AKI
Angelo King Institute
for Economic and Business Studies

MONITORING THE PHILIPPINE ECONOMY

State of the Economy Report

Summary:

The Philippine economy recovered from the COVID-19 pandemic during 2022. It posted a very high annual growth rate, 7.6%, although this must be understood in the context of a low base. AKI's State of the Economy Report focuses on three issues in the context of the new Administration's 8-Point Socioeconomic Agenda and the Philippine Development Plan 2023-2028: growth, inflation, and the fiscal deficit and national debt. Overall, we have a positive view of the economy over the medium and long-term. However, we argue that:

-The focus of economic policy has to shift decisively toward changing the structure of the economy by reducing the share of employment in agriculture and increasing exports of more complex products. Otherwise, it will be very difficult to attain (and even more so, maintain) an annual growth rate of 6.5-8% during 2024-2028, as targeted by the administration.

-The Russia-Ukraine war price hike has been exacerbated by low productivity growth and an inefficient distribution system. Prices increased significantly within the Food and Housing groups. Nevertheless, the overall price increase (5.8% in 2022 and 8.3% in the first quarter of 2023) was not as dramatic as it has often been portrayed and treated. Interest rate increases will not do the job because this is not a case of excessive demand.

-The government does not have full control of the fiscal outcome. Hence, targeting a 3% fiscal deficit by 2028 is an erroneous goal. The fiscal deficit outcome is mostly residual and depends on the saving preferences of the private sector. If the latter decideds to net save, the government wil have to run a fiscal deficit. Likewise, the reduction in national debt to about 50% of GDP by 2028 is also an unclear goal as most of it is domestic currency, and interest rate payments are income for the private sector. Debt issuance is a tool to maintain interest rates within the corridor set by BSP. The government of the Philippines will not default on debt issued in its own currency unless it voluntarily chooses to do so.

-The administration ought to recalibrate some objetives of its economic program.

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RECOVERY FROM COVID-19 AND BEYOND

1. Introduction: we are cautiously optimistic

The Philippines recovered from the COVID-19 pandemic during 2022, as the economy started to open up, and restrictions eased due to the downward trend of cases and to an increasing vaccination rate. Both the business and education sectors returned to almost full operation after two years of online and work-from-home set-up. The benefits of opening up were palpable: a more vibrant economy, increased economic activity, and a reduction in the unemployment rate. However, the Russia-Ukraine war in the first quarter dampened the world economy's recovery through its effect on oil prices that resulted in inflation and was felt in the Philippines. Though the impact of this shock on domestic prices was short-lived, inflation continued to rise, this time due to internal factors. Despite this, we consider that the recovery phase is complete.

The *AKI's State of the Economy Report* discusses the performance of the Philippine economy in 2022 and the first quarter of 2023. We chose to focus on three targets of the administration: (a) growth of the economy after the pandemic; (b) inflation; and (c) fiscal deficit and government debt. The background of the discussion is the plans of Ferdinand Marcos Jr's Administration and the Philippine Development Plan 2023–2028. The first part of the report is descriptive. The second part provides our views and recommendations. We provide insights into how to deal with inflation, evaluate the reduction in the budget deficit and national debt, and discss how growth can be sustained, given that the first quarter of 2023 revealed a decline in the growth rate.

Overall, we have a positive view of the economy for the medium and long-term. The past three and a half years have been very difficult ones, with the economic and health shocks first, and then immediately afterwards the negative effects of the Russia-Ukraine war. Despite our positive outlook, we believe that the administration ought to recalibrate some of the objectives of its economic program.

2. The New Administration: an ambitious agenda

Ferdinand Romualdez Marcos was sworn in on June 30, 2022, as the 17th President of the Philippines. Soon after that, he delivered his first State of the Nation Address outlining the key economic objectives for 2022–2028, including:

- 6.0% to 7.0% real GDP growth in 2023
- 6.5% to 8.0% annual real GDP growth between 2024 and 2028
- Increase per capita income to reach upper-middle income
- Reduce the fiscal deficit to 3% of GDP by 2028
- Reduce national debt to 48%–53% of GDP by 2028
- Reduce the poverty rate to 8.8%–9% by 2028
- Generate high-quality employment

These economic goals were included in the Philippine Development Plan 2023–2028, approved in January 2023. The list of economic goals of the new administration is extensive (see Table 1). The key objective of the Administration is the social and economic transformation of the Philippines, and it views growth as the *necessary* condition to increase income per capita, reduce poverty, and create employment. Although the Development Plan contains clear and legitimate goals and tools, some others are less clear. Achieving a long list of goals simultaneously may prove challenging, primarily due to the need for a comprehensive understanding of how they are interconnected and how sustained high growth can be attained.

Table 1

Philippine Development Plan 2023-2028 Annual Target Outcomes

Indicator	Annual Target					
	2023	2024	2025	2026	2027	2028
GDP Growth Rate (in %)	6.0 - 7.0	6.5 – 8.0	6.5 – 8.0	6.5 – 8.0	6.5 – 8.0	6.5 – 8.0
GNI Per Capita (in USD)	4,130 - 4,203	4,454 - 4,592	4,814 - 4,920	5,256 - 5,563	5,645 - 6,056	6,044 - 6,571
Headline Inflation Rate (in %)	2.5 – 4.5	2.0 – 4.0	2.0 – 4.0	2.0 – 4.0	2.0 – 4.0	2.0 – 4.0
Food Inflation Rate (in %)	2.5 – 4.5	2.0 – 4.0	2.0 – 4.0	2.0 – 4.0	2.0 – 4.0	2.0 – 4.0
National Government Deficit to GDP Ratio (in %)	6.1	5.1	4.1	3.5	3.2	3.0
Outstanding National Government Debt Stock to GDP Ratio (in %)	60 - 62	57 - 61	56 - 59	54 - 58	50 - 55	48 - 53
Global Competitiveness Index Rank (in score and rank %)	Top 43% Score: 62.1	Top 41% Score: 62.7	Top 39% Score 62.9	Top 37% Score: 64.3	Top 35% Score: 64.9	Top 33% Score 65.1
Global Innovation Index Rank	57th	54th	52nd	49th	46th	43rd
Ratio of Wage and Salary Workers in Private Establishments to Total Employed (in %)	50.3 – 50.7	50.9 – 51.5	51.4 – 52.4	51.9 – 53.3	52.5 – 54.1	53.0 – 55.0
Unemployment Rate (in %)	5.3 – 6.4	4.4 – 4.7	4.8 – 5.1	4.0 – 5.0	4.0 – 5.0	4.0 – 5.0
Poverty Incidence Rate (in % of population)	16.0 – 16.4	–	12.9 – 13.2	–	10.0 – 10.3	8.8 – 9.0

Source: Philippine Development Plan 2023–2028

3. Annual Growth Performance in 2022: high but from a low base

GDP growth rate in 2022 was 7.6%. This was believed to be historic and momentous for the economy, not only because it exceeded the target range set in the State of the Nation Address (SONA) by the new administration but also because it was the highest growth registered since 1976. National Economic and Development Authority (NEDA) Secretary Balisacan referred to this growth as "robust" given that the government continues to intensify its efforts to restore the economy to its high-growth trajectory, creating more and better-quality jobs and speeding up poverty reduction. The Development Budget Coordination Committee (DBCC) believes that the country is achieving its

growth targets after growing 6.4% in the first quarter of 2023. The country's economic recovery is being driven by increased government spending, accelerated vaccination efforts, and the reopening of various sectors. The optimistic outlook also reflects positive indicators, such as higher exports and remittances, which contribute to the projected growth rate. This growth rate provided a good starting point post-COVID (see Table 2). The level of GDP in 2022 (19,943,630 million 2018 pesos) has already surpassed the level in 2019 (19,382,751 million 2018 pesos). Table 3 shows how the economy performed on a quarterly basis.

Table 2

GDP Level and Growth (y-o-y), 2018–2022

Year	*GDP Level (million 2018 pesos)	Percent GDP Growth Year-on-Year
2018	18,265,190	—
2019	19,382,751	6.1
2020	17,537,843	-9.5
2021	18,540,084	5.7
2022	19,943,630	7.6

Source: Philippine Statistics Authority

Table 3

GDP Level and Growth (y-o-y and q-o-q), Q4 2020–Q4 2022

Year	Quarter	*GDP Level (million 2018 pesos)	Percent GDP Growth	
			*Year-on-Year Same Quarter	Quarter-to-Quarter
2020	Q4	4,825,596	-8.2	—
2021	Q1	4,265,322	-3.8	-11.6
	Q2	4,645,533	12.13	8.9
	Q3	4,425,697	7.0	-4.7
	Q4	5,201,501	7.8	17.5
2022	Q1	4,613,155	8.2	-11.3
	Q2	4,992,671	7.5	8.2
	Q3	4,763,641	7.6	-4.6
	Q4	5,577,338	7.2	17.1

Source: Philippine Statistics Authority

The growth rate of 7.6% in GDP in 2022 obscures an important factor contributing to this high figure—the presence of a low base effect in 2021. This is shown in Table 2. This is not to say that the Philippines performed poorly in 2022. In fact, it attained positive GDP growth (already attained in 2021), employment levels were restored, consumer spending increased, and business activity improved.

Table 4 provides a comparison of the economic performance of the Philippines with that of a group of selected Asian economies. The country's high dependence on imported raw materials and low value added exports made the economy vulnerable to the external shock caused by the COVID-19

pandemic. Table 4 shows that the Philippines suffered the largest drop in growth in 2020 among the South East Asian economies, 9.5%. COVID-19 restrictions started to ease in 2021. This led to the gradual opening up of economies. The Philippines posted a positive growth in 2021. The Philippines continued to display positive economic growth in 2022, 7.6%, among the hightest in Southeast Asia, although but this was mainly a result of the low base coming from the pandemic. The recovery has continued during the first quarter pof 2023.

