting productivity loss in human capital investment and returns is estimated at P15.5 trillion for the next 40 years. Of this amount, P4.5 trillion are losses due to premature deaths and the loss in productivity from sickness. The remaining P11 trillion represents the reduction in future wages and productivity as a result of the suspension of face-to-face classes in school year 2020 and 2021, and the lost wages of parents who forego or reduce work hours to accompany their children in online classes.[12]

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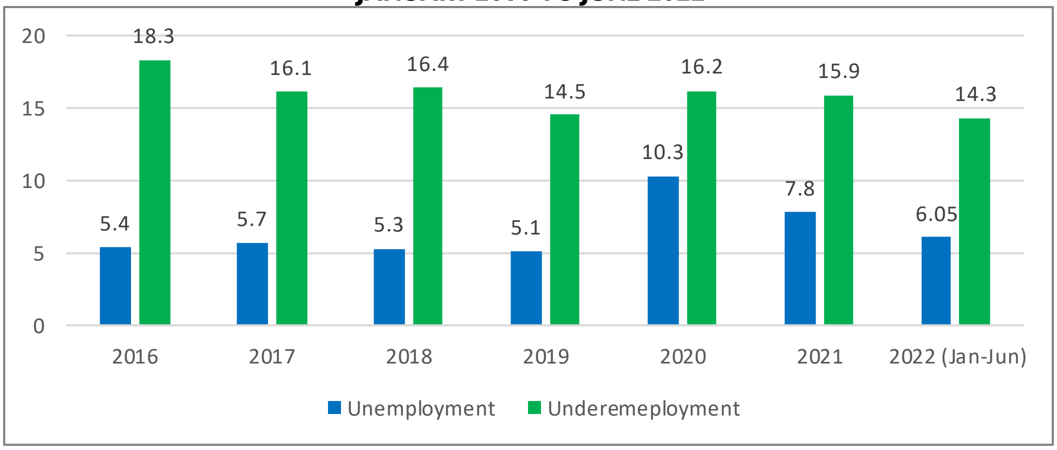
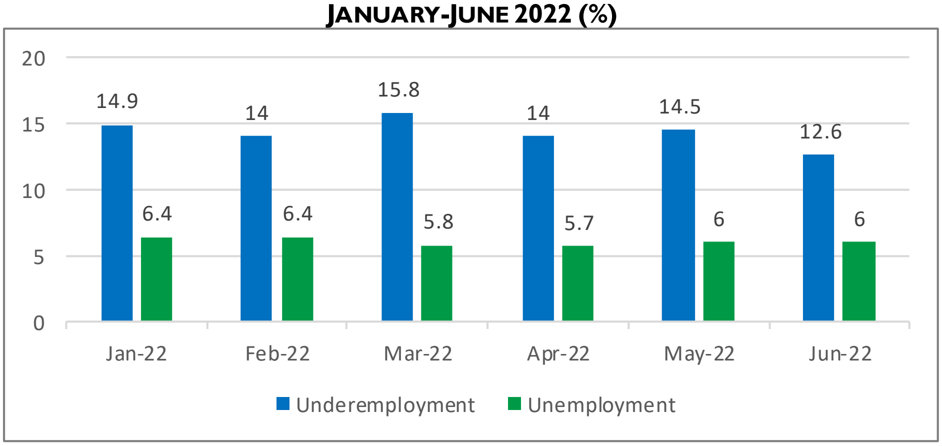
[12] *https://neda.gov.ph/covid-19-pandemic-to-cost-php-41-4-t-for-the-next-40-years-neda/*

CHART 6.
ANNUAL UNEMPLOYMENT AND UNDEREMPLOYMENT RATES (%), JANUARY 2016 TO JUNE 2022



Source: PSA

CHART 7.
MONTHLY UNEMPLOYMENT RATE AND UNDEREMPLOYMENT RATE, JANUARY-JUNE 2022 (%)



Source: PSA

- After being severely hit by the pandemic, the services sector is poised to recover with the resumption of face-to-face classes in August 2022, and consequently of businesses operating at 100% capacity. Note that the services sector employs around 58% of all employed persons in the Philippines. In June 2022, the top five subsectors in terms of job losses (month-on-month) were noted in the following: wholesale and retail trade (1.22 million); manufacturing (101,000); accommodation and food service activities (91,000); transportation and storage (90,000); and financial and insurance activities (55,000). These same subsectors are expected to gain with the full reopening of the economy.

