The Philippines Monthly Economic Developments

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- The Philippine economy grew by 6.0 percent year-on-year in the second quarter of 2018, driven by capital formation.
- Growth in services and industry sectors, albeit strong, moderated in the second quarter of 2018 relative to the first quarter.
- The *Bangko Sentral ng Pilipinas* raised its key policy rate for the third consecutive time in 2018 as inflation continued to accelerate in July.

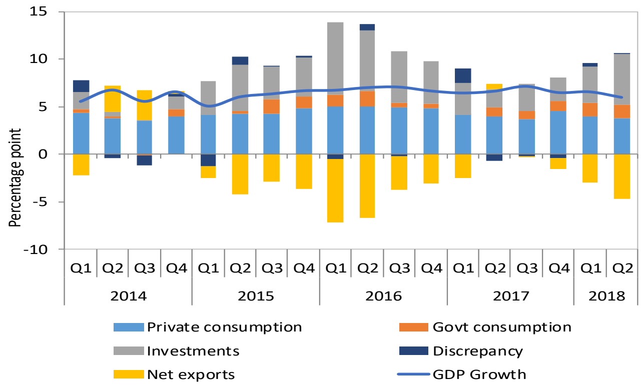
The Philippine economy grew by 6.0 percent year-on-year in the second quarter of 2018, driven by capital formation. This represented a slowdown from the 6.6 percent in the first quarter of 2018 and 6.6 percent the second quarter of 2017. Capital formation was the principal engine of growth, expanding by 20.7 percent year-on-year in the second quarter of 2018, higher than the 12.4 percent growth in the first quarter of 2018 and nearly three times the 7.6 percent growth registered a year ago. The acceleration of capital formation was driven by investment growth in durable equipment and construction. Public consumption growth accelerated from 7.6 percent year-on-year in the second quarter of 2017 to 11.9 percent in the second quarter of 2018, consistent with the government's expansionary fiscal policy stance. Private consumption growth remained strong at 5.6 percent year-on-year in the second quarter of 2018, lower than the 6.0 percent and 5.7 percent in the second quarter of 2017 and the first quarter of 2018, respectively. Meanwhile, net-exports dragged growth, as import growth outweighed export growth. Import growth accelerated in the second quarter of 2018 to reach 19.7 percent year-on-year from 9.6 percent in the first quarter of 2018 and higher than the 18.6 percent in the second quarter of 2017, driven by durable goods import growth (telecommunication equipment mainly). Meanwhile, exports grew by 13.0 percent year-on-year in the second quarter of 2018, an improvement from the 6.5 percent in the first quarter of 2018 but substantially slower than the 21.4 percent a year ago.

Growth in services and industry sectors, albeit strong, moderated in the second quarter of 2018 relative to the first quarter. The services sector grew by 6.6 percent year-on-year in the second quarter of 2018, slightly less than the 6.8 percent in the first quarter but higher than the 6.4 percent in the same period in 2017, driven by growth in trade, finance, and transportation services. Growth in the industry sector fell from 7.1 percent year-on-year in the second quarter of 2017 and 7.7 percent in the first quarter of 2018 to 6.3 percent in the second quarter of 2018, driven by slower manufacturing growth and a contraction in the mining and quarrying sub-sectors. Agriculture growth continued to disappoint in the second quarter of 2018, registering 0.2 percent year-on-year growth, much weaker than the 6.3 percent in the second quarter of 2017 and the downward-revised 1.1 percent in the first quarter of 2018.

Manufacturing activities remained robust in June, with output growing at double-digits but indicating further signs of moderation in July. The volume of production index expanded by 18.0 percent year-on-year in June, sustaining its double-digit growth since January 2018. Strong activities were recorded in printing, petroleum, and textiles, manufactures. However, the manufacturing sector expanded at a weaker pace in July compared to a year ago, according to the Nikkei Philippines Manufacturing Purchasing Managers' Index. The index dropped from 52.8 in July 2017 to 50.9 in July 2018 as output and new orders slowed down. Average capacity utilization inched up from 83.8 percent in June 2017 to 84.3 percent in June 2018, similar to 84.2 percent in May 2018.