Table 4

GDP Growth of Selected Countries

	Percent GDP Growth				
Selected Countries	**2019**	**2020**	**2021**	**2022**	**2023 (1st quarter)**
Philippines	6.1	-9.5	5.7	7.6	6.4
China	6	2.2	8.4	3	4.5
India	4.6	-6	8.9	6.7	-
Indonesia	5	-2.1	3.7	5.3	5
Malaysia	4.4	-5.5	3.1	8.7	-
Singapore	1.3	-3.9	8.9	3.6	-
South Korea	2.2	-0.7	4.1	2.6	0.8
Taiwan	3.1	3.4	6.5	2.5	-3
Thailand	2.1	-6.1	1.5	2.6	-
Vietnam	7.4	2.9	2.6	8	3.3

Source: Bangko Sentral ng Pilipinas

4. Inflation: 8% is "low" inflation, not hyperinflation

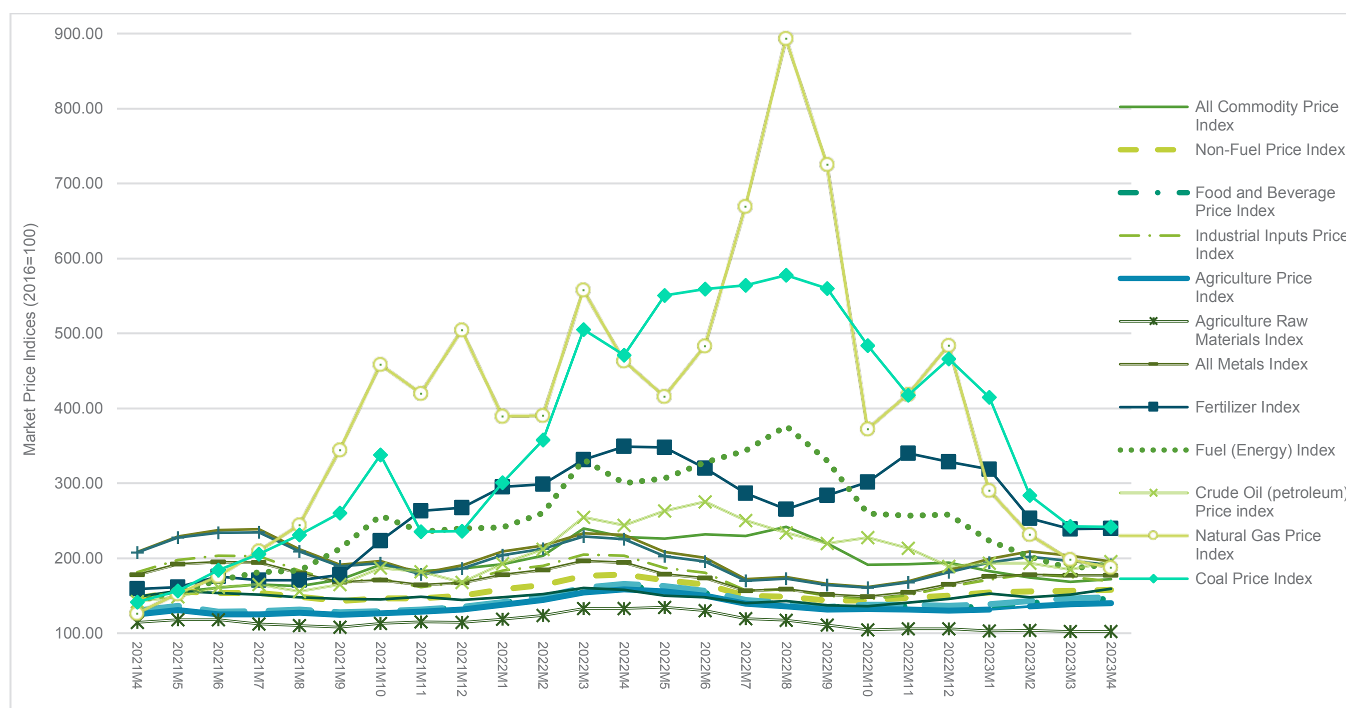
The world faced severe economic hardships and financial burdens because of the increase in prices in 2022. Although inflation eroded purchasing power, impacted savings, and exacerbated inequality because it hit the Food and Housing groups (see below), the overall price increase was not as dramatic as it was often portrayed. Indeed, reading some assessments of the increase in prices (especially in 2022), it appeared that the world was experiencing extremely high inflation, even hyperinflation -something that historically arises only under extreme conditions: war, political mismanagement, and the transition from a command to market-based economy. The discourse on inflation has often invoked unfounded narratives, such that, once begun, inevitably becomes uncontrollable. Also, it is widely believed that inflation harms growth; hence, inflation has to be contained sooner rather than later. There is no empirical evidence to support these claims (Felipe 2023). Yet, the evidence indicates that inflation seems to harm growth only at very high rates, above 40% (Bruno and Easterly 1998). Moreover, it is not inflation that causes output to decline, but rather, inappropriate and draconian efforts to curb it (Bernanke et al. 1997).

Prices shot up in 2022 due to Russia's invasion of Ukraine in February. Western sanctions on Russia, a major crude oil producer, raised oil prices by more than a third. Figure 1 documents the price increase in some commodities like natural gas, coal, and fuel, of which the Philippines is a net importer. As a result, food costs surged due to higher fertilizer and transportation costs, along with Russian blockades of Ukraine's grain exports (a major wheat producer).

Appendix 1 offers an analysis of the different causes of inflation that have been discussed. Ultimately, inflation (the increase in the CPI) occurs because firms decide to increase prices. Hence, it is important to understand how the initial shock was transmitted to the Philippine domestic economy and why prices continued to increase duing 2022 and early 2023. This also matters in order to evaluate the measures the Bangko Sentral ng Pilipinas (BSP) and the government are implementing to address it.

Figure 1

Commodity Indices, in Terms of US$, Market Prices

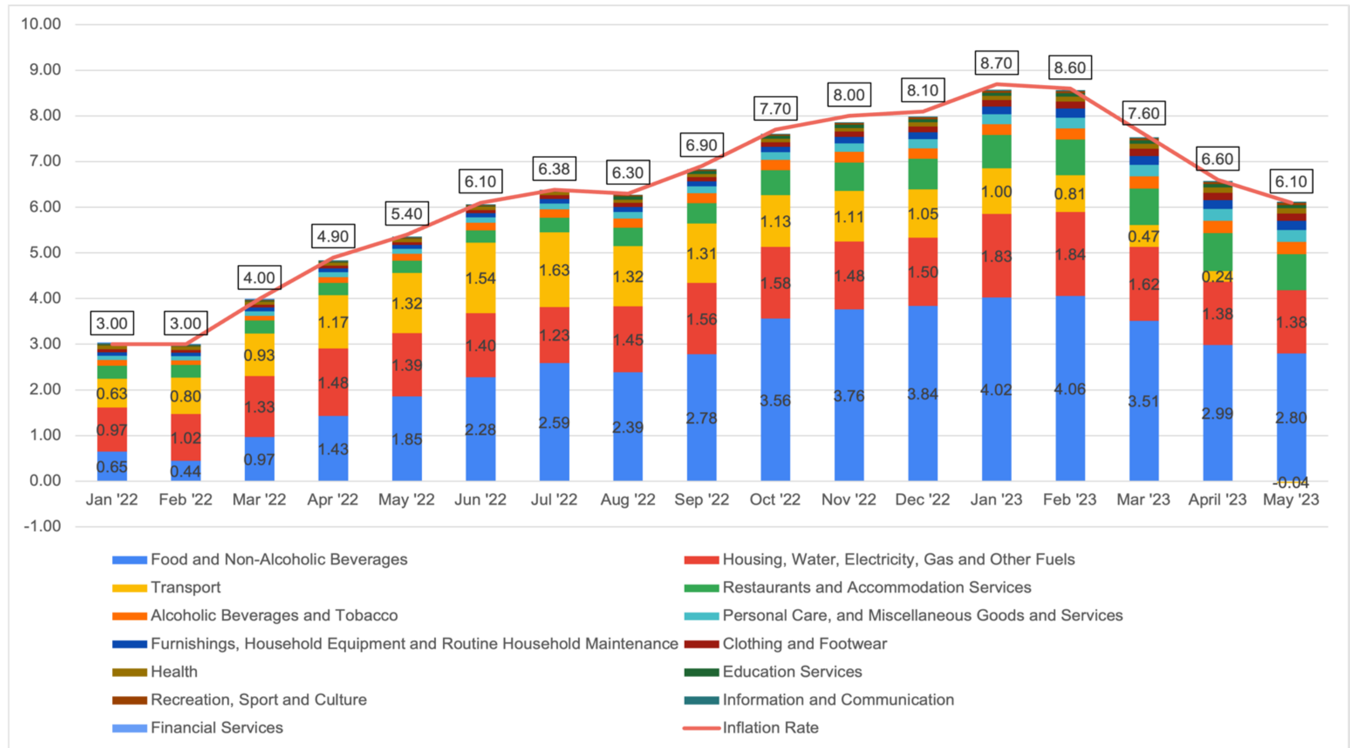


Source: International Monetary Fund

In the Philippines, the headline inflation rate averaged 5.8% in 2022, above the 3.9% inflation rate in 2021. This is the highest figure reported since November 2008 (See Figure 2). After the outbreak of the Ukraine-Russia war, inflation started to move past the 3% recorded in January and February and consistently rose in the following months. The increase in the CPI was mainly the result of price increases in two groups, Food and Non-Alcoholic Beverages (the items that saw the highest yearly increase were sugar, confectionery, and desserts (38.8%); vegetables, tubers, cooking bananas, and pulses (32.4%); and corn (26.3%)), and Housing, Water, Electricity, Gas, and Other Fuels (Figure 2). The depreciation of the Peso (Figure 3), which peaked in October 2022 with an average monthly exchange rate of P58.82 per dollar, made already high import prices of food and energy artificially more expensive.

Figure 2

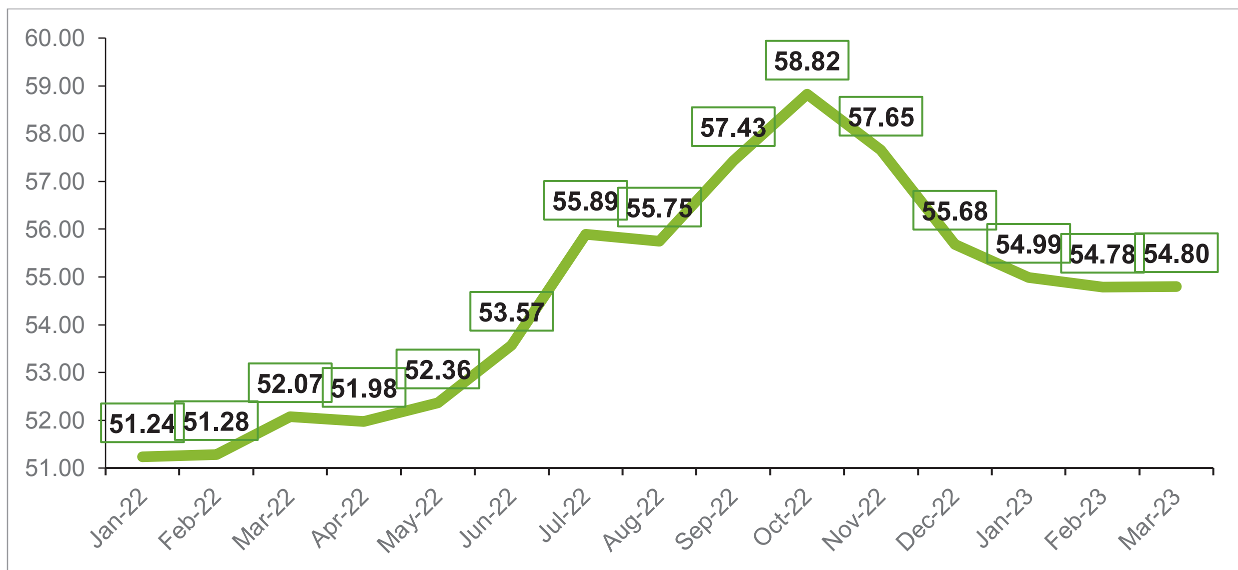
Consumer Price Index (y-o-y, %)



Source: Philippine Statistics Authority

Figure 3

Peso-USD Exchange Rate, Monthly Average



Source: Bangko Sentral ng Pilipinas

Table 5 provides a comparison of inflation rates across Asia. The table documents the generalized price increase across the region in 2022 and early 2023. Philippine inflation in 2022, was slightly higher than Indonesia's, Malaysia's, or Vietnam's; but slightly below India's, Singapore's, or Thailand's. However, Philippine inflation in the first quarter of 2023 was the highest among the sample of countries. This happened despite the efforts by the Bangko Sentral ng Pilipinas to contain the price increase through raising the policy interest rate in 2022 and 2023. During the fourth quarter of 2022, the prices of transport and commodities, components of the CPI that rely on imports, stabilized. Yet, the price of food and non-alcoholic beverages, and of services such as recreation, sports and culture, and hotel accommodation, continued to shoot up.