- Hopefully, the reopening of the economy would also arrest the continuing deterioration of the quality of jobs in the market. It has been observed that the share of self-employed and non-paid workers remains high despite businesses operating at almost 100% capacity. The share of self-employed without any paid employee at 27.9% on average from January to June 2022, although smaller than those recorded in 2020 and 2021, is still higher than the 27.1% share pre-pandemic. Also, the percentage of unpaid family workers (or those without pay in own-family-operated farm or business) continued to increase from 6.3% in 2020 to 7.3% in 2021, and now at 7.4% during the first half of 2022.

TABLE 8.
SHARE OF EMPLOYED PERSONS BY CLASS OF WORKER
IN PERCENT (%), JANUARY 2019 TO JUNE 2022

	2019	2020	2021	Jan-Jun 2022
CLASS OF WORKER	100.0	100.0	100.0	100.0
Wage and salary workers	64.2	62.8	62.2	62.4
Worked for private household	4.3	4.2	4.6	4.1
Worked for private establishment	50.4	48.8	47.9	48.9
Worked for government or government corporation	9.1	9.5	9.3	9.1
Worked with pay in own-family operated farm or business	0.3	0.3	0.4	0.4
Self-employed without any paid employee	27.1	28.4	28.1	27.9
Employer in own family-operated farm or business	2.9	2.5	2.4	2.3
Worked without pay in own family-operated farm or business (Unpaid family worker)	5.8	6.3	7.3	7.4

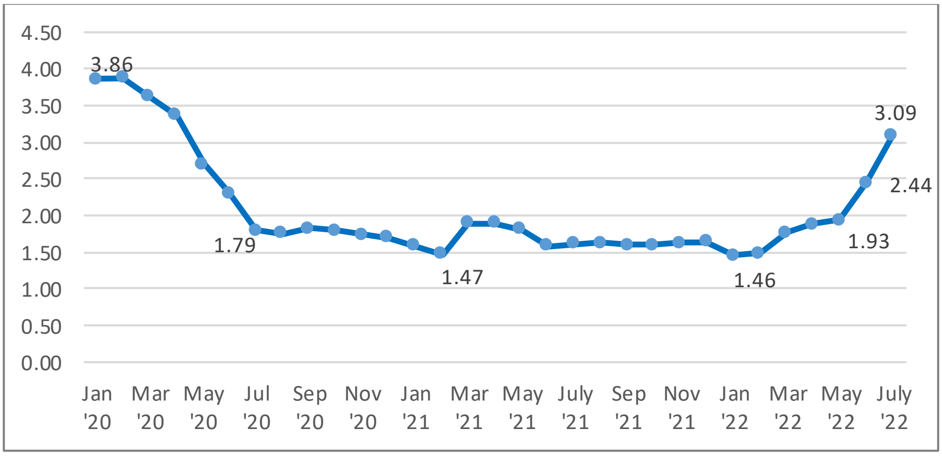
Source: PSA

T-Bill Rates

- The **364-day Treasury Bill (T-Bill) rate** refers to the interest rate on Treasury Bills maturing within 364 days issued by the national government to general funds for general purposes, including the payment of outstanding obligations of the government. It serves as a bellwether indicative of the rate of interest in the market. The T-Bill rate is an important factor affecting the budget in terms of the level of domestic debt, the cost of servicing the public domestic debt, and the level of revenues via the tax withheld from the interest income on the sale of government securities. An increase in T-Bill rate will raise government disbursements but at the same time can increase revenues due to the withholding tax on interest income (DBM, 2012).

- ***T-bill rates have been increasing which can translate to higher government disbursements and therefore to the total budget deficit.*** Since March 2022, T-bill rates have risen from 1.46% to 3.09% in July 2022 (Chart 8). T-bill rates are said to follow the hikes in key policy rates set by the Bangko Sentral ng Pilipinas (BSP). The BSP since January 2022 had raised key policy rates on borrowing by 175 basis points from 2.0% to the most recent 3.75% on 18 August 2022. The hike in interest rates was made by the BSP to address mounting inflationary risks and anchor inflation expectations. As of July 2022, inflation rate was 6.4%. The hike was also in response to the US Federal Reserves' raising its benchmark overnight interest rates by 225 basis points since the beginning of 2022 to curb their own inflation which hit a record high of 9.1% in June 2022.

