



DLSU REPORT OF THE PHILIPPINE ECONOMY

March 2026

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We maintain our February forecasts while we wait for additional evidence and for the air to clear

Our March 2026 forecasts (shown in Table 1) are the same as those in our February report. The updated indicators that feed our forecasting model clearly confirm that the economy decelerated during the last part of 2025—even more than our forecasts indicate. Our model has been gradually capturing this slowdown as the indicators have been updated. At present, the indicators still refer to 2025. For this reason, we have decided to maintain the forecast until we get further and new evidence to revise our estimates.

Table 1: Year-on-Year Growth Rates (%)
Actual (2025) and Forecasts (Q1-Q4 2026, 2027-2028)

	2025 ^a	2026				2026	2027	2028
		Q1	Q2	Q3	Q4			
GDP	4.4	2.5	3.8	4.5	5.9	4.19	5.34	5.30
Private Consumption	4.6	4.1	4.0	4.5	6.6	4.81	4.95	4.53
Government Expenditure	9.1	6.0	10.9	13.2	13.6	10.88	13.06	12.73
Gross Fixed Capital Formation	0.5	-10.2	-10.3	-9.1	-7.3	-9.25	-5.83	-6.85
Exports	8.1	12.5	15.3	15.7	12.9	14.09	10.68	12.08
Imports	5.1	5.3	7.6	8.7	8.5	7.52	6.36	7.20
Agriculture	3.1	0.6	0.4	0.5	0.6	0.55	0.46	0.31
Industry	1.5	-0.4	0.3	1.8	2.6	1.10	1.33	0.65
Service	5.9	4.0	5.8	6.3	8.0	6.01	7.62	7.71

Source: Philippine Statistics Authority (actual), DLSU High-Frequency Model of the Philippine Economy (forecasts)

Notes:

- (i) a — Actual values (Philippine Statistics Authority)
- (ii) The forecasts generated by the DLSU High-Frequency Model of the Philippine Economy are based on the Seasonally-Adjusted National Accounts.

From a slow start in Q1 2026 (2.5%), we expect economic expansion to accelerate by 3.8% in Q2 and by 4.5% in Q3, eventually peaking at 5.9% in Q4. Full-year growth for 2026 is anticipated to settle at 4.19%, which lies below the re-revised target of 5.0-6.0%. Looking ahead, the economy is predicted to expand by 5.34% in 2027 and by 5.30% in 2028—both of which still lie below the government target of 5.5-6.5%.

The Philippine High Frequency Model of De La Salle University (DLSU) generates monthly and quarterly forecasts of the Quarterly National Accounts, reported by the Philippine Statistics Authority. The model uses Quarterly National Accounts and over 50 monthly indicators. The process involves pooling the indicators into factors used for predicting both the National Accounts and the indicators themselves. The predicted values of the National Accounts undergo disaggregation and benchmarking to obtain the forecasts. This report presents the actual and forecast year-on-year (y-o-y) and quarter-on-quarter (q-o-q) percentage changes of the National Accounts, and y-o-y growth rates of the indicators, based on the latest available information.

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We anticipate consumer spending to moderate during the first two quarters of 2026. Household expenditure is projected to mellow at 4.1% in Q1 2026 and 4.0% in Q2 2026. A gradual recovery is expected in the second half of the year as growth improves to 4.5% in Q3 and 6.6% in Q4, resulting in an estimated full-year growth of 4.81% in 2026. The momentum is predicted to carry over into 2027 with a 4.95% growth before moderating to 4.53% in 2028.

Consistent with our previous reports, our forecast maintains a subdued outlook for gross fixed capital formation. Bank lending growth was also reported to have slowed to 9.3% in January 2026, the slowest pace observed in 23 months (since the 8.7% growth recorded in February 2024). According to recent data from the Bangko Sentral ng Pilipinas (BSP), FDI net inflows slumped to a five-year low of \$7.791B in 2025 (-17.1% y-o-y). Investments in debt instruments, which include intercompany borrowing or lending between foreign direct investors and their subsidiaries or affiliates in the Philippines, also fell 27% year-on-year in 2025. Both indicators explain the dismal capital formation growth in 2025 (0.5%).

Against this backdrop, we believe that government spending must play a pivotal role in driving economic growth amid prevailing uncertainties. As the government has begun resuming several infrastructure projects, stalled due to corruption scandals, our model predicts that fiscal expenditure will increase by 6.0% in Q1 2026 before returning to double-digit growth in the succeeding quarters (10.9% in Q2, 13.2% in Q3, and 13.6% in Q4). Full-year growth is projected to close at 10.88% in 2026. Strong public spending is also expected to be sustained in 2027 at 13.06% and 12.73% in 2028.