Table 5

Inflation Rate of Selected Countries

	Inflation Rate					
Selected Countries	**2019**	**2020**	**2021**	**2022**	**2023 (1st quarter)**	**2023 (2nd quarter)**
Philippines	2.4	2.4	3.9	5.8	8.3	6.6
China	2.9	2.5	0.9	2	1.3	-
India	3.7	6.6	5.1	6.7	6.2	-
Indonesia	-	-	1.6	4.2	5.2	4.3
Malaysia	0.7	-1.1	2.5	3.4	3.6	-
Singapore	0.6	-0.2	2.3	6.1	6.1	-
South Korea	0.4	0.5	2.5	5.1	4.7	3.7
Taiwan	0.6	-0.2	2	2.9	-	-
Thailand	0.7	-0.8	1.2	6.1	3.9	2.7
Vietnam	2.8	3.2	1.8	3.2	4.2	2.8

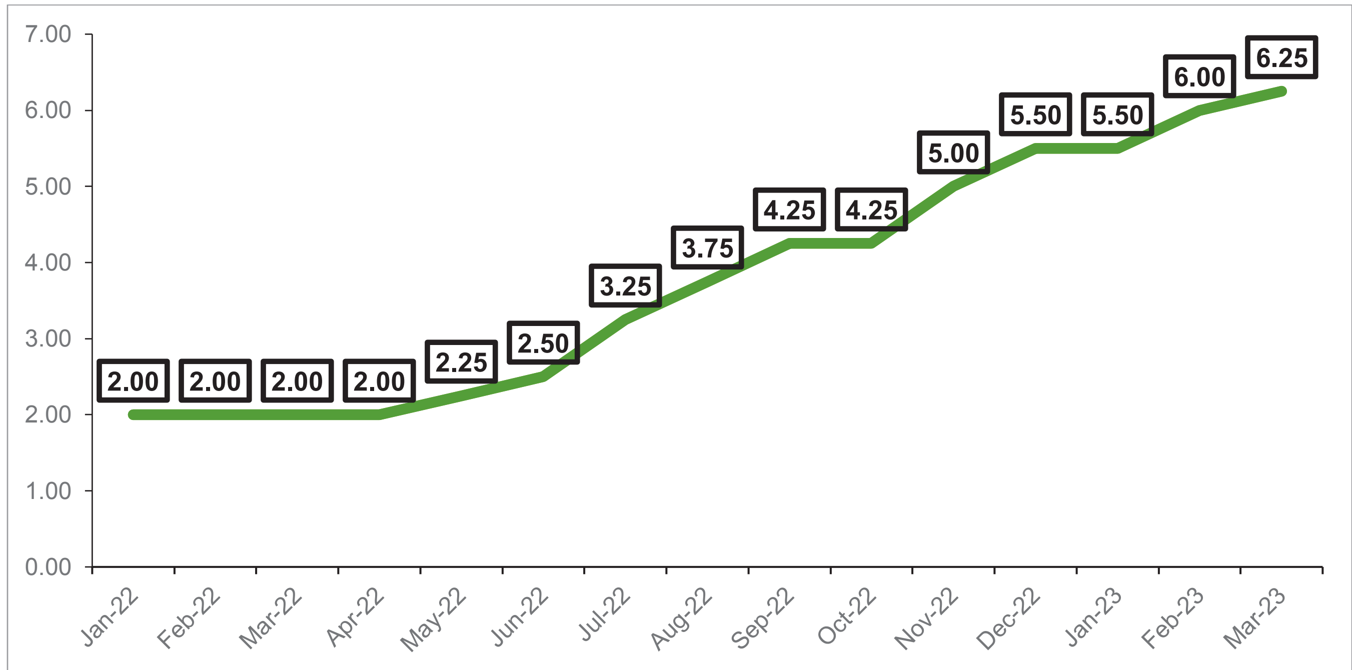
Bangko Sentral ng Pilipinas

After the U.S. Federal Reserve increased policy rates to tame U.S. inflation, BSP, like other central banks around the world, was also forced to raise rates (by late 2022, IMF and World Bank were urging stronger anti-inflationary measures, mainly by raising interest rates, arguing – without offering any convincing evidence – that not acting with immediate decisiveness would mean worse later). Such contractionary monetary policy measures were aimed at defending the Peso from losing its value and taming inflation. BSP raised the policy interest rate seven times in 2022, from 2% in March to 5.5% in December, and two times in 2023, up to 6.25% currently (see Figure 4). However, by the end of 2022, the Peso had appreciated and returned to 55-56 Pesos/U.S. dollar.

Global commodity prices have also returned to their pre-war levels. Yet, the Philippines continues to experience one of the highest inflation rates within the ASEAN region -although it is declining, at 6.1% in May 2023 against 6.6% in April. Core inflation, which strips out volatile food and energy items, slowed to 7.7 percent from 7.9 percent. During the fourth quarter of 2022, the prices of transport and commodities, components of the CPI that rely on imports, stabilized. Yet, the price of food and non-alcoholic beverages, and of services such as recreation, sports and culture, and hotel accommodation, continued to shoot up (See Figure 2).

Figure 4

BSP's Overnight Reverse Repurchase Rate, Monthly Average



Source: Bangko Sentral ng Pilipinas

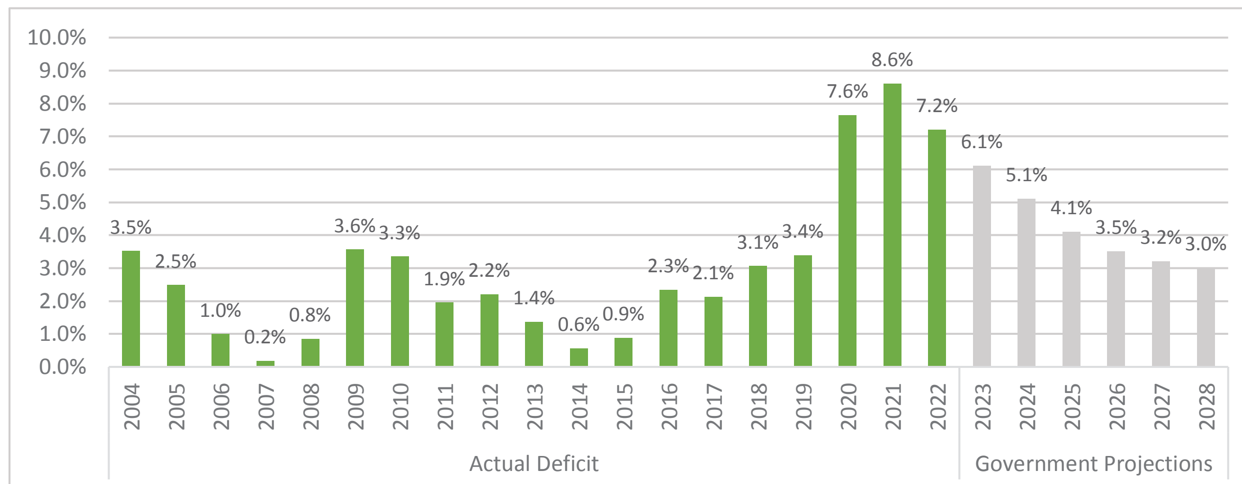
As discussed in Appendix 1, ultimately, inflation gets entrenched into the economy because firms and workers try to maintain, if not improve, their respective returns (wage and profit rates) and shares in national income. There are no clear signs of significant profit and wage inflation as well as of excessive demand. The culprit is low productivity growth.

5. Government Deficit and Debt: the objective is to bring them down

The Philippine Development Plan argues that the Philippines needs "prudent fiscal management," as this is thought to help growth. Firstly, it aims to gradually decrease the government deficit-to-GDP ratio from 6.5% in the first half of 2022 to 3% by 2028 (see Figure 5). Secondly, it also aims at reducing national (public) debt by gradually decreasing the outstanding government debt-to-GDP ratio from 63.7% in September 2022 to 51.1% by the end of 2028 (see Figure 6). It is worth noting that most debt is denominated in pesos.

Figure 5

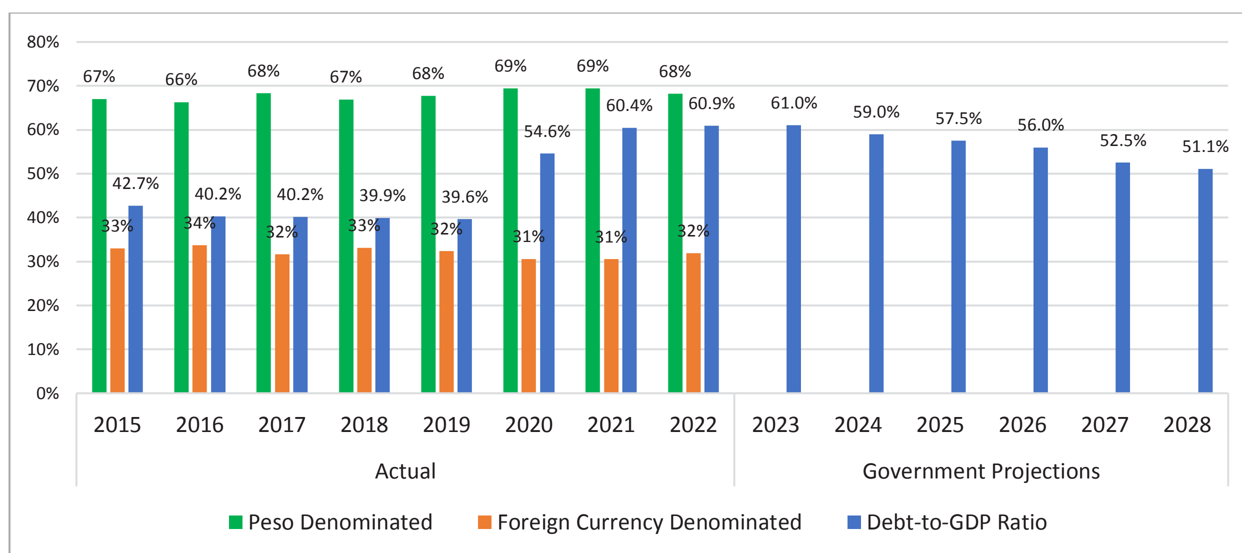
Government Deficit, % of GDP, Philippines, 2004–2028



Source: Department of Finance and Philippine Development Plan 2023-2028

Figure 6

Debt-to-GDP Ratio, Philippines, 2015–2028



Source: Source: Department of Finance and the Philippine Development Plan 2023-2028

Notes: (i) Foreign currency-denominated debt was converted into pesos and added to peso-denominated debt to express it as a percentage of total debt (in peso); (ii) The percentages we show in the bar chart for each year from 2023 to 2027 are the average of the medium-term projection ranges provided in Table 1.1 of the Philippine Development Plan (PDP) 2023-–2028 (Table 1 above). For 2028, we use the target detailed in the PDP, which is an outstanding government debt to GDP ratio of 51.1% by 2028-end. The debt-to-GDP ratio projections provided in the PDP are the following: 60–62% for 2023, 57–61% for 2024, 56–59% for 2025, 54–58% for 2026, 50–55% for 2027, and 48–53% for 2028.