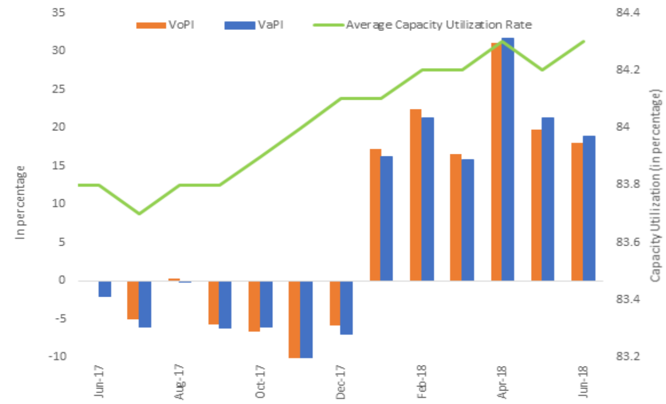
Merchandise exports contracted for the sixth consecutive month in June. The 0.1 percent year-on-year contraction in June reversed the strong growth of 17.1 percent a year ago. The contraction in merchandise exports in June was primarily the result of the year-on-year decline in mineral (-37.5 percent) and agriculture (-4.9 percent) exports. Manufactured goods, representing more than 80.0 percent of the total export bill, grew by 3.2 percent year-on-year in June, recovering from the 2.7 percent contraction in May 2018 and flat growth in June 2017. In addition, electronics exports grew at an annual rate of 13.5 percent year on-year in June, more than three times the growth registered a year ago. The slow recovery in export growth is partly related to the softening of global trade activity and rising global trade tensions. Meanwhile, import growth accelerated strongly in June, expanding by 24.2 percent year-on-year from 0.6 percent a year ago. Robust import was driven by the healthy expansion of imports of capital goods (30.1 percent), raw materials and intermediate

Figure 1: Economic growth moderated in the second quarter of 2018 to the lowest level in three years.



Source: Philippine Statistics Authority (PSA).

Figure 2: Manufacturing output growth remains strong.



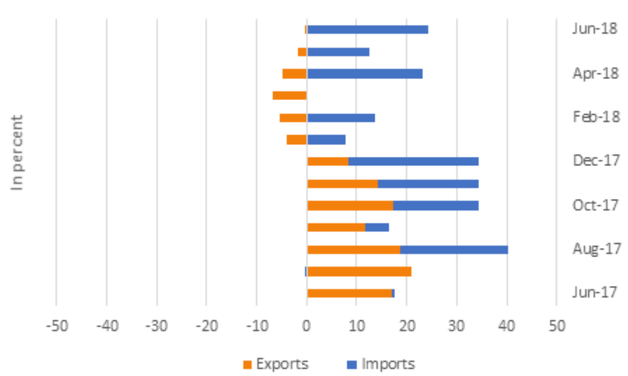
Source: PSA.

goods (21.0 percent), and consumer goods (15.6 percent). As a result, the trade deficit more than doubled in June, increasing to US$3.4 billion from US$1.6 billion a year ago.

The Philippine Stock Exchange Index' (PSEi) recovery over the past month and a half was cut short due to fear of contagion from the financial and currency crisis in Turkey. The main PSE index fell by a total of 3.6 percent to 7,528 at the end of the trading session on August 14 from 7,805 on August 10 as investors digested the potential impact of the Turkish crisis on the global market. This put a temporary halt on the ongoing recovery of the PSEi, which rose by 8.0 percent since July 2, 2018. The market response was stronger compared to the response at the start of the US-China trade war, when the PSEi contracted by 1.5 percent on June 18, 2018 as the US government announcement on imposing US$50 billion in tariffs on Chinese products on June 15, 2018.

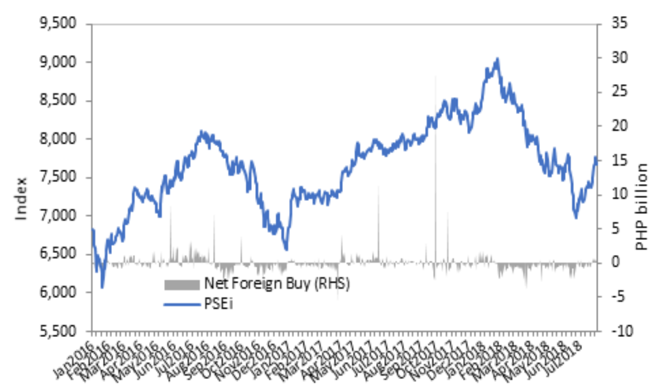
The Philippine peso appreciated slightly in July but fear of contagion reversed the trend in August. Peso traded between a narrow range of Php/US$53.26-53.52 closing rates in July. At end-July the peso stood at Php/US$53.26, which represented a 0.5 percent month-on-month appreciation from the June closing. The strengthening of the peso coincided with the rebound in the Philippines stock market. Nonetheless, the peso depreciated by 5.0 percent year-on-year in July from Php/US$50.58 in July 2017, in part due to the country's widening trade deficit. Given recent development in Turkey, peso depreciated 0.7 percent between August 13 and August 16 wiping out the July gain. As a result, gross international reserves declined from US$81.1 billion in July 2017 to US$76.9 billion in July 2018. At its current level, the reserves can cover 7.4 months' worth of imports of goods and payment of services and primary income, a decline from 8.4 months' worth in July 2017.

Figure 3: Merchandise exports contracted slightly in 2Q2018 while import growth rose sharply.