The external sector has been serving as an important buffer from the recent economic shocks. Amid the continued depreciation of the Philippine peso, export performance is projected to strengthen across all quarters of the year. The recently signed agreement between the Philippines and Cambodia aims to reduce to 10% the withholding tax on technical services offered by Philippine companies to Cambodia. Short-term projects (spanning six months or less) related to engineering and construction will not be taxed. The Philippines is also hoping to conclude its negotiations with the European Union (EU) on a free trade agreement. With this, from a strong performance in Q1 2026 (12.5%), export growth is expected to peak at around 15% in the second and third quarters (reaching 15.3% in Q2 and 15.7% in Q3) before slightly decelerating at 12.9% in Q4. Full-year growth is predicted to close at 14.09% in 2026.

Meanwhile, import growth is anticipated to expand at a slower pace in the first quarter of the year at 5.3%, with a consistent rise in the next three quarters (7.6% in Q2, 8.7% in Q3, and 8.5% in Q4). Annual growth is expected to settle at 7.52% in 2026. Looking ahead, the trade sector is expected to stay resilient despite uncertainties in the global economic landscape. In the medium term, export growth (10.68% in 2027 and 12.08% in 2028) will consistently outpace import growth (6.36% in 2027 and 7.2% in 2028).

On the supply side, agricultural output is expected to remain muted in the near term. Growth in the agricultural sector is projected to reach only 0.55% in 2026, with quarterly expansion remaining under 1% throughout the year. The trend is expected to continue in the next two years as growth further decelerates to 0.46% in 2027 and 0.31% in 2028. Recently, the Philippine government gained access to foreign grants amounting to PhP 4.44 B and loans amounting to PhP 177.61B. These financial resources will be allocated for programs to improve farm productivity, crop diversification,

and agricultural logistics, among others. Thus, we expect these forecasts to change since most of the aforementioned projects will be launched this year and in 2027.

Such weakness, however, is likely to be offset by a robust output growth in the service sector. Despite a slight deceleration to 4% in the first quarter of 2026, quarterly growth will rebound towards the last three quarters of the year, peaking at 8.0% in the fourth quarter. As a result, full-year growth will settle at 6.01% in 2026. Similar to previous forecasts, the service sector is anticipated to constantly outperform other sectors, expanding by 7.62% in 2027 and 7.71% in 2028.

In contrast, fragility in the industrial sector remains. Industry output growth is projected to contract by 0.4% in Q1 2026, followed by a minimal recovery in the subsequent quarters of 2026 (0.3% in Q2, 1.8% in Q3, and 2.6% in Q4). Growth is expected to remain pale in the medium term, reaching only 1.33% in 2027 before easing again to 0.65% in 2028. Such a muted outlook is broadly consistent with the foreseen dip in investment activity, particularly in gross fixed capital formation.

As mentioned earlier, our estimates for this monthly release remain unchanged. We are also cautious because of the Iran–US–Israel war that started at the end of February. Oil prices have increased and there is a risk that the conflict may spread. We are also cautious because the BSP decided to lower the policy rate recently (to 4.25%) just before the conflict started, to help the economy in the face of the corruption scandal. Governor Remolona stated that monetary policy cannot do more to revive the economy. He argued that the country needs a fiscal push. This opens three questions: (i) how much will the decrease in the policy rate contribute to restoring growth?; (ii) if inflation picks up as a result of an increase in oil prices, will BSP reverse the recent decrease?; and (iii) what is the fiscal policy that the country is willing to implement? We address these issues in the following sections.

Growth constraints and an impending policy dilemma

The Philippine economy faces a weaker growth trajectory this year, with the Department of Economy, Planning, and Development (DEPDev) acknowledging that growth may be below 5%. Such downward revision reflects the convergence of three mutually exclusive reinforcing constraints: a tightening credit environment, oil-driven inflationary pressures, and a still-impaired infrastructure pipeline. Taken together, these factors simultaneously suppress investment, erode household purchasing power, and a government that, unfortunately, thinks that it has a narrow fiscal space—with the latter compounded by corruption-related disruptions that exacerbate economic pessimism.

Using this context, some indicators offer a more nuanced near-term picture. The Purchasing Managers' Index (PMI) rebounded in January, signalling a tentative improvement in business conditions. Broad money supply (M3) grew at 8.6% year-on-year (the highest in five years), suggesting ample liquidity in the financial system. Consumer loan growth reached 21.3% year-on-year, credit card lending increased by 27.7%, and auto loans grew by 14.9%. Though these figures may partially cushion short-run growth, they also constitute a double-edged signal: consumption is being sustained by household borrowing, perhaps more than from wage increases. Authorities ought to monitor private debt.