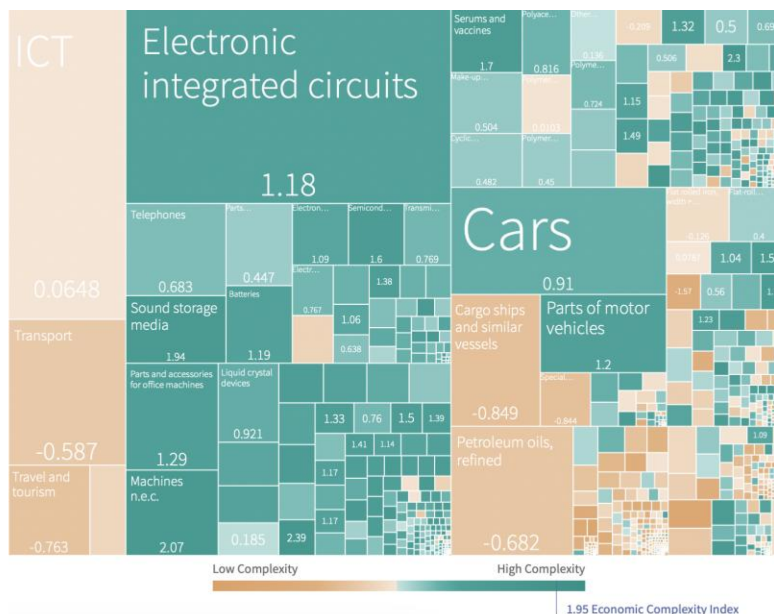
IMPLICATIONS AND INSIGHTS FOR 2023 AND BEYOND

1. **Growth Prospects: the need to transform the economy**

   What is necessary to attain high and sustained growth throughout the Marcos Jr. administration? This is obviously a difficult question to answer. It requires an understanding of what is necessary for the Philippines to develop—a process of structural transformation. Historically, countries that have reached high-income status have made it by transferring labor out of agriculture into manufacturing and advanced services as well as by focusing on making more complex products. High-income countries make complex products with a high-income elasticity of demand. South Korea is an example (Figure 7). Its export basket (the greener the product, the more complex; the browner, the less complex) is one of the most diversified and unique in the world. How fast the Philippines can grow will depend on how much policy focuses on the quality and sophistication of the products it makes and exports. The Philippines' export basket has changed significantly during the last decades, but it is not as complex as South Korea's (Figure 8). The country's export portfolio mainly consists of food, agriculture, and basic manufacturing. It is crucial to address this concern as exports play a vital role in generating foreign currency, which is necessary to pay for imported capital goods required for the country's development.

Figure 7

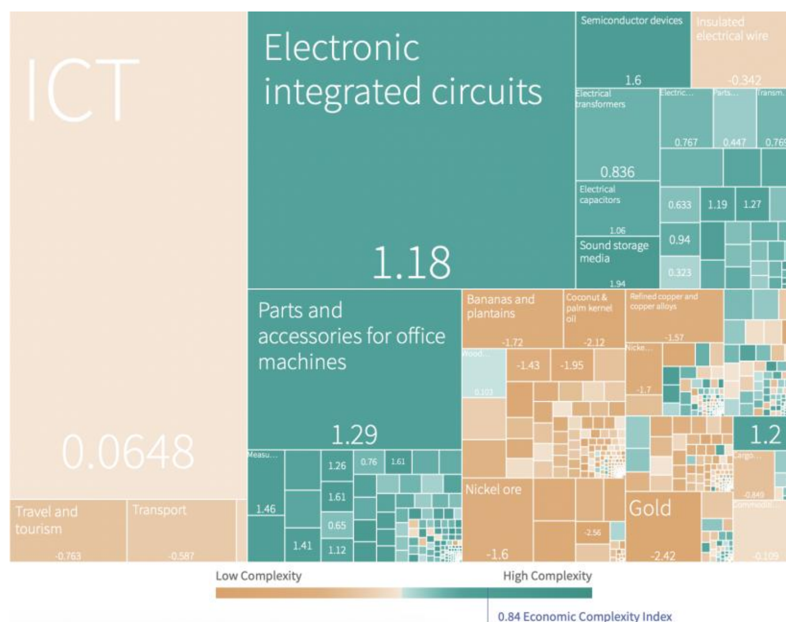
Export Complexity and Product Space, South Korea, 2020, Harmonized System 1992



Source: Harvard Atlas for Economic Complexity

Figure 8

Export Complexity and Product Space, Philippines, 2020, Harmonized System 1992



Source: Harvard Atlas for Economic Complexity

To ascertain whether or not it is possible to attain and maintain a 6.5%–8% annual growth during 2023–2028, it is important to understand what constraints Philippine growth. The Philippines needs to import capital goods (and many others) that are crucial for its development. These have to be paid in hard currency (e.g., dollars). The only way for the Philippines to obtain these currencies is to export (or continue receiving overseas remittances), given that relying on capital inflows is more difficult. This means that the ultimate constraint on growth lies in the balance of payments, in particular, the need to avoid persistent current account deficits (as, indeed, these would not be permanently compensated with capital inflows). What underlies this argument is that, before achieving its potential growth rate (supply side), an economy's actual growth performance can be curtailed by macro constraints. For emerging economies like the Philippines, the external constraint associated with the current account balance is particularly significant, given the country's dependence on the availability of foreign exchange to finance its imports. Current account deficits can be sustainable and, indeed, necessary in the short run—especially when they allow for faster capital accumulation. But countries cannot finance ever-growing current account deficits in the long run, as there is a limit beyond which the deficit becomes unsustainable (or is perceived as such by financial markets), and a balance-of-payments crisis ensues. Thus, countries that find themselves in balance-of-payments problems may be forced to constrain growth while the economy still has the surplus capacity and surplus labor—that is, while the actual growth rate is still below the potential growth rate.

The above indicates that there is a growth rate of GDP consistent with the current account dynamic equilibrium. Our current estimate of this growth rate is about 6%. This is the maximum growth rate that the Philippine economy can attain without incurring balance of payments problems. This growth rate incorporates the contributions of exports of goods and services, remittances, foreign direct investment, and the terms of trade.

We stress that more than simply exporting, the Philippines' focus should be on enhancing the quality and sophistication of its export basket. By doing so, the country can improve its trade balance and foster economic growth. Policymakers must prioritize efforts to enhance the non-price competitiveness of the country's exports (quality, perception in international markets). Although there has been an improvement on this front during the last decades, this point must be emphasized, and the quality of the Philippine export basket must improve even further. Without this, the economy will continue depending on remittances and will not be internationally competitive. With the current export structure, the Philippine economy can grow by about 6% (also allowed by its long-run labor force growth and productivity growth trends). Above this rate, the economy will encounter macroeconomic problems.

2. Inflation Woes: the need to increase productivity growth and firms' organizational capabilities, and improve the distribution system

The price increase episode during 2022 and early 2023 was caused by supply-side bottlenecks initially induced by COVID-19 and the Russia-Ukraine conflict later. As discussed above, the increase was concentrated in the Food and Housing groups. While we acknowledge the impact on the low-income groups, we believe that the overall price increase has not been as dramatic as often portrayed, and the medicine to solve (increase in interest rates) may make things worse by slowing down the economy. We believe that this is a temporary phenomenon (inflation is clearly receding).

We can distinguish three episodes with inflation having different sources (admittedly a simplified depiction of the reality). The first one was the initial shock in early 2022: prices of imported goods and commodities increased and at the same time the peso depreciated. Firms in general, but in particular those with market power, reacted by passing these two effects on to domestic prices. These firms only engage in price hikes if they expect their competitors to do the same. This requires an implicit agreement that coordinates price hikes. Sector-wide cost increases can generate such an implicit agreement: since all firms want to protect their profit margins and know that the other firms pursue the same goal, they can increase prices by relying on other firms doing the same. Probably some firms have passed through an equal increase in their costs while others took advantage of the situation and increased prices by more, with the consequence that their profit margins increased.

The second phase was characterized by two effects. First, as it was clear that inflation was taking a toll on consumers' purchasing power, some firms may have contained and even reduced their profit margings to keep market share (e.g., this may have been done via discounts to increase sales,

or by lowering markups). Second, nominal wages probably did not increase and this was compounded by possibly negative productivity growth (that is, unit labor costs increased), a remnant from the COVID days, when firms hoarded labor. The source of inflation was likely this second effect.

In the third phase, in 2023, as demand conditions become more favorable (reflecting a pent-up demand for consumer goods unleashed before war-disrupted supplies were restored), we expect that those firms withdrew their discounts increase markups, and so prices will return to their previous normal level, that is, to the price firms are willing to charge when they operate at normal capacity and earn a profit rate that satisfies their strategies. Second, nominal wages will increase but we also expect that productivity eventually catches up (so the growth of unit labor costs shoul be is nil). If prices increase during this phase it will be mostly the effect of the recovery of the profit margings, although this is not, strictly speaking, inflation (it is a recovery of profit margins).

The price of key commodities like oil is on a downward trend. Indeed, the oil price has declined by about 8% during the first five months of 2023 with respect to the price in December 2022 (actually, the oil price increased by just 5% in 2022 despite the the war). The price of gas is also on a downward trend. We do not think it was demand driven either. Profit-driven inflation may be the problem in some commodities but not a generalized problem in today's context.

We believe that the inflation problem (and its solution) ultimately lies in low productivity growth (even in the face of some nominal wage growth) compounded by an inefficient distribution system. The productivity problem is very likely to be temporary but important to understand current inflation and long run growth. See Appendix 1.

On the distribution system, some traders have capitalized on the prevailing supply-demand gaps in agriculture due to the confluence of supply value chain problems due to the Ukraine-Russia war, typhoons, and numerous diseases like the African Swine Flu (Mapa, 2023). According to the United Sugar Producers Federation of the Philippines (UNIFED), agriculture traders and retailers have hoarded commodities and raised prices, contributing to the already unsystematic agricultural supply shock (Cabuenas, 2023). For instance, there were reports indicating that higher-than-average rainfall devastated onion farms, causing the cost of onions to shoot up from around 70 pesos a kilo in April to as much as 700 pesos in December, making them more expensive than meat (Dela Cruz & Portugal, 2023). Another case was refined sugar, selling at P90 to over P100 per kilogram despite the importation of 150,000 metric tons of sugar and the start of harvest and milling season (Reyes, 2022). In addition, agricultural smuggling activities continue to distort pricing outcomes in agricultural markets. Such rent-seeking behavior capitalizes on weak enforcement of national laws.

Ultimately, the problem is the lack of real-time information systems to transmit data to national policymakers. This stems from the multiplicity of activities in the production process, from raw materials to the final sale of goods of most agricultural commodities. These series of steps

contribute to costs and profits at each stage, resulting in an increased price as the product progresses toward the end retailers and which makes it also harder to identify where unjust markups proliferate (Corpuz, 2018). Aside from this, the deep structural issues faced by the agriculture value chain include low productivity, lack of facilities, and high procurement cost of low-quality products like rice.

Considering all the aforementioned factors, we contend that the price surge witnessed at the onset of 2022 can be attributed to imported inflation resulting from the Russia-Ukraine war. Conversely, the inflation witnessed in the latter months of 2022 and early-2023 can be attributed to low productivity growth and market inefficiencies within the agricultural distribution system, stemming from agricultural traders imposing exorbitant markups after capitalizing on supply gaps.