CHART 8.
AVERAGE 364-DAY TREASURY BILL RATES, JANUARY 2019-JULY 2022

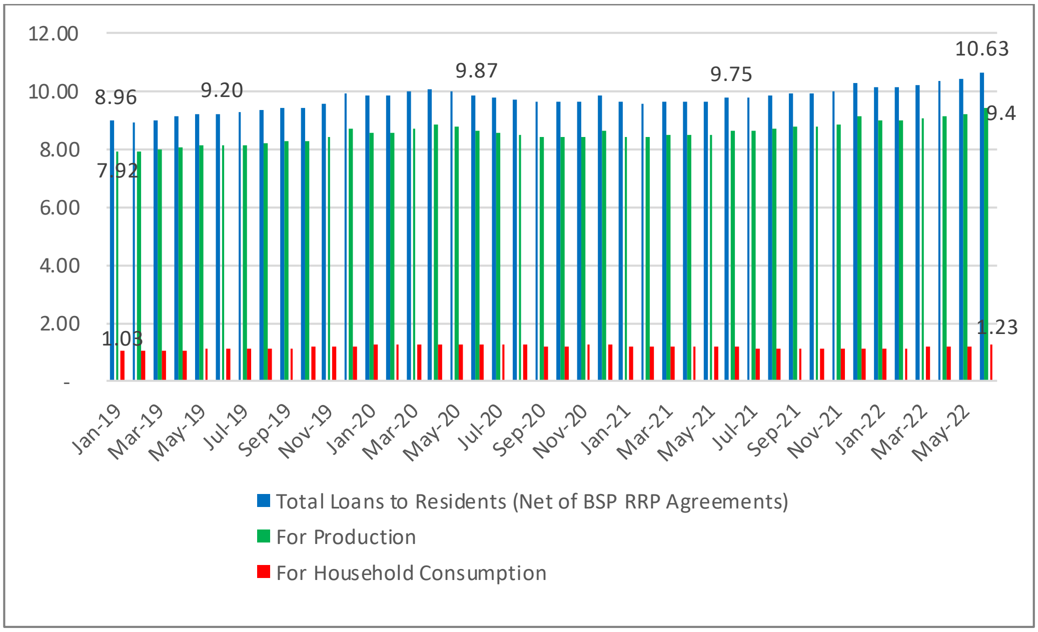


Source: Bangko Sentral ng Pilipinas

- The high interest rate could increase the cost of servicing government debt and therefore worsen the budget deficit. Note that the DOF's sensitivity analysis model for FY 2022 indicated that with a 1% increase in the T-bill rate, the budget deficit will increase by P4.6 billion while the sensitivity analysis model for FY 2023 estimated that a 1% increase in T-bill rate will increase the deficit by P4 billion holding all other variables constant. (Table 4). Interest payments of the government now stood at P429.4 billion in 2021 or an increase of 190% compared with payments in 2019 as cumulative net borrowings of the government in 2021 stood at P2.25 trillion. And as of June 2022, interest payments is P257.2 billion which is already 60% of the total payments in 2021 or a jump of 23.3% compared to the same period last year. Note also that T-bill rates is at 3.09% as of July 2022 compared with the annual average interest rate of 2.42% in 2020 when substantial borrowings were made. Previously, net borrowings swelled to P2.5 trillion in 2020 from just P876.3 billion in 2019 or a growth of 185.2% as the government turned to borrowing to fund programs that would address the impact of the Covid-19 crisis (i.e. social amelioration, vaccine purchase, health facilities).