At present, the ongoing conflict in the Middle East remains the primary source of global external risk. The per-barrel price of oil has rapidly climbed over the past weeks, with projections that it may reach \$140—a level that would drastically alter the inflation outlook and amplify the growth constraints. This fuel price shock directly feeds into firms' production costs, dampening business confidence and

contributing to the contraction in capital formation. The cost will be passed on to households. Beyond its inflationary impact, the heightening tensions endanger many overseas Filipino workers in the Middle East and their remittance flows amounting to about \$30 billion. Threats on this critical consumption line for millions of Filipino households compound their already-deteriorating purchasing power due to foreseen inflation spikes, further undermining the role of private consumption to usher in rapid economic expansion.

Several legislative responses have already been filed in Congress to mitigate these pressures. An excise tax bill (HB 8418) has already passed the second reading. A proposal to reduce the value-added tax rate from 12% to 10% is also being pushed forward. While aiming to ease household burden and support consumption, the effects of such measures are unlikely to immediately take effect. These policy responses are also not guaranteed to fully offset the inflationary impacts of the oil price shock.

More importantly, the recent economic slump and the brewing inflation now pose a policy dilemma on the side of the BSP—and three possible policy paths are slowly emerging. First, the default case remains an extended hold. The BSP may pause its easing cycle while assessing whether oil price shocks are transitory or sustained before committing to a specific move. Second, rate cuts remain technically viable (despite Governor Remolona's statements), but only under certain conditions: (i) a rapid de-escalation of the Iran conflict, (ii) timely implementation of the excise tax suspension to dampen headline inflation, and (iii) a sharp deterioration in growth that overrides inflation concerns. The third path is a rate hike. This emerges as a reasonable decision. Baseline inflation projections (that even exclude worst-case oil price scenarios) now support the case for monetary tightening. This is due to the possibility of inflation reaching 4% once oil prices hit over \$100 per barrel (already there) and remaining at this level for some time. The Philippine peso has also been depreciating, adding an exchange rate dimension to the inflation risks. Thus, a possible rate hike has moved from an unlikely outcome to a plausible policy option—for the first time in over two years.

These constraints highlight a broader point, something that our previous monthly reports have repeatedly raised, and that Governor Remolona explicitly mentioned in a recent statement: monetary policy alone is insufficient to restore economic confidence, especially in an environment beset by serious governance issues.

The BSP Governor's call for fiscal policy to retake the central role in propelling economic expansion is a recognition that restoring confidence requires credible action on governance and public investment. Recently, the government has sought to signal its commitment to structural reform through efforts to improve ease of doing business and measures to enhance sector competitiveness. The Philippines has also signed a memorandum of understanding with South Korea, covering priority industries that include shipbuilding and energy. These are indeed noteworthy efforts to augment capital formation, deepen the economy's productive base, and increase the economy's resilience to external shocks.

However, the credibility of these signals remains in question. The government must now confront the elephant in the room: resuming infrastructure-related spending and rolling out appropriate industrial reforms while simultaneously demonstrating that public resources are being deployed with integrity. This is not simple in a country that is wary of running fiscal deficits. Unless these qualms are put to rest, a new chapter of uncertainty worsened by external factors commences—and stagflation becomes a looming, inevitable reality.

A New World Order based on chaos

In recent years, the global economy has seemed to master the art of absorbing repeated blows without quite knowing where the next one will come from—constantly rewriting its plans on the fly while somehow managing to stay on its feet. Since the severe pandemic of 2020 and the economic coma it briefly induced, the world economy has faced one shock after another without falling into a generalized recession. After the pandemic came Russia's invasion of Ukraine, which triggered an energy shock that, together with disrupted supply chains, produced the worst inflationary surge in four decades.

Central banks responded with sharp increases in interest rates—moves that in the past often triggered deep economic crises. Yet the outcome was something many economists had considered almost miraculous: disinflation and a soft landing.

Then, Donald Trump took over the White House as President of the United States, for the second time, in January 2025. He landed with a set of policies that defy the *status quo* that has defined world relations, economics, and politics, since WWII namely multilateralism. As a result of the fact that not all countries across the world are the same in terms of power, there was respect for the rules of the game. However, Mr. Trump has been defiant in key areas that until now were under the realm of multilateralism: trade, natural resources, and climate change. We do not know yet how far he will go and how his policies will reshape the world.