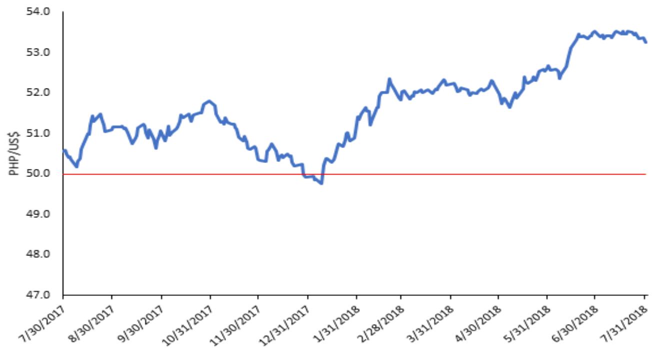
Source: PSA.

Figure 4: The PSEi recovered in July, posting a month-on-month gain for the first time in six months.



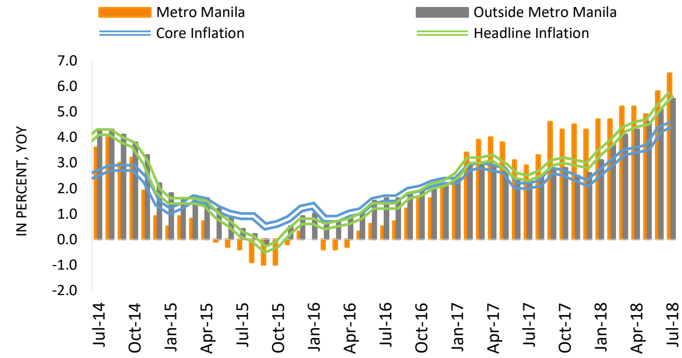
Source: Philippine Stock Exchange.

Figure 5: The Philippine peso appreciated month-on-month in July.



Source: PSA.

Figure 6: The BSP raised its key policy rate by 50 basis points as inflation continued to accelerate in July.



Source: PSA.

The *Bangko Sentral ng Pilipinas* (BSP) raised its key policy rate for the third consecutive time in 2018 as inflation continued to accelerate in July. The 12-month consumer price index increased 5.7 percent year-on-year in July 2018, faster than the 5.2 percent rate in June, and more than twice the 2.4 percent increase a year ago. The acceleration of inflation was driven by an increase in food prices, which soared from 2.8 percent year-on-year in July 2017 to 7.1 percent in July 2018. The spike in food prices was driven by lower supply caused by typhoons and heavy rains in the northern part of the country resulting in double-digit price increases in vegetables (16.0 percent), corn (13.0 percent), and fish (11.4 percent) while rice inflation remained elevated (5.0 percent). In addition, a rise in electricity, gas, and other fuel prices reached 9.4 percent year-on-year in July, in part due to rising global crude oil prices. Year-to-date headline inflation rose to 4.5 percent in July, beyond the BSP's 2-4 percent inflation target range. Core inflation, which excludes volatile food and energy items, reached 4.5 percent year-on-year in July, an uptick from the 4.3 percent rate in June, and more than double the 2.1 percent in July 2017, indicating demand-driven pressures. In order to manage inflation expectations, the BSP raised its key policy rate by 50 basis points to 4.0 percent in August 10, the third consecutive rate increase this year.

Domestic liquidity and bank lending grew at a slower rate in June. Domestic liquidity (M3) reached an approximate Php11.1 trillion in June 2018, growing by 11.7 percent year-on-year, slower than the 14.3 percent growth in May and 13.4 percent in June 2017. Outstanding loans, net of reverse repurchases, expanded by 19.1 percent year-on-year in June 2018, similar to the 19.3 percent in May and 19.0 percent in June 2017. The growth of lending to firms, which constitutes 88.6 percent of the banks' total loan portfolio, eased slightly to 19.2 percent in June from 19.3 percent in May but still higher than the 17.9 percent in June 2017. Most of the lending went to the wholesale and retail trade and financial and insurance activities. Lending to households' growth eased to 17.7 percent year-on-year in June from 18.4 percent in May and 22.5 percent in June 2017 due to slower growth in the motor vehicle industry and the contraction of other types of household loans.

The government posted a narrower budget gap in June, as the surge in revenue growth outpaced expenditure growth. National government revenues reached Php224.2 billion in June 2018 after expanding by double-digits for the tenth consecutive month, from an annual nominal rate of 2.4 percent in June 2017 to 24.7 percent in June. Tax revenue growth remained robust and reached Php188.2 billion in June, growing by 11.9 percent year-on-year in nominal terms, more than twice the 4.6 percent growth registered in the previous year. In addition, non-tax revenue more than tripled in the same month, driven by a surge in privatization proceeds. Meanwhile, growth in public expenditures, which totaled Php278.5 billion in June, decelerated from 22.6 percent year-on-year in nominal terms in June 2017 to 2.9 percent in June 2018—the slowest pace since September 2017. Yet, public spending on infrastructure and other capital outlays remained strong and grew by 38.6 percent year-on-year in nominal terms in June, driven by construction and maintenance of road networks. As a result, the government's budget deficit narrowed from Php90.9 billion in June 2017 to Php54.3 billion in June 2018.