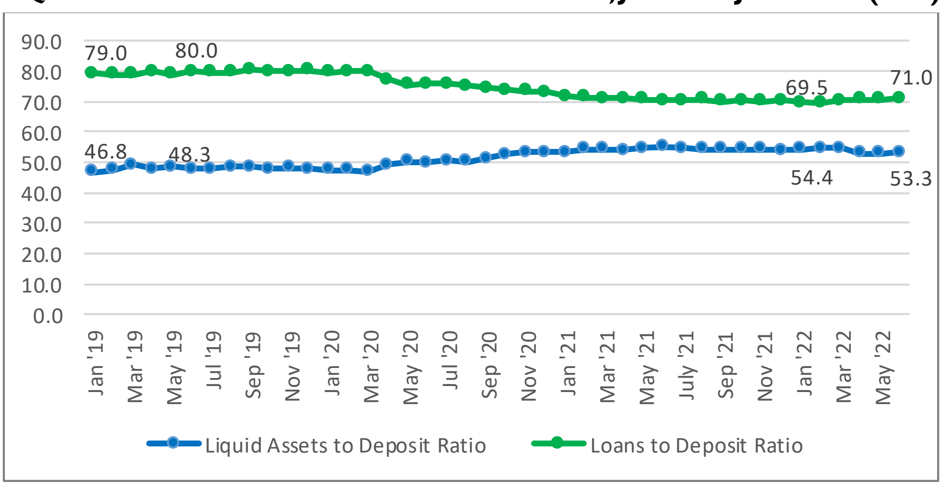
- ***The BSP, however, should be mindful that repressive levels of interest rates may not bode well for an economy that is still recovering from the impact of the Covid-19 pandemic*** and that is now facing the aftermath of the Russia-Ukraine war and other geo-political tensions within the region. High interest rates could curtail credit growth and consumption needed to sustain the growth of the domestic economy. Although total loans outstanding since January 2022 have exceeded levels recorded before the pandemic (Chart 9), loans as a percentage of deposits of 70.2% for the 1st semester of 2022 is still lower than the 79.2% in the same period in 2019 and banks' liquid assets as a percentage of deposits of 53.8% is higher than the 47.9% in 2019 (Chart 10). This indicates the wariness of the banking system to lend money to the private sector or the lack of enthusiasm on the part of the private sector to acquire loans to expand businesses. This is against the backdrop of a still relatively high non-performing to loans (NPLs) ratios of 4.0% compared to just 2.1% in 2019.

CHART 9.
TOTAL LOANS OUTSTANDING (NET OF BSP RRP AGREEMENTS), JAN 2019-JUNE 2022 (IN TRILLION PESOS)



Source: BSP

CHART 10.
LIQUID ASSETS AND LOANS TO DEPOSITS RATIOS, JAN 2019-JUNE 2022 (IN %)



Source: BSP

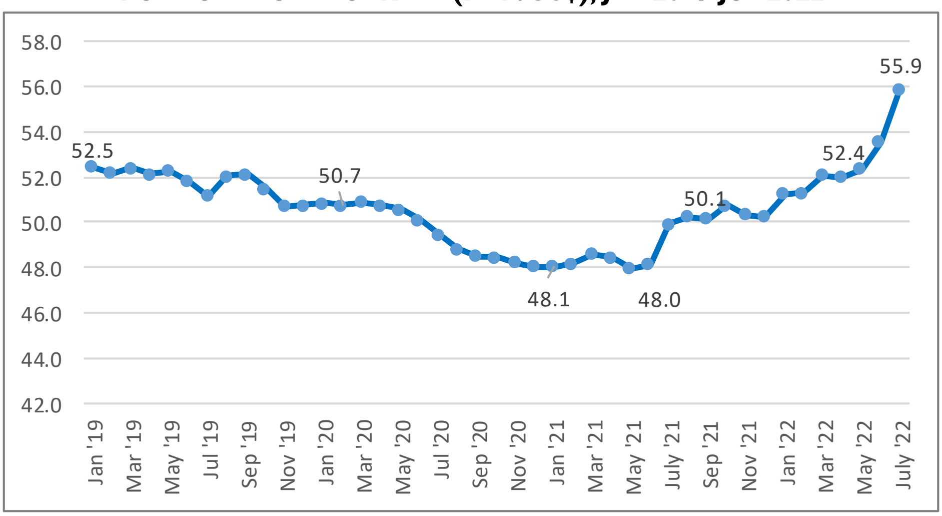
Exchange Rate, Gross International Reserves

- The **foreign exchange rate** is the rate at which a currency is exchanged for another currency, in the case of the Philippines, the peso to the US dollar. Any change in the exchange rate assumption will correspondingly change the peso cost of all government expenditures paid in

US dollars like foreign debt service, both repayment and interest, the regular operating requirements of foreign-based government offices like embassies, consulates, etc. and other government contracts which are to be settled using foreign currency. On the one hand, a weaker currency increases the peso value of imports that could result to higher government revenues from import duties and taxes.