Mr. Trump's policies have brought back to center stage an economic worldview that is surprisingly realistic: mercantilism. In this sense, Mr. Trump has sent the world 300 years back in time. His objective is to eliminate the American current account deficit, which he thinks is unfair and damages the American economy. This is a question of multilateralism versus predatory behavior. To solve this issue, he substantially increased import tariffs on virtually all nations across the globe. Second, Mr. Trump needs to secure the supply of natural resources that are key to the production of modern technologies. This is also a matter of predatory behavior and of ignoring that natural resources are scarce and finite.

The result is that economic uncertainty increased dramatically during 2025, which materialized in a relatively low worldwide growth rate. We are yet to see what happens after the Supreme Court's decision to strike down US President Donald Trump's tariffs on US imports imposed in 2025.

One year later, in late February 2026, the United States and Israel launched military strikes against Iran. It is increasingly clear that this is not another episodic confrontation of the kind that has punctuated the region in recent years. What is unfolding instead resembles the opening stage of a broader war. Strikingly, only a day before the first missiles were fired, Iranian and American officials were still meeting in Geneva in an effort to negotiate an agreement that might avert conflict.

The United States and Israel appear determined to reshape the political map of the Middle East. The method chosen is a forceful and risky military gamble—one whose long-term consequences could be profound and whose first effects are already being felt across the global economy.

Iran's theocratic regime is hardly a model of political freedom or civil rights. Yet, the prospect of its collapse cannot justify the scale of destruction now beginning to take shape, the loss of additional civilian lives, and the growing risk of a wider regional conflagration. Such an escalation would not

remain confined to the Middle East. It would carry potentially severe consequences for global economic stability, including the energy markets on which much of the world still depends.

Meanwhile, Russia has not only carried out an illegal invasion of a sovereign country—much as the United States did in Iraq—but has gone further by crossing the red line of seeking the annexation of Ukraine, opening what could prove to be a dangerous Pandora’s box.

The rules-based multilateral order that made modest advances after the end of the Cold War is now buckling under a fierce assault from multiple directions.

As Spain’s Prime Minister Pedro Sánchez warned in a speech on 4 March 2026, in which he positioned Spain against the war, “we must learn from history” and “we cannot play Russian roulette with the fate of millions.” He also recalled a telling historical episode: in 1914, when asked how the First World War had begun, the German chancellor Theobald von Bethmann-Hollweg reportedly replied, “*Oh, if only I knew!*”

The Strait of Hormuz and the Risk of a New Energy Shock

Energy crises rarely announce themselves clearly. There is no precise moment when rising prices suddenly become a crisis. But certain thresholds tend to trigger an alarm. Oil at \$100 per barrel or gas prices around \$30 per MMBtu—levels last seen during the upheaval following Russia’s invasion of Ukraine in 2022—are among them.

The first week of renewed conflict in the Middle East has not yet produced an energy shock on that scale. Supply disruptions remain more of a risk than an immediate reality. Yet markets have already begun to react, and the consequences are spreading through the global economy. Energy prices are rising, inflation expectations are adjusting upward, and financial markets are becoming more volatile. The warning issued on 6 March by U.S. President Donald Trump—that no agreement with Iran will be possible “unless there is unconditional surrender”—hardly suggests a rapid easing of tensions.

Consumers are already feeling the effects. Gasoline prices have recorded their sharpest increase in eight months, electricity costs are creeping upward, and maritime freight rates are climbing as shipping companies impose surcharges that in some cases double the cost of transporting containers. If the conflict persists, the economic impact could broaden, affecting employment and investment. Financial markets are already adjusting to the new uncertainty. Just before the conflict erupted, the Bangko Sentral ng Pilipinas (BSP) had begun lowering its policy rate as inflation pressures eased and growth expectations for 2026 worsened. A renewed surge in energy prices, however, could complicate that trajectory. If higher oil and gas costs feed into domestic inflation, the central bank may have to reconsider the pace of monetary easing.

At the center of the turmoil lies the Strait of Hormuz, one of the most critical chokepoints in the global energy system. Roughly one-fifth of the world’s oil supply passes through this narrow corridor, along with large volumes of refined fuels, petrochemical inputs, fertilizers, and around 20% of global liquefied natural gas (LNG)—a crucial fuel for electricity generation across much of the world. Shipping traffic through the strait has slowed sharply, sending tremors through commodity and financial markets alike. The price of Brent crude has jumped and surpassed \$100 per barrel, while global equity markets have recorded their worst week since the outbreak of the Ukraine war.

Gas markets have reacted even more dramatically. LNG prices have surged following disruptions to Persian Gulf supply routes. Qatar, one of the world's largest LNG exporters, has warned that even if hostilities ended immediately it could take weeks or months to restore normal export flows after recent drone attacks. The temporary shutdown of the Ras Laffan LNG terminal, the largest liquefaction facility in the world, has further amplified market anxiety. Even so, current energy prices remain below the extraordinary peaks reached during the Ukraine war, when gas briefly approached \$100 per MMBtu and Brent crude traded above \$120 per barrel.