BSP was forced to increase interest rates to counteract the peso's fall and this way minimize the impact of imported inflation. Yet, as noted above, the peso's fall lasted for a few months in 2022, while interest rates increases continued. Inflation has remained entrenched because BSP's policy rate increases are meant to tame demand-driven inflation, not solve agricultural supply shocks, high agricultural traders' markups, or low productivity. Contractionary monetary policies are meant to tame inflation if there is an increase in core inflation due to significant increases in spending when the economy reopens, firms attain full production capacity, and then further increases in demand have to be met with increases in prices. Yet, at least in 2022, average core inflation ~~only~~ increased by just 0.9%.

Therefore, the policy response by the BSP ought to be reconsidered. Certainly, higher interest rates are unlikely to reverse specific higher prices, for example, those of food. Inicreases in interest rates address the effects, not the causes of inflaiotn. Aside from being unable to tame inflation, it may exacerbate the problem by increasing borrowing costs and affecting investment, and may have contributed to slower economic growth in the first quarter of 2023 (6.4%), the lowest since the country first reported a positive growth rate in the second quarter of 2021 (Philippine Statistics Authority, 2023a). Higher interest rates may have led to lower consumption and investment levels (although the statistical evidence on the negative impact of increased interest rates is scant) as it makes it more expensive for consumers to borrow money and businesses to take out loans and expand operations, respectively. Moreover, interest rate hikes inflict the burden of combating inflation on the most vulnerable – typically low-paid unskilled workers. The unavoidable short-term pain for long-term gain is a dubious argument.

Indeed, if what triggered inflation was a supply and not a demand shock, then we cast doubts on the usefulness of increases in interest rates. These may have an impact on inflation but rather indirect and after a long lag. Increases in interest rates would be much more appropriate if this had been a case of excessive demand. We acknowledge that wages may have started increasing now, but how much above productivity is less clear, and this is, perhaps, what the BSP is trying to avoid by hiking interest rates. Indeed, most central bankers claim interest rate hikes are necessary to prevent 'second-round' effects of 'wage–price spirals. As of now, however, there is no evidence

of such wage–price spiral, although nominal wages may have risen. Moreover, if the problem is one of low productivity growth, the job of BSP will become much more difficult. Changes in interest rates will do little to remedy the inflation problem—a problem not due to excess demand, not due to supply-chain problems, not due to higher markups, or conflicting claims between workers and firms, but due to low labor productivity growth (even a regress in some activities) during the pandemic.

Our view is that, to tame inflation, the Philippine government ought to focus on increasing productivity growth and addressing regulatory issues in the agricultural sector, particularly traders and middlemen who exhibit monopolistic behavior and increase their profit margins. This should be combined with fiscal policy measures to support low-income families, and monitor how firms increase their markups.

Low productivity in most small firms (the majority in the country) is a perennial problem. This is the result of a lack of *organizational capabilities* at the firm level (e.g., organization of the workflow), resulting in the production of simple products that are not competitive in international markets. Most Filipino firms are small and find it difficult to introduce modern methods of production. According to the Department of Trade and Industry (DTI), micro, small and medium enterprises (MSMEs) represented 99.6% of the total number of firms in 2021. Second, low productivity is a problem particularly in agriculture. Unless workers move out fast into other activities, agricultural productivity will not increase because it will be very difficult to modernize the sector. Also, the government should work with the Department of Agriculture and other agricultural trading groups to investigate middlemen who contribute to the inefficiencies in the agricultural distribution system. Moreover, gaps in the implementation of the Agriculture and Fisheries Modernization Act should be addressed. The Department of Trade and Industry should also monitor prices and set reasonable standard retail prices (SRP) to maintain competitive and affordable prices. Finally, the government could also look into ways how to make the distribution system more efficient by lessening the multiple layers of middlemen.

Although inflation has been slowing since March 2023, the reversal of high markups by traders due to congressional pressures and the continued normalization of the agricultural market distribution system deserves more credit for the reduction in the inflation rate than the interest rate increases over the past year. This is evidenced by the significant drop in prices of food and non-alcoholic beverages documented above. We celebrate the monetary board's decision in May to pause rate hikes after careful consideration of the country's recent economic performance.

Although international institutions forecast lower inflation this year, the Philippine government still needs to address regulatory issues in the agricultural sector, particularly traders and middlemen who capitalize on supply gaps by unjustly increasing profit margins. We laud the government's initiative to form an Inter-agency Committee on Inflation and Market Outlook (Fernandez, 2023). Similar to what other policymakers have advocated, we recommend the development of policy frameworks to monitor price setting in agricultural markets and allow

structures similar to automatic stabilization policies to provide moral suasion. Moreover, the government could also investigate ways how to make the distribution system more efficient by lessening the multiplicity of layers of middlemen. In this sense, the aims of the agricultural industry chapter in the Philippine Development Plan 2023–2028 are worth citing. We support the view of economic managers that combating inflation requires a concerted commitment to focus on lingering problems in the sector. When efficiently implemented, the New Agrarian Emancipation, the National Land Use, and the Livestock Development and Competitiveness Bills may help achieve a productivity rebound in the agricultural sector.

Finally, we have undertaken a spatial analysis of inflation. Details are in Appendix 2. In particular, we have analyzed inflation data outside of the National Capital Region. We find the following: (i) more provinces have experienced declines in inflation than those that experienced increases in inflation; (ii) Inflation differences in the provinces tend to converge over time; (iii) Some provinces were able to achieve negative accumulated change in inflation, while others registered positive estimates; and (iv) there is evidence of negative spatial correlation, implying that provinces that could lower inflation may be neighbors of provinces that have struggled to achieve lower inflation.

3. **Fiscal deficit and debt reduction: the need to understand government finances**

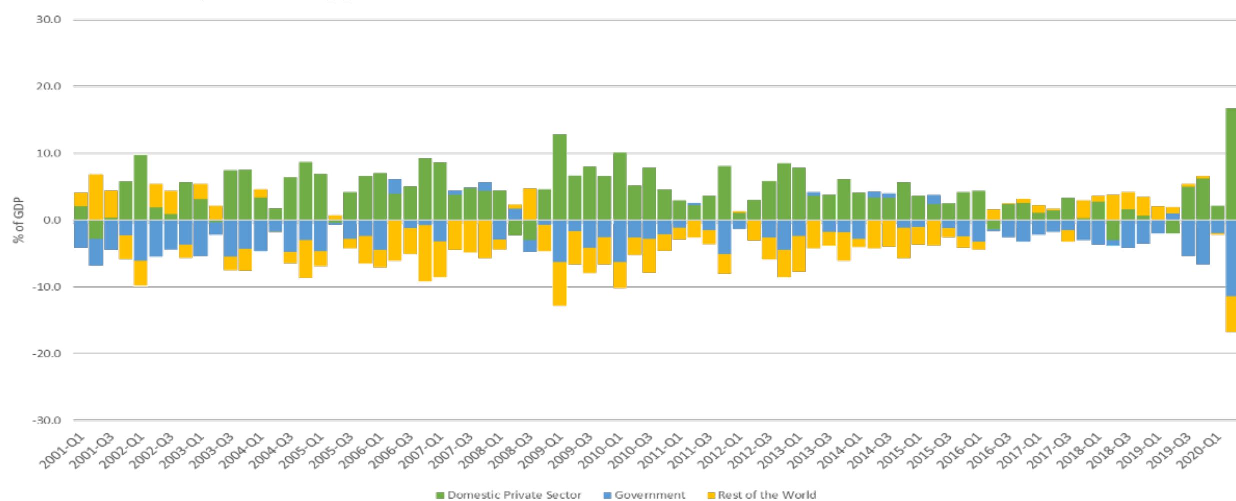
Reducing both the fiscal deficit and national debt poses challenges. It is important to understand that the government's control over the fiscal deficit is limited, as it must consider the spending and saving patterns of both the domestic private sector and the external sector. The fiscal authorities are continuing to simplify tax administration and improve efficiency through several tax reform packages. On the expenditure side, the government may need to prioritize budget items with high multiplier effects on growth. See Appendix 3 for the complete argument. Moreover, as noted above, the majority of the national government's debt is held in domestic currency rather than foreign currency. The Philippine government will not default on debt issued in its own currency—unless it chooses to do so.

On the reduction of the fiscal deficit, it is important to recognize that the government's deficit cannot be examined in isolation. Instead, it must be considered alongside the surplus or deficit of the domestic private sector and the external sector, as these three sectors' balances add up to zero by construction. A government deficit implies a surplus (or net saving) on the part of the domestic private and external sectors together. This is because the three sectoral balances add up to zero by construction. For this reason, the government has limited control over its deficit. The fiscal deficit is a residual outcome that depends on the spending and saving behavior of the domestic private and external sectors. Consequently, reducing the fiscal deficit to 3% by 2028 can be seen as a speculative endeavor as it fluctuates depending on the needs of both government and non-government sectors. Figure 9 shows the three sectoral balances for the Philippines between Q1 of 2001 and Q2 of 2020 -they add up to zero at each poin tin time. The figure shows that the surplus of the domestic private sector (green) is the other side of the fiscal deficit (blue). The latter is the

source of the significant liquidity of the private sector in 2020. Even if the 3% target is achieved, such fiscal deficit merely restricts the level of saving that the non-government sectors will attain, which may or may not align with their preferences. Determining the specific desires of the non-government sectors at present is challenging. What is essential for the government is to ensure that there is enough economic activity to produce a level of income that helps achieve the intended level of savings for the non-government sectors. Consequently, even though the government's control over its deficit is limited, it should actively work towards maintaining sufficient economic demand to support the desired income and savings levels for the non-government sectors.

Figure 9

Sectoral Balances of the Philippines, Q12001–Q22020



Source: Authors based on National Accounts data

Therefore, will a fiscal deficit of 3% of GDP materialize in 2028? It is impossible to know today. The fiscal outcome is not under the control of the government. The fiscal deficit is, from an accounting point of view and ex-post, the difference between government spending and tax revenues. Yet, behaviorally, it depends on the saving desire of the domestic private and external sectors. In fact, it makes no sense to speak of the government's balance without reference to the other two balances; and the sector balances do not tell us the complex causalities that lie behind the resulting outcome (that they add up to zero). What we know is that the fiscal outcome for a currency-issuing government like the Philippines is largely residual, rising when private domestic and foreign demand shrinks and falling when demand rises. In other words, the fiscal deficit finances the desire by the non-government (domestic and foreign) sector to save overall. This is achieved by maintaining sufficient demand to produce a level of income that will generate the desired level of net saving.

A responsible government would seek to meet the desirable national objectives, and whether these require a larger deficit, a smaller deficit, or even a surplus in some circumstances should not be the concern because such a government understands how its own finances work.

The second point to address is debt reduction. At present, the stock of national debt is estimated at P13.4 trillion as of 2022-end, equivalent to about 60.9% of GDP (almost 70% is in domestic currency). The government aims to reduce it to between 48%–53% of GDP by 2028. As explained in Appendix 3, our view is that the discussion of debt is also unclear and misses crucial points about what the so-called debt is, how it is generated, who owns it, and its role in the economy. These misundersrtandings have generated fear about the recent increase in national debt. Indeed, the issue tends to be one of the most misunderstood points in macroeconomics as the term "debt" has a negative connotation because it is erroneously associated with the family analogy. We must make it clear that the much-circulated debt threshold of 60% of GDP has no basis. Moreover, most government debt in the Philippines is denominated in domestic currency in the form of treasury bills and bonds, and it is virtually risk-free. The only relevant questions to ask are: is the government spending on what the country needs to attain the national objectives? Are legislators allocating funds efficiently? Are these funds being used for initiatives that create high and sustained growth?