- ***The peso to dollar exchange rate continues to rise as downside risks seem to materialize.*** From a low of P48/US$1 in May 2021, the peso to the dollar exchange rate shot up to P56.37/US$1 on 18 July 2022 – the highest since 2004 at P56.43 (Chart 11). It then settled at P55.9 on average in July 2022 and P55.64 as of 22 August 2022. The drastic depreciation of the peso against the US dollar on account of the US Federal Reserve's policy of increasing interest rates or monetary tightening to tame worsening inflation and the dollar being a risk haven for investors due to recessionary fears globally affecting portfolio investments into the country. Domestically, market sentiments may have contributed to a weaker peso as softer unemployment and manufacturing data could already reflect the effects of higher prices or inflation and expectations of higher long-term interest rates or borrowing costs that may be a drag on economic recovery prospects.[13]

CHART 11.
FOREIGN EXCHANGE RATE (PHP/US$), JAN 2019-JUL 2022



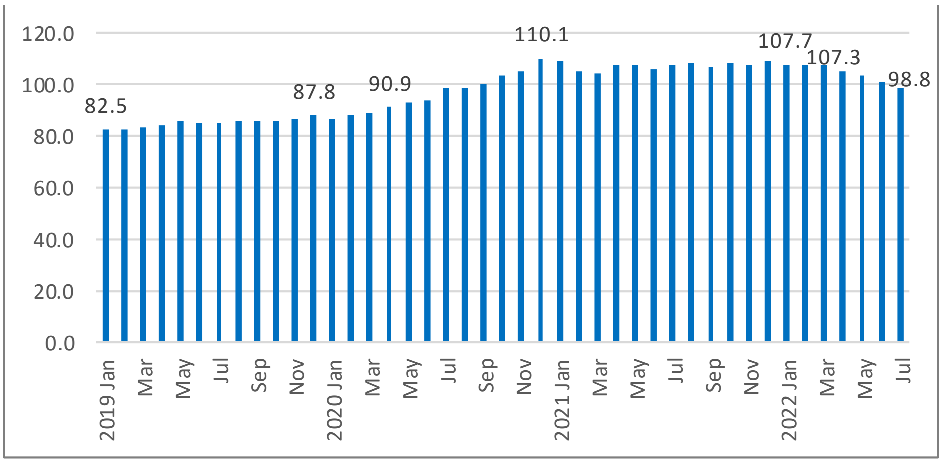
Source: PSA

- With the depreciation of the peso to the US dollar starting May 2021 up to the present, the net benefit on the government budget is expected to increase from the bigger peso value of imports. The DOF's sensitivity analysis model projected that a P1 depreciation in the peso-to-US$ exchange rate would improve the budget balance by P7.6 billion in 2023 with all the other factors remaining constant. The depreciation of the peso, however, could put upward pressure on inflation as the price of imported goods that are directly consumed or used as inputs to production would be higher, thus diminishing productive activities and household

[13] *https://www.manilatimes.net/2022/07/08/business/top-business/peso-falls-to-nearly-17-year-low/1850175*

expenditures. Moreover, the weakening of the peso could jack up interest payments on foreign borrowings which stood at P281.57 billion or 27.6% of total borrowings from January to June 2022 or an increase of 125.4% from P124.92 billion borrowed externally in the same period last year.

CHART 12.
GROSS INTERNATIONAL RESERVES, JAN 2019-JULY 2022
(IN BILLION US$)



Source: BSP

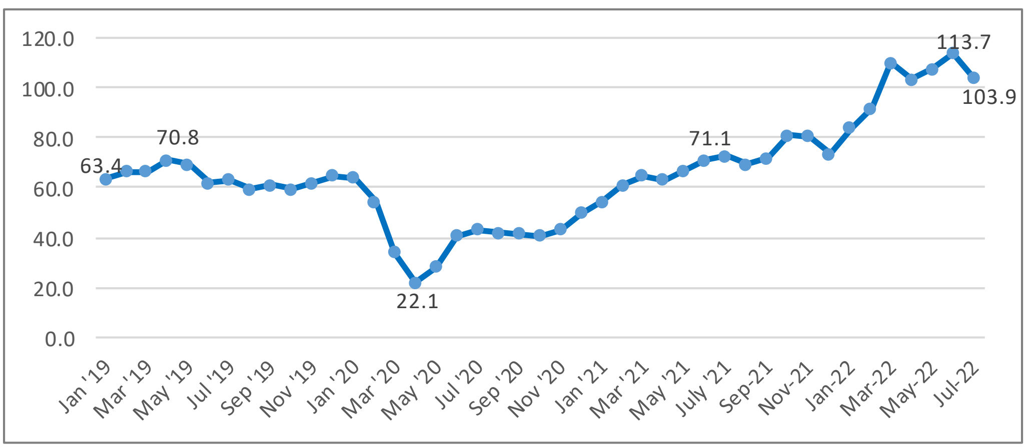
- ***Gross international reserves (GIR) have been decreasing as the economy opens up.*** As the economy remained partially open in 2021 due to a surge in Covid-19 cases in the first half of the year and the emergence of the more deadly strain Delta Covid-19 virus, the GIR remained substantial at an annual average of US$107.1 billion which can cover around 10 to 12 months worth of imports. However, as the spread of the virus has been contained due to the nationwide vaccination program during the latter part of 2021, community quarantines were lifted in most parts of the Philippines resulting in the reopening of businesses including some that require person-to-person contact. As economic activities resume, the demand for imported commodities specifically for oil products and input materials for manufacturing also increased. With a depreciating peso and elevated world commodity prices, drawdown on international reserves also increased. Thus, starting January 2022, the GIR amounting to US$107.7 billion, equivalent to 9.3 months of imports, steadily went down to just US$98.8 billion in July 2022 which could only cover 8.3 months worth of imports (Chart 12). Note, however, that the GIR level in July 2022 is still larger that the annual average pre-pandemic level of US$84.98 billion in 2019 with an import cover of 7.3 months. This means that government and private companies are assured of an ample supply of dollars for foreign dominated interest payments and much needed imports.