How is it possible that oil prices have increased above \$100 per barrel while the oil that passes through the Hormuz Strait is just 20% of the world's total? The reason is that oil prices are set in the global market and respond to risk expectations, not only to current physical shortages. A disruption affecting even 20% of the supply can move prices dramatically. Here are the main reasons: (i) Oil demand and supply are very inelastic in the short run; (ii) Oil is traded in futures markets. Prices, therefore, reflect expected future supply; (iii) Hormuz is a strategic chokepoint. The 20% figure is misleadingly small because the oil passing through Hormuz is extremely important. Major exporters using Hormuz are Saudi Arabia, Iraq, Kuwait, UAE, Iran, and Qatar (for LNG). These producers account for a very large share of globally traded oil, not just production; (iv) Spare capacity is limited. Only a few producers can increase output quickly; (v) Strategic reserves and logistics take time. Countries have strategic petroleum reserves, but releasing them takes time; and (vi) Shipping and insurance costs rise immediately.

The implications extend well beyond the Middle East. Countries across Southeast Asia, including the Philippines, are particularly exposed to disruptions in Gulf energy flows. Much of the oil that ultimately supplies the Philippine economy originates in producers such as Saudi Arabia, the United Arab Emirates, Iraq, and Kuwait. Tankers carrying this crude typically exit the Persian Gulf through the Strait of Hormuz, cross the Indian Ocean, and pass through shipping lanes such as the Strait of Malacca before reaching Asian refineries or Philippine ports.

The Philippines' dependence on Middle Eastern energy operates through two channels. On the one hand, the country imports crude oil—about 98% of which comes from the Middle East. On the other hand, it imports refined fuels such as gasoline, diesel, and jet fuel mainly from Asian refining hubs including South Korea, Singapore, China, Japan, and Malaysia, which together account for roughly 97% of these imports. Yet these refineries themselves rely heavily on Middle Eastern crude. In practice, therefore, the country remains highly exposed to disruptions in Gulf energy supply.

If the crisis persists, competition for energy resources could intensify sharply. China, Asia's largest commodity importer, would inevitably seek additional supplies from alternative producers, pushing prices higher across global markets. Early signs of such competition are already visible. According to shipping data reported by Bloomberg, several LNG tankers originally bound for Europe have recently changed course mid-Atlantic to head toward Asian markets.

Oil price forecasts are becoming outdated almost as quickly as they are published. At the start of the conflict, Brent crude traded near \$80 per barrel; within days, it had surpassed \$100. Oil prices have reacted more gradually than gas markets—which surged sharply at the onset of the crisis—but pressure continues to build as shipping disruptions persist.

If producers cannot export crude by sea, they will eventually be forced to reduce output as storage facilities fill up. Iraq has already suspended part of its production, and Kuwait could soon face similar

constraints. Although Saudi Arabia and the United Arab Emirates possess pipelines capable of bypassing the Strait of Hormuz, their capacity is limited. In a worst-case scenario, some analysts warn that Brent crude could rise to \$120–130 per barrel. In fact, it reached almost \$120 on March 9. About an hour and a half before the close of Wall Street, U.S. President Donald Trump told Reuters that the war was “virtually over.” Following his remarks—and reports pointing to a possible seizure of the Strait of Hormuz—the price of Brent crude, the benchmark for European markets, dropped sharply, ending the session at around \$90 per barrel. For now, threats of retaliation and the intention to keep the Strait of Hormuz closed (Tehran reserves the right to protect its security) have had a greater impact on markets than the International Energy Agency’s (IEA) announcement that its member countries will release 400 million barrels of oil from strategic reserves. The irony of the current situation is that even as the Strait of Hormuz remains effectively under Tehran’s control—according to reports on Tuesday by The Wall Street Journal and confirmed by the maritime tracking firm TankerTrackers.com—Iran is exporting more oil than it did before the United States and Israel launched their attacks.

For consumers, the consequences would be immediate. Higher oil prices translate directly into higher transport costs and rising fuel bills, eroding purchasing power and feeding inflation. Even if the conflict were resolved quickly, some inflationary impact is already unavoidable. Fuel prices track crude oil closely, while gas markets remain under pressure from supply disruptions and geopolitical uncertainty. The appreciation of the U.S. dollar, which tends to strengthen during periods of global turbulence, further increases the cost of energy imports.