Summing up: The Philippines completed its recovery from the COVID-19 pandemic during the latter part of 2022 and the early months of 2023. The Marcos Jr. Administration took over in mid-2022 with an ambitious agenda of recovery and economic and social transformation for 2023–2028. Although we understand and support this agenda, we think it is based on overly optimistic assumptions, in particular about growth, at the center of most economic targets. The targeted annual growth rate of 6.5%–8% during the course of the Administration is very high. Unless the structure of the economy changes very fast, and becomes more diversified andsophisticated, it will be very difficult to attain, and in particular sustain, such a high growth rate.

Inflation has never been out of control and it appears to be on a downward trend. We have argued that addressing low productivity growth (during the pandemic) and an inefficient distribution system in agriculture would do more than the monetary policy of the BSP.

Finally, the reduction in the budget deficit to 3% of GDP by 2028 is a dubious target becaue it does not consider the saving preferences of the private and external sectors of the economy. If they decide to net save, the government will have to run an equal fiscal deficit. Likewise, the national debt, an interest-bearing option to liquid funds (and a tool to maintain interest rates with the BSP corridor), is in the hands of the private sector (interest on debt is income for the private sector). Reducing it (to about 50% of GDP by 2028) may even have negative implications for the economy. The portion of national debt denominated in pesos (most of it) does not pose any default problem. The Philippine government will not default on it unless it voluntarily chooses to do so.

Given the above, we believe that the administration ought to recalibrate some of the objetives of its economic program.

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Appendix 1: Inflation

Discussions of inflation in the Philippines have lacked clarity and depth about what ultimately has caused price rises. Most often, references to inflation confuse increases in the different components of the CPI basket (food, housing, transport, etc.) with its underlying causes. Looking at the components of the CPI (which categories of the basket led the increase) is obviously a first approach, but it is not an explanation for why prices increased. A better understanding is fundamental to also discuss how effectively the Administration is fighting inflation. Given the difficulties to obtain data to properly test the different causes of inflation, we summarize and discuss what many economists have been debating around the world.

In what follows, we summarize the discussions in Chowdhury and Sundaram (20023), Lavoie (2023), Eladio (2023), and Pressman (2023). There are up to four possible explanations that have been mentioned and discussed. First is the classical excessive demand argument. The second one is based on the role of industry concentration and imperfect competition, which allows firms to increase their markups (profit inflation). The third thesis is associated with rising inflation being caused by excessive wage increases. The fourth one blames inflation on the rising price of unit material costs, or raw materials and intermediate goods. These are goods whose prices are a markup on all costs.

The excessive demand explanation rests on the view that inflation today is mainly the result of the overly-generous support programs of the government during 2020 and 2021, during the COVID-19 pandemic. This argument is buttressed by the fact that these government deficits were in large part financed by central banks (including BSP in the Philippines), thus leading to excessive creation of money—an explanation reminiscent of monetarism, the dominant view of the inflationary acceleration in the 1970s. In this view, inflation is always and everywhere a demand phenomenon and requires contractionary monetary policy to be kept under control. This narrative links current inflation to excess demand due in part to a scarcity of supply arising from the COVID pandemic. The apparent difficulty of firms to find employees (also heard in the Philippines) is given as evidence that the economy is running overly close to full employment and potential output, thus justifying the claim of excess demand and the recent restrictive actions of central banks.

This story has been played somewhat in some circles in the Philippines, given that the budget deficit hit 7.6% of GDP in 2020 and 8.6% in 2021. The Administration of President Marcos Jr. is set on reducing the budget deficit to 3% of GDP and the national debt to about 51% of GDP (from the current 60.7%) by 2028. It is also shown in the actions of BSP (increase in its policy rate). This is further discussed in Appendix 3. Nevertheless, it is worth noting that Government intervention during 2020 and 2021 (COVID-19) was much smaller than that seen in other Asian countries (Yap, 2023). Yet, as ADB (2021, see Tables 19 and 20) documents, the actual package per capita was in line with its income per capita.

The second explanation that has been debated focuses on industry concentration and imperfect competition. During the COVID pandemic, researchers from the International Monetary Fund (IMF) predicted that dominant firms would become more entrenched in their market positions and will continue to exercise corporate market power due to market consolidation resulting from the high incidence of bankruptcies of small and medium-scale enterprises (Akcigit et al. 2021). The COVID pandemic and the Russia-Ukraine war, with their detrimental effects on bottlenecks in the supply chains of manufacturing and on agricultural and energy prices, have given a rising impulse to price inflation. This argument is probably the preferred explanation of inflation in the Philippines. Linked to this second explanation is the argument that the initial impulse given by the supply bottlenecks has been followed by an additional effect that has sustained or amplified the inflation rate. This additional effect, called profit inflation, is the result of firms with some market power taking advantage of the confusion amongst buyers and consumers arising from the distorted information provided by quickly rising prices, thus seizing the opportunity to raise their markup rates. We are not aware that this point has been raised in the Philippines.

To understand this latter point, we must note that recorded inflation as an increase in the CPI is *always* the result of firms' decisions to increase prices. If firms did not increase prices, there would be no inflation. Price increases are certainly legitimate. What we must understand is the process. The typical firm in the manufacturing sector sets its prices as a markup on its costs, the most important of which are the unit labor costs (the ratio of the nominal wage rate to labor productivity) and materials. Therefore, the increase in prices (inflation) is the result of the sum of three components (any one of them or all): (a) the increase in the markup; (b) the difference between the increase in the nominal wage rate and the increase in productivity; and (c) the increase in the price of materials. Understanding inflation this way brings to the fore the distribution of income between firms and workers as the underlying cause of inflation. This is so because the markup is related to the share of profits in revenue, whereas the wage rate and productivity are related to the share of wages (both shares add up to one). Inflation arises because firms and workers try to maintain or increase their respective positions in terms of the distribution of income (wage and profit rates and their shares).

Suppose the price of oil increases, which would lead to an increase in a firm's costs. For this to translate into inflation, the firm must pass on the increase to the final product, the price consumers pay. However, the firm may not necessarily increase prices. Strategically, it may behave this way to gain market share if it thinks the competition will increase prices. This way, it may steal customers and compensate with an increase in volume. A second option is to pass on to the final price (the price consumers pay) exactly the increase in its costs. The third option is to increase the markup in the face of poor information and uncertainty (nobody knows exactly how much the price of materials increased). This will lead to an increase in the share of profits (and a decrease in the share of wages).

There is evidence of the weight of this second explanation in some developed countries by looking at the sharp increase in profits, the rising profit share in national income, and the higher profit margins observed among non-financial corporations. This is clear in industries such as oil, which have benefitted from higher profit margins. Yet, the current inflation problem may not be due to a general rise in profit inflation. The reason is that we have seen profits rising for decades. This has been well documented in developed countries, where in many of them, wages flattened while worker productivity continued to rise.

The distributional aspect of inflation has not surfaced in the discussions of inflation in the Philippines (at least directly, although it is implicit in recent remarks by Diwa C. Guinigundo (2023), former deputy governor for the Monetary and Economics Sector, BSP), although possibly (we put it this way because it is very difficult to calculate the shares properly) the share of wages in GDP and real wages declined during COVID. The fall in real wages is the result of the fact that nominal wages have not managed to catch up with prices. This means that the distributional aspect of inflation driven by wage catch-up may be the next step in the inflation process. Is this what BSP is trying to avoid by hiking interest rates? It is difficult to test this hypothesis as there are no data on firms' markups, wage rates, and productivity. Yet, it is important to consider it in the discussion.

The third possible explanation of inflation is the other part of the pricing model described above, namely excessive wage increases. Given that the variable that matters is unit labor costs, the story has to be that nominal wages have increased faster than labor productivity. There is not a great deal of evidence of large wage increases, at least so far. We do not have good data to check this. We think that productivity has not increased in the very short period being discussed. Although wages probably did not increase during the pandemic, they may have started increasing now, but by how much and above productivity is less clear. What we have been observing in the last two years is a pass on of rising energy prices to final goods and services prices in order to protect profit rates. We do not think there have been "second-round" effects, that is, wages increasing above average CPI inflation.

The above points to the fact that, if there is a problem—it is not very rapid wage increases but low productivity growth. If this was negative, it would have directly contributed to inflation by pushing up the cost of producing goods.

We think the current inflation problem in the Philippines is largely a productivity growth problem caused by COVID-19, and exacerbated by small-firms' low organization capabilities; and combined with an inefficient distribution system, especially for agricultural products. This is probably a more serious cause of inflation than higher markups, greater profits, or high wage growth.

It has been documented that the pandemic resulted in more people working from home with less managerial supervision (also seen in the Philippines). As economies reopened in late 2021 and 2022, many workers accepted new jobs, which required some training and learning. Also, there were significant labor shortages as economies reopened following COVID. Some businesses decided to hoard workers during 2020 and 2021, keeping them on the payroll even though they were not needed. In these cases, the decline in labor productivity growth should be temporary. Once workers get trained and used to their new jobs, once workers spend more time at the office, once inefficient firms disappear, and once labor shortages are reduced, labor productivity should grow and inflation should fall.

Another possibility is that COVID changed the mindset of workers. People are no longer willing to work as hard as possible (indeed, many young Filipino workers demand very comfortable working conditions). They want to enjoy life more and may even be willing to accept lower wages in exchange for a more balanced lifestyle. This story, if true, portends little labor productivity growth and continued inflationary pressures. In addition, learning losses are believed to affect the future productivity of affected students when they join the workforce, thereby resulting in high expected earnings losses.

The final explanation entertained is that inflation has been the result of the increase in the price of unit material costs, or raw materials and intermediate goods. These are goods whose prices are a markup on all costs. Under these circumstances, rising profit shares need not be the consequence of rising profit rates or markups. This can happen, we stress, in the presence of fixed costs (e.g., overhead labor) combined with increasing output—unit total costs decrease as output rises, with direct labor productivity being constant—or when the price of imported inputs (intermediate goods or raw materials) rises. Why should the increase in the price of intermediate goods and raw materials rise more than that of final goods? One possibility is COVID. During 2020 and 2021, there were plant shutdowns and slowdowns that restricted supply and led to higher prices and profits.

Summing up, although we think the trigger of inflation in the Philippines was the combination of COVID-19 and the Ukraine war, these may have been compounded by low productivity growth, though we stress there is no data to test this, and an inefficient distribution system. It would be good if evidence could be gathered to deepen our understanding of the causes of inflation.

Now that energy prices are falling, inflation is receding. However, because the prices of goods and services are rather rigid downwards, this fall in costs will lead to true rising sectoral profit rates that will have to be offset through rising nominal wages in the near future.

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Appendix 2: Spatial Inflation

This appendix analyzes the spatial aspects of inflation. First, we show the contributions of various components to the inflation rate in the Philippines and areas outside of the National Capital Region (NCR). We use accumulated changes in inflation as our key measure to document how regions and cities were able to respond to inflation. Afterwards, we focus on inflation in the provinces and explore disparities.