Dubai Crude Oil Price

- ***Government would nonetheless gain from higher world oil prices.*** Based on the DOF's sensitivity analysis model, a 1% point increase in imports will result in an additional government revenue of P6.5 billion in 2023 holding other factors constant. An increase in the price of imported fuel would have the same effect. The government is currently imposing a 12% value-added tax (VAT) on oil imports. Consequently, higher world oil prices coupled with a weaker currency increases the peso value of imports that could result in higher revenues for the government. In 2021 and in the second quarter of 2022, imports of mineral fuels and lubricants made up 14.3% and 19.9%, respectively, of the total value of imports. For 2022, government is expected to collect around P15.6 billion of VAT from oil imports.[14]

- While high world oil prices could translate to higher tax revenues for the government from the increase in the peso value of imported oil, it can also put upward pressure on inflation since oil is an input to the electricity sector and the transport services sector. This could stifle recovery in the manufacturing and services sector as well as discourage household spending.

CHART 13.
DUBAI CRUDE OIL PRICE, JANUARY 2019 – JULY 2022
IN US$/BARREL



Source:https://www.mbie.govt.nz/building-and-energy/energy-and-natural-resources/energy-statistics-and-modelling/energy-statistics/weekly-fuel-price-monitoring/

- Chart 13 shows the movement of the Dubai crude prices which represent world oil prices in the Philippines. Although initially falling to US$22.1 per barrel at the onset of the Covid-19 pandemic, world oil prices since then recovered to surpass pre-pandemic levels in June 2021 at US$71.1 per barrel and settled above US$100 per barrel since March 2022. The surge in oil prices was originally attributed to disruptions in supply chains caused by the pandemic which

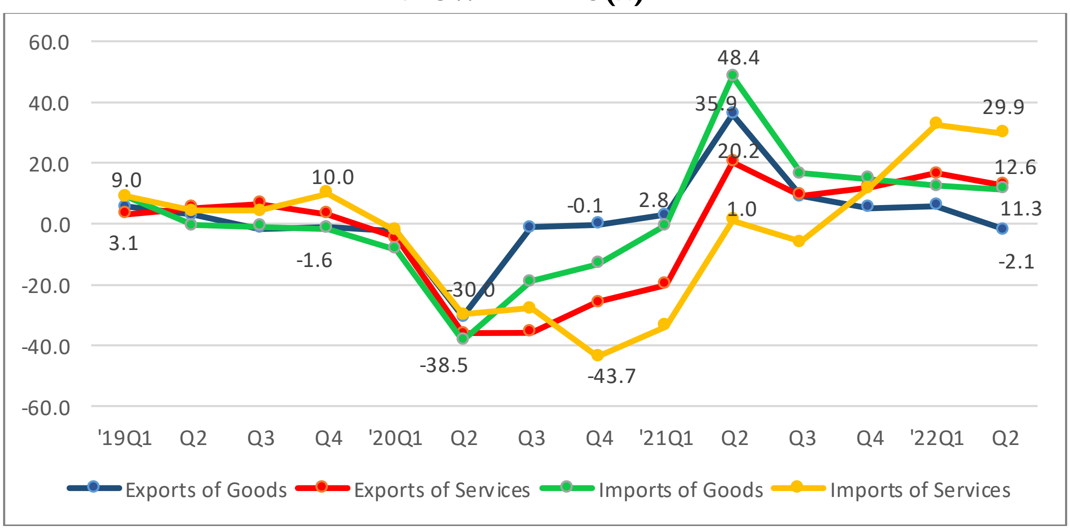
[14] *https://www.bworldonline.com/top-stories/2022/03/17/436498/duterte-nixes-fuel-tax-suspension/#:~:text=The%20current%20excise%20tax%20rate,liquefied%20petroleum%20gas%20(LPG).*