The energy shock triggered by Russia’s invasion of Ukraine in 2022 forced governments around the world to rethink the strategic importance of energy security and its relationship with geopolitics. The resulting surge in inflation was the most severe experienced in advanced economies in half a century and was widely felt across Asia as well. Barely four years later, the prospect of another global energy shock is once again coming into view.

The Need for a Fiscal Policy for Nation Building: why are we so reluctant?

We welcome the recent statement by the Governor of the Bangko Sentral ng Pilipinas (BSP), Dr. Eli Remolona, that fiscal policy must now play a more active role in supporting the Philippine economy. Monetary policy alone cannot do much more to stimulate growth. This remark came only days before the United States and Israel attacked Iran, a development that has already pushed energy prices upward again. It also followed BSP’s decision to lower the policy rate in an effort to support economic activity. The question now is whether the central bank might reconsider that decision if inflationary pressures return (discussed above).

While Governor Remolona’s remarks are welcome, they come too late. The Philippines has long lacked a coherent fiscal policy capable of providing the public goods the country urgently needs: modern infrastructure, quality public education, adequate public health services, addressing malnutrition, and designing a coherent industrial policy.

For decades, fiscal policy in the Philippines has been shaped by a strong aversion to deficits. The key economic departments, led by the Department of Finance, have traditionally been wary of running them, largely out of fear of repeating the fiscal mismanagement of the 1970s and 1980s. Fiscal deficits are believed to be inherently dangerous because they supposedly lead to inflation and higher interest rates, and thus crowd out private investment. In fact, during the years preceding the Asian Financial Crisis of 1997-98, the Philippines even ran fiscal surpluses. The current Philippine

Development Plan (PDP) 2023–2028 targets a reduction of the fiscal deficit to 3 percent of GDP. This fear is largely unjustified today. These fears are today reinforced by concerns that increased public spending might also increase opportunities for further corruption.

The basics of monetary policy in the Philippines

Though the focus of the write-up is fiscal policy, the reality is that this is intimately linked to what is commonly referred to as monetary policy and the role of the central Bank (BSP). Most people think that the two areas, while complementary aspects of economic policy, run separate courses. This is not true. Here we summarize the inflation-targeting framework and the interest rate corridor system that the BSP follows. Then, we show how interest-rate setting interacts with fiscal policy.

Policy thinking in the Philippines has long relied on the idea that monetary policy could support the private sector through the [inflation-targeting framework](#), adopted in 2002. Over the past four decades central banks have focused primarily on price stability. In the 1990s, central banks moved from targeting the growth of the money supply to targeting a policy interest rate under their control.

Supporters of the inflation targeting framework argue that this regime provides a credible anchor for inflation expectations and therefore helps stabilize the economy. If markets believe inflation will remain within a narrow range, unemployment can fluctuate significantly before inflation expectations become destabilized. In this view, inflation targeting improves the trade-off policymakers face between inflation and employment. Evidence of this, however, remains limited. It is also argued that inflation targeting increases the accountability of central banks.

In addition to adopting inflation targeting, the BSP introduced the [interest rate corridor system](#) in 2016. Under this framework, the central bank sets not only a policy rate—the reverse repurchase rate—but also a ceiling and a floor rate for short-term market rates. The ceiling is the overnight lending rate; the rate banks pay when borrowing reserves from the central bank. The floor is the overnight deposit rate, the rate the central bank pays on excess reserves deposited by commercial banks. The purpose of the corridor is to manage liquidity so that market interest rates remain close to the policy target. Interbank lending rates fluctuate within this corridor: no bank will borrow above the ceiling or lend below the floor.

Under the corridor system, the central bank supplies reserves to the banking system on demand in order to maintain financial stability. The supply of reserves is effectively horizontal at the ceiling rate. Yet many analysts still rely on outdated frameworks such as the loanable funds model—which assumes a fixed pool of savings—or the fractional reserve banking, according to which loans are mechanically determined by customers’ deposits. Both are incorrect in today’s monetary setting, and do not reflect the reality of the banking and monetary system.

Understanding how this framework interacts with fiscal policy

Let’s move now to the link with fiscal policy.

Fact 1: The first one concerns how government payments are actually made. Contrary to the standard and easy-to-understand rhetoric, according to which the government collects taxes and these are used to make payments, the truth is that the government does not spend using the taxes it collects, or the proceeds from bond issuance. Instead, whenever the Treasury instructs the BSP to make a payment (yes, the role of BSP is key here: BSP executes the payments, not the Department of Budget), the central bank creates new *reserve balances* —these are digital funds held by commercial banks

in accounts at the central bank, acting as the base money for the financial system. This is the ‘money’ created exclusively by the central bank for interbank payments and transactions. BSP generates reserve balances *ex nihilo* (literally, out of nothing). Every time Treasury instructs BSP to execute a payment, the latter simply uses its power to create new money (reserve balances). We insist: these payments are not taxes.