Table A2.1 indicates that between February and March 2023, overall inflation (all items) declined by one percentage point. The major expenditure items, Food and non-alcoholic beverages, Transport, furnishing, household equipment, and routine household maintenance, registered significant declines.

Table A2.1

Contributions of different components of the Consumer Price Index (CPI) to month-to-month changes in inflation in the Philippines, February-March 2023

Components	Weights (%)	Feb-23	Mar-23	Difference	Weighted Difference
All items	20.3	8.7	7.8	-1.0	-0.2
Food and non-alcoholic beverages	6.0	11.6	9.3	-2.3	-0.1
Alcoholic beverages and tobacco	0.4	6.4	7.9	1.5	0.0
Clothing and footwear	0.5	3.2	3.1	-0.1	0.0
Housing, water, electricity, gas, and other fuels	5.6	7.7	7.9	0.2	0.0
Furnishings, household equipment, and routine household maintenance	0.7	6.9	6.4	-0.5	0.0
Health	0.5	2.2	2.2	0.0	0.0
Transport	1.6	10.8	6.2	-4.6	-0.1
Information and communication	0.9	0.3	0.2	-0.1	0.0
Recreation, sport, and culture	0.2	3.8	3.5	-0.3	0.0
Education services	0.5	8.1	8.1	0.0	0.0
Restaurants and accommodation services	2.6	10.9	11.0	0.2	0.0

Financial services	0.0	0.0	0.0	0.0	0.0
Personal care and miscellaneous goods and services	0.9	3.5	3.3	-0.2	0.0

Source: Authors' calculations using CPI data from PSA.

In areas outside the NCR, the inflation developments are consistent with national-level developments. Transport accounted for the biggest declines in areas outside NCR, followed by housing, water, electricity, gas and other fuels, food, and alcoholic beverages. Sources of inertia to downward adjustment include alcoholic beverages, tobacco, personal care, and miscellaneous goods and services (see Table A2.2).

Table A2.2

Contributions of different components of the Consumer Price Index (CPI) to changes in inflation in areas outside of the NCR, February-March 2023

	Weights (%)	Feb-23	Mar-23	Difference	Weighted Difference
All items	79.7	8.5	7.5	-1.0	-1.0
Food and non-alcoholic beverages	31.8	10.5	9.3	-1.3	-0.5
Alcoholic beverages and tobacco	1.8	11.8	13.0	1.1	0.0
Clothing and footwear	2.6	5.1	5.3	0.2	0.0
Housing, water, electricity, gas, and other fuels	15.8	8.9	7.4	-1.5	-0.3
Furnishings, household equipment, and routine household maintenance	2.6	5.9	6.0	0.2	0.0
Health	2.4	4.2	4.2	0.1	0.0
Transport	7.4	8.5	5.1	-3.5	-0.3
Information and communication	2.5	0.9	0.9	0.0	0.0
Recreation, sport, and culture	0.8	4.6	4.8	0.2	0.0
Education services	1.5	2.1	2.1	0.0	0.0

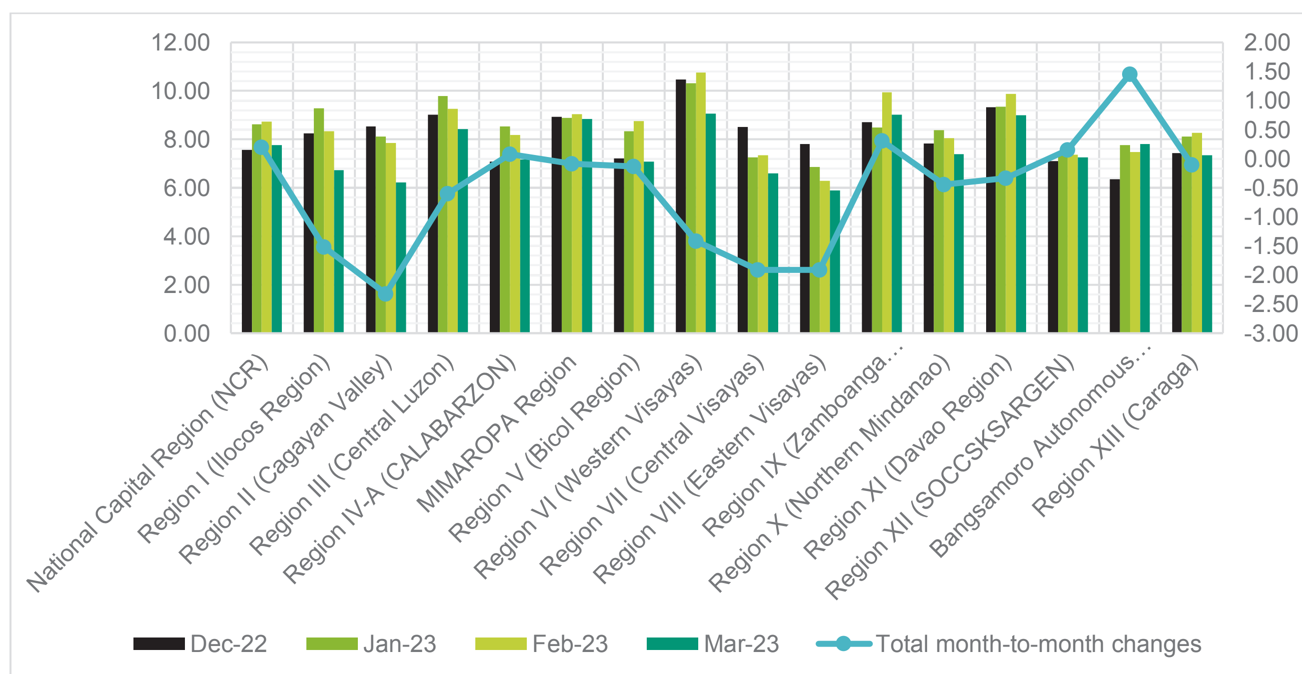
Restaurants and accommodation services	7.0	7.1	7.3	0.2	0.0
Financial services	0.0	0.0	0.0	0.0	0.0
Personal care and miscellaneous goods and services	3.6	5.8	6.1	0.4	0.0

Source: Authors' calculations using CPI data from PSA.

Once we focus on regions outside the NCR, we get a different picture. Focusing on individual regions, Figure A2.1 shows inflation across regions, and Figure A2.2 shows inflation across a selected number of cities nationwide. There is evidence of downward price rigidity. For instance, Figure A2.1 shows that data on accumulated month-to-month changes in inflation from December 2022 to March 2023 varied within the percentage point interval of (-2.32, 1.46). BARMM registered the biggest accumulated month-to-month change in inflation, +1.46 percentage points, followed by Central Luzon, +0.60 percentage points. In contrast, Cagayan Valley, the home of vast agricultural plantations, registered the best outcome, -2.32 percentage points.

Figure A2.1

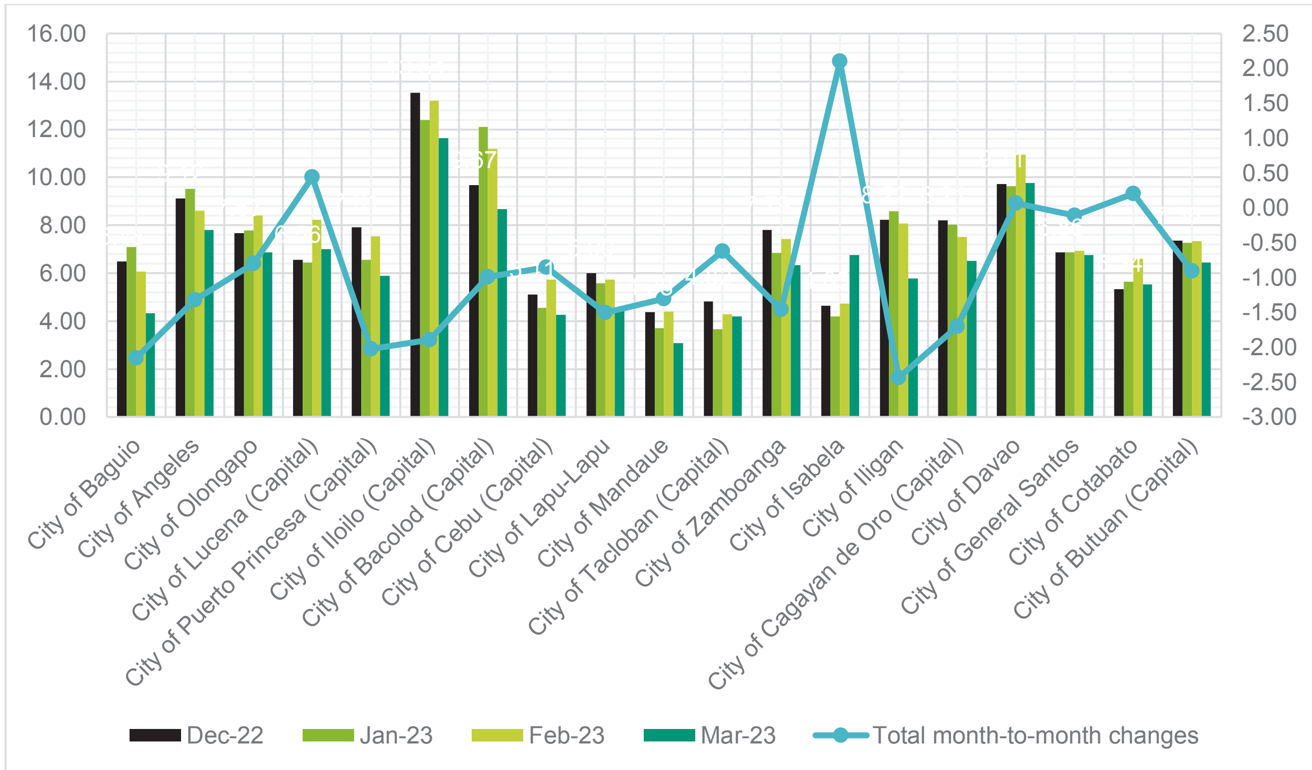
Inflation rates, accumulated month-to-month changes in Philippine Regions