constricted available oil in the world market but was subsequently exacerbated by the Russia-Ukraine war which started in late February 2022. The Dubai oil price reached a peak of US$113.7 per barrel or an increase of 35.6% since February 2022 before dropping to US$103.9 in July 2022. As of 12 August 2022, the cost of Dubai oil further fell to US$ 96.44 per barrel[15] due mainly on mounting recession fears globally which can lead to lower demand for oil and petroleum products.

Exports and Imports

- ***Declining exports may weaken manufacturing's contribution to budget balance.*** Exports contributed on average 28.6% of GDP from 2017 to 2021. Of this, exports of goods of which 73.0% is made up of manufactured goods contributed 16.5% of GDP and 68.6% of the total value of exports in the last five years. Even at the height of the pandemic in 2021, the goods exports subsector has been credited to be one of the sectors which quickly rebounded – posting positive rates since the first quarter of 2021 until the first quarter of 2022 (Chart 14). In fact, the output of the subsector in 2021 of P3.18 trillion exceeded the pre-pandemic level of P3.12 trillion.

CHART 14.
EXPORTS AND IMPORTS OF GOODS AND SERVICES, 2019-2ND QTR 2022
GROWTH RATES (%)



Source: PSA

[15] *https://www.mbie.govt.nz/building-and-energy/energy-and-natural-resources/energy-statistics-and-modelling/energy-statistics/weekly-fuel-price-monitoring/*

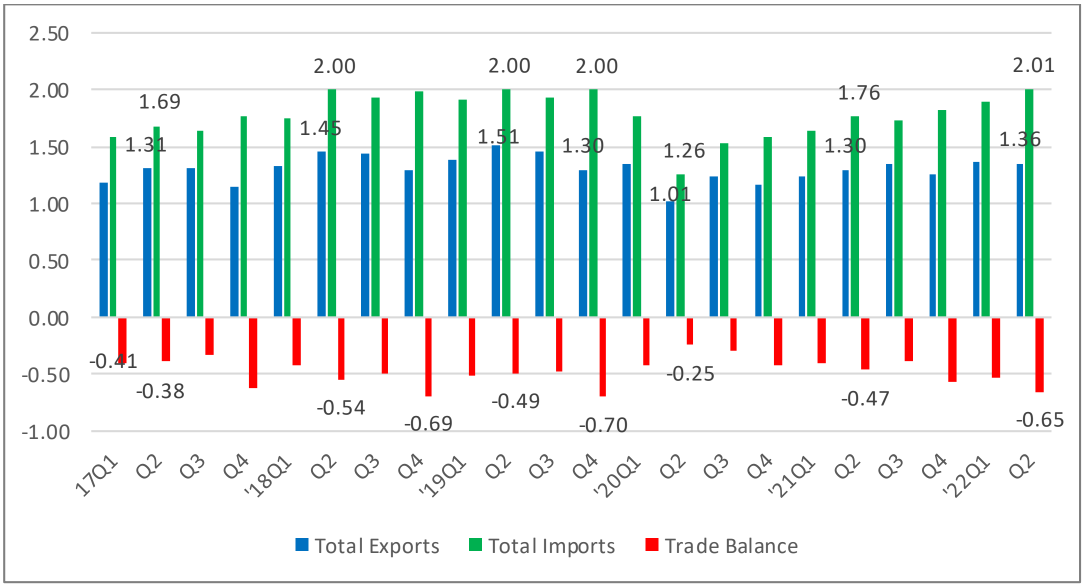
- More recently, however, exports of goods contracted by 2.1% in the second quarter of 2022 after five consecutive quarterly positive growths (Chart 14) which is indicative of a weakening global demand especially among the Philippines' major trading partners, the US and China. The US economy is on the brink of a recession –contracting by 1.6% and 0.9%, respectively, in the first and second quarter of 2022.[16] Inflation was also at an all-time high with 9.1% in June 2022, the highest in 40 years.[17] On the other hand, China's economy grew slightly by only 0.4% in the second quarter of 2022, as inflation hit a two-year high of 2.7% in July 2022.[18]

- A bright spot, however, is the continuing rebound of the exports of services. The 12.6% growth in the second quarter of 2022 is the fifth consecutive quarters of positive growth rates – four of which were greater than 10%. The most promising sector is the telecommunications, computer and information services whose output at P230 billion in the first semester of 2022 has exceeded the P225 billion earned in 2019. The transport sector's output in the second quarter of 2022 also exceeded the 2019 level by 5.5%. And although still below pre-pandemic levels by 72.9%, the output of the travel sector grew by 109.3% in the second quarter of 2022 which could hopefully help in the recovery of the tourism sector.