Fact 2: In the other direction, taxes paid by households and firms simply return to the Treasury’s account at the BSP and remain there—and are not reused. Deposits decrease in the corresponding bank accounts of households and firms when these pay taxes but their banks use reserve balances (which also decrease) to settle tax payments with the Treasury/BSP. It is true though that, by law, the Treasury’s account at BSP cannot fall to zero when payments are made. This means that taxes must be collected or bonds issued before payments occur, but this requirement reflects a self-imposed legal constraint, not a financial limitation of the central bank itself. The reality, **shocking to many**, is that taxes are not used to finance government spending.

The institutional framework established under [Republic Act 7653](#) (and [RA 11211](#)) makes the above clear. It is the same as in other nations.¹ Call BSP and ask.

Unfortunately, officials in some government departments are not aware of this and believe that taxes do pay for government spending. They are shocked when we show them the [interview to the Federal Reserve Bank Chairman Ben Bernanke in 2009](#), which we reproduce here (watch 7’57” to 8’15”):

“Scott Pelley (anchor): Is that tax money that the Fed is spending?

Chairman Bernanke: It’s *not tax money*. The banks have accounts with the Fed, much the same way you have an account in a commercial bank. So, to lend to a bank, we simply use the computer to *mark up* the size of the account they have with the Fed.” (our italics)

This does not happen in the United States because it uses a reserve currency. Nothing to do with this. It is how central banks operate. The Philippines’ BSP does the same thing. “Marking up” simply means that BSP increases the amount of this digital money on the liability side of its balance sheet, and credits a commercial bank’s asset side by the same amount, by changing a number on its ledger. Ouch...

Fact 3: The other crucial point is the fact that government spending creates, peso for peso, net financial assets for the private sector. Public spending ultimately appears as deposits in the accounts of households—for example through public sector wages—or firms, such as contractors building schools, hospitals, or other infrastructure. It is therefore **puzzling** when members of the private sector criticize fiscal deficits without recognizing that government surpluses would imply the opposite outcome: the private sector paying more in taxes than it receives in public spending, a situation that would have deleterious consequences for our economy. What an irony. One may have a negative view of the government for different reasons but it is unquestionable that government spending creates net worth in the private sector. Unfortunately, large segments of the private sector equate the fiscal deficit with a company losing money, or something along these lines, and hence think it is bad for the nation.

¹ We add that this description applies to the central government, not to the LGUs.

Fact 4: What happens then when the government runs a fiscal deficit—when government spending exceeds tax revenues? This appears in the banking system as excess reserve balances (because all payments from the government to the private sector and from the latter to the former are mediated through the banking system). This excess liquidity places **downward pressure on interest rates** because banks attempt to lend their surplus reserves to one another. Unless the BSP, in coordination with the Treasury, drains these reserves, the interbank rate will fall toward the floor of the corridor, rendering monetary policy (the corridor system) ineffective. To prevent this, the authorities issue government bonds—purchased primarily by banks—to absorb the excess reserves. These bonds are what we commonly refer to as public debt.

Fact 5: This has three implications: (i) Fiscal deficits cannot crowd out the private sector; (ii) government bonds are issued not because the government must borrow from the private sector to finance its spending, but because excess liquidity must be absorbed from the banking system; and (iii) although the initial government spending that creates a deficit may raise concerns about inflation, the subsequent bond issuance drains the excess reserves and neutralizes that pressure. When the full sequence—government spending followed by bond issuance—is understood, the obvious conclusion is that this process cannot be considered inherently inflationary. In reality, there is no monetization or printing money as is often referred to. The truth is that a government deficit shows up as new bond issuance plus the increase in the money supply. The split is a decision of the private sector, not of the government.

Fact 6: The bonds issued by the government (referred to as national debt) are ultimately held by the private sector. They therefore constitute **private wealth**. It is surprising that the financial sector—which initially acquires these bonds (primary market) before they circulate in secondary markets—rarely emphasizes this fact. Government securities play an important stabilizing role in financial portfolios because they are essentially risk-free assets. Misunderstanding this has led to misleading claims about public debt, such as the idea that each Filipino “owes” a large amount of government debt. In reality, those liabilities correspond to financial assets held by the private sector.