Source: Philippine Statistical Authority

Figure A2.2

Inflation rates, accumulated month-to-month changes in select Philippine Cities



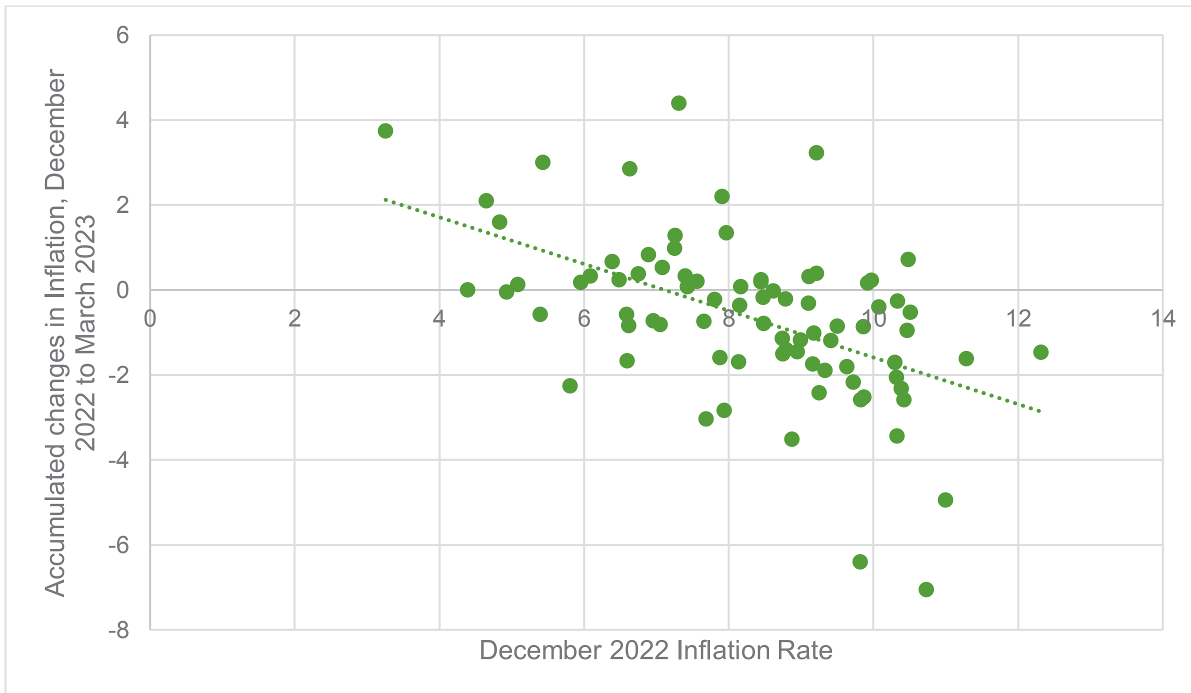
Source: Philippine Statistical Authority

Similar patterns are observed in a selected number of cities outside of the NCR. For example, the city of Iligan topped the list with accumulated month-to-month changes in inflation, -2.44 percentage points, followed by Baguio City, -2.16. Some cities in Mindanao have yet to be more successful in achieving significant accumulated month-to-month changes. These are the cities of Isabela, +2.10 percentage points, and Cotabato, +0.20.

To analyze with inflation in the provinces, we use the accumulated changes in inflation measures. Figure A2.3 shows the relationship between the inflation rate in December 2022 and the accumulated change in inflation between December 2022 and March 2023. The relationship is negative, that is, provinces with a higher inflation rate in December 2022 have experienced lower changes in inflation.

Figure A2.3

Association between Accumulated Changes in Inflation and the December 2022 Inflation Rate

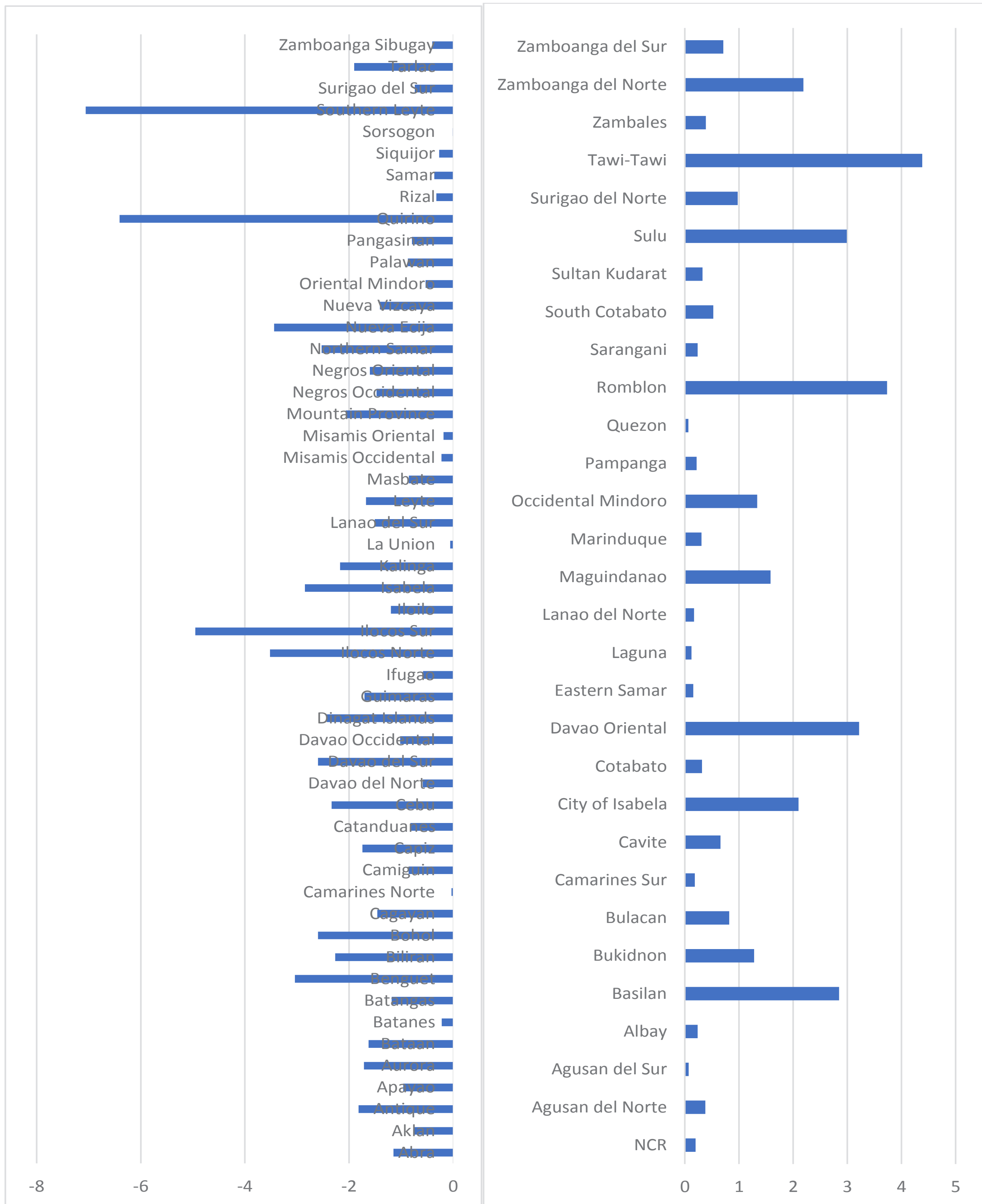


Source: Authors' calculations using Monthly CPI data from the PSA.

Figure A2.4 shows provinces where inflation has increased and provides where inflation has declined between December 2022 and March 2023.

Figure A2.4

Accumulated Changes in Inflation



Source: Authors' calculations using Monthly CPI data from the PSA.

Finally, we have investigated: (i) the direction of spatial correlation. Positive spatial correlation indicates that a province in a cluster of provinces with high-inflation experiences high inflation. Conversely, negative spatial correlation indicates that a low-inflation province may be situated in a cluster of high-inflation neighbors; and (ii) whether or not there are spillovers across regions, that is, the extent to which accumulated changes in inflation in one province are affected by the average accumulated changes in neighboring provinces. Key takeaways of the statistical analysis of provincial inflation:

1. Provinces with significantly negative accumulated inflation changes tend to be far from local clusters.

2. Provinces with higher inflation rates in December 2022 tend to have lower accumulated (or more negative) changes in inflation; that is, the association between the inflation rate in December 2022 and accumulated changes in inflation is negative.

3. There is convergence across provinces, that is, inflation rates tend to equalize.

4. We found negative spatial correlation, implying that provinces that could lower inflation may be neighbors of provinces that have struggled to achieve lower inflation. This is a result that requires further validation.

Appendix 3: Fiscal Deficit and Debt

Debt is the accumulation of budget (fiscal) deficits that correspond to bond issuance minus what is paid back. Although this is mechanically correct, it is important to highlight some key aspects of what it is, without which discussions about it often become problematic.

First, the finances of a sovereign government (one that issues its own currency) are radically different from those of a family or a firm. The latter two do clearly have a budget constraint. Sovereign governments do not have it (unless they self-impose it, which many governments do) because they operate with fiat money. A sovereign government can determine how much it spends in its own currency. Moreover, governments make payments by simply crediting accounts electronically (a transfer) or by issuing a check (never returned). Therefore, often-heard arguments such as ‘the government does not have money" are utterly incorrect. This does not mean that the government can spend without considering the implications for the economy. We will get back to this point later. It simply means that sovereign governments have "money".

Second, it is also wrong to think that the key interest rate in the economy is set by the intersection of the demand and supply of funds (the loanable funds model) and that a budget deficit leads to an increase in interest rates that crowds out the private sector and induces inflation. The reality cannot be further from the truth. First, the policy interest rate of the Philippines is set by BSP. BSP will supply Pesos at that rate. Second, a budget deficit is, in reality, excess liquidity in the system (government spending larger than what is collected from the public in the form of taxes). This will cause the Central Bank's overnight rate to fall. Once it has fallen below the target rate, the Central Bank will respond by selling bonds. In normal times, the Central Bank will have a limited supply of government bonds, and hence it can only sell the bonds that it has previously bought. So, in the presence of a fiscal deficit, the Central Bank would need the Treasury to create and sell more bonds in the primary market. The two institutions coordinate their operations to ensure that fiscal operations have minimal undesired impacts on banking system reserves. Hence, bonds will be issued more or less in line with the fiscal deficit in order to drain from the banking system excess reserves that result from spending above taxes. This casts doubt on the standard inflation argument. Government spending may be inflationary if it is not drained and brings the economy close to full employment.

Third, debt in the form of Treasury bills is owned by the private sector, which decided to exchange its liquid funds for an interest-bearing option. This was done because T-bills pay interest and because there is no default risk. A sovereign government always pays back.

Something completely different is debt issued in a foreign currency. This is the one developing countries should be concerned with, as in order to pay it, the country must have earned the foreign currency via exports or investment inflows. In the Philippines, 32% of the national debt is in foreign currency; that is, most government debt is in Peso. We are sure the Philippine government will not default on this one.

Fourth, interest payments on debt are part of the private sector's disposable income. Attempts to reduce these debt payments will have a direct impact on disposable income (will decline), the main determinant of private consumption.

Fifth, one cannot analyze the fiscal deficit (taxes minus government spending) without considering the other two important sectoral balances of the economy, namely that of the private sector (saving minus investment) and that of the external sector (the current account). This is so because, by construction, the three balances add up to zero. History indicates that a continued deficit in the private sector is an indicator or signal of a crisis. This means that the private sector needs to be in surplus (saving greater than investment) to avoid a crisis. Economies that run a current account deficit need the government to run a fiscal deficit to compensate for it. In the simplest case, think of an economy with a balanced current account. It is self-evident that the only way for the private sector to be in surplus is if the government runs a fiscal deficit.

What this also implies is that the reduction in the fiscal deficit and debt planned by the Philippine government until 2028 depends on the saving decisions of the private sector. The fiscal outcome of a nation is the result of a combination of the discretionary policy choices taken by the government and the spending and saving behavior of the non-government sector (outside the power of the government). In other words, the government can decide how much it can increase spending and, ex-post, we will observe some combination of increased tax revenue (the degree to which taxes rise will depend on the responsiveness of tax revenue to rising aggregate spending and income), increased bonds held by the private sector, and increased monetary base (money holdings, or reserves held by banks and cash held by the non-banking private sector). The latter two will be identical to the fiscal deficit, and the split between the two will depend on the preferences for interest-earning assets, given the overnight interest rate set by the Central Bank policy.

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