- ***Total imports of goods and services continue to post double-digit growth widening the trade deficit.*** With the removal of community lockdowns in 2021 and the reopening of the economy in 2022, the value of imports steadily increased from just P1.26 trillion in the second quarter of 2021 to P2.01 trillion in the second quarter of 2022 or an increase of 16.7% (Chart 15). The P2.01 trillion is also the biggest import value recorded within a quarter since 2017. The sharp increase in the value of imports in the first half of 2022 compared to the same period in 2021 has been attributed to increasing import prices as indicated by high implicit price indexes (at 2018=100) on the following products: cereals and cereal preparations (227.0); metal products (209.1); mineral fuel (186.0); and feeding stuff (184.15). Note that with the acceleration in imports and the minimal increments in exports, trade deficits have increased from just P470 billion in the second quarter of 2021 to P650 billion in the second quarter of 2022.

[16] *https://www.bea.gov/data/gdp/gross-domestic-product*
[17] *https://www.bls.gov/opub/ted/2022/consumer-prices-up-9-1-percent-over-the-year-ended-june-2022-largest-increase-in-40-years.*
[18] *https://edition.cnn.com/2022/07/14/economy/china-q2-gdp-2022-intl-hnk/index.html*

CHART 15.
TOTAL EXPORTS AND IMPORTS AND TRADE BALANCE, 2017-2ND QTR 2022
(IN TRILLION PESOS)



Source: PSA

- Persistent huge trade deficit weakens the economy in the long run as it diminishes the manufacturing sector, puts downward pressure on the wages of production workers by eliminating good paying jobs in the manufacturing sector, and reduces investments in research and development, thereby undermining productivity growth and contributing to the stagnation of incomes.[19]

CONCLUDING REMARKS

- With a promising first semester performance in 2022, the economy is poised to contribute significantly in raising the revenues of the government after a slowdown caused by the onset of the Covid-19 pandemic. Output of industry and services sectors recovered, with GDP growing robustly by 5.5% and 8.4%, respectively in the first of 2022, and even surpassing the output levels pre-pandemic in 2019. However, this growth notwithstanding, unemployment remained elevated at 6% compared to the 5.1% in 2019. Growth of the economy for the rest of the year is expected to be sustained with the full operation of businesses and the resumption of face-to-face classes in the third quarter.

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[19] *https://www.epi.org/publication/trade-deficits-consequences-policy-implications/*

- Prospects for a continued robust recovery, however, could easily be tempered or succumb to a negative outlook due to emerging downside risks. A weakening external environment marred by geopolitical tensions around the globe has been translated to lower demand for the country's goods exports in the second quarter of 2022—although slightly compensated by an improvement in services exports. This could affect the ability of the manufacturing sector to contribute to the budget balance. Growth, however, can be sustained by improving domestic demand.

- The agriculture and industry sectors can only take advantage of the benefits of a recovering services sector if and only if existing obstacles to the efficient and fair production of goods and services are reduced. Aside from high cost of raw materials, logistical challenges, shipment delays and port congestion have been cited as major problems of these sectors[20]. More than maintaining fiscal stability, the government's role is to ensure overall governance quality by enacting and implementing institutional and regulatory policies that would help increase productivity, investments and employment.

- Although an increase in inflation and the depreciation of the peso is estimated by the government to contribute significantly to its revenues, gains may be offset with the increase in the cost of delivering critical public services and infrastructure. A very high inflation fueled by a very weak peso may also constrain overall output growth as production costs increase and real incomes are reduced. Inflation is a regressive and arbitrary tax, the burden of which is typically borne disproportionately by those in the lower income brackets.

- While public expenditures can boost the economy, financing it through borrowings will further increase interest rates and inflation. In these uncertain times, the best strategy for the government is to focus spending on productivity enhancing programs and projects specifically in education, public health, and research and development, and at the same time restore fiscal space with revenue-raising and cost saving reforms.

[20] *https://www.manilatimes.net/2022/08/02/business/top-business/ph-pmi-down-to-508-in-july-sp/1853078*

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