Whether this so-called debt represents 60% or 70% of GDP is almost irrelevant if one understands what it really is. It is also true that the government pays interest on the bonds and this is an expenditure in the national budget. Three clarifications are needed. First, a sovereign government will never have problems honoring these payments when they are its own currency. Foreign debt is an altogether different proposition. This was the case of the 1980s crisis—the government borrowed dollars. Second, interest payments represent income in the pockets of the private sector. It is again **puzzling** to hear negative comments by the private sector about the so-called national debt. Why would primary and secondary dealers buy it? Could it be that many do not realize that the bonds they hold are what they criticize as debt? Third, it is true that if interest payments on debt grow much faster than GDP for a long time, they may end up representing a significant share of the national budget and they could displace other necessary spending categories. But let’s make it clear: the share of debt interest payments in the national budget (which, we repeat, are payments to the owners of the bonds), at about 14% today, is larger than the shares of health (4-5%) or social protection (3-4%) simply because somebody decided to allocate smaller amounts to these two categories, not because we “do not have money.” Moreover, the interest rate paid on sovereign securities is not subject to normal market forces. Since short-term government debt is essentially equivalent to interest-paying reserves, and thus a close substitute to lending in the overnight interbank market, the overnight rate set by the central bank will govern the short-term government ‘borrowing’ rate. In other

words: auction yields are anchored by the money-market rate corridor set by BSP. This indicates that a sovereign nation can choose short-term interest rates on government debt as low (or high) as it wants. Whether the base rate will be zero or 100% is a monetary policy matter, not subject market determination.

Can the Philippines develop a more effective fiscal policy?

We believe that small changes in long-term interest rates may have little impact on spending. Therefore, reliance on monetary policy to impact aggregate expenditure, and indirectly on the inflationary process, is highly problematic. Long-run expectations of an uncertain future, which underpin profit expectations, are quite volatile, however, and reflect confidence. Therefore, there is no guarantee that a 'small' reduction in borrowing rates would have a positive impact on investment spending. In addition, the proposed level of investment in year t will be the outcome of detailed planning in prior months and is unlikely to be sensitive to modest interest rate changes in the short term. We conclude that the recent decrease in the policy rate will not contribute to restoring growth. Moreover, if inflation picks up, BSP will face a great dilemma given its mandate.

The need for fiscal deficits in the Philippines becomes even clearer once the country's external position is considered. When a country runs a current account deficit, the government must run a fiscal deficit if the private sector is to accumulate financial assets. In the years leading up to the 1997–1998 Asian financial crisis, the Philippines recorded fiscal surpluses while the private sector ran deficits—a warning sign of the vulnerabilities that would later emerge. When governments run surpluses in economies with external deficits, the domestic private sector is effectively deprived of liquidity. A crisis follows as it happened in Southeast Asia, including the Philippines, in 1998.

Consequently, a reduction in the fiscal deficit (a target of the current administration) cannot, *per se*, sustain long-term growth. Unlike the government, the private sector faces strict financial constraints and cannot remain in deficit indefinitely while accumulating rising levels of debt. Eventually, the pressure of fiscal consolidation forces households and firms to retrench, pushing the economy toward recession as they attempt to rebuild savings and reduce debt exposure. For this reason, fiscal consolidation aimed solely at lowering deficits is not a sensible objective. In the years ahead, fiscal deficits may in fact be necessary simply to maintain economic stability—to allow the private sector to save and to avoid future crises.

It is important to emphasize that a fiscal deficit is more than simply the difference between government spending and tax revenues. By accounting identity, its counterpart is a surplus in the non-government sector—that is, the private sector, both domestic and external. This surplus appears in the form of government bonds (financial assets) and an increase in the money supply held by the private sector. Conversely, and in the opposite direction, government surpluses reduce the financial savings of the non-government sector. Such a strategy cannot sustain economic growth over time. Unlike the government, the private sector faces strict financial constraints and cannot remain in deficit indefinitely while accumulating ever-increasing debt. Eventually, fiscal contraction exerts a drag on the economy, pushing it toward recession as the private domestic sector attempts to rebuild savings and reduce the fragility of its balance sheet.

The maximum 3 percent of GDP fiscal deficit objective, the same as the maximum 60 per cent of GDP national debt, borrowed from the European Union (where such constraints have been and are still controversial), are bad policy targets for a nation like ours because pursuing them reflects poor

understanding of our economic reality: that we need the injection provided by the fiscal deficit to compensate the leakage induced by the current account deficit. The fiscal deficit will reflect the net saving desire of the private sector.

Finally, there is also a broader argument that supports the need for a fiscal deficit. Delegating to the private sector responsibilities that properly belong to the state represents poor economic management. It is not nation-building. The private sector cannot and should not be expected to provide all the public services a society requires. Firms will supply goods and services when doing so is profitable—and rightly so. But public goods exist precisely because they must be provided collectively and universally. Their purpose is to create a more inclusive and equitable society. In the Philippines, however, the current trajectory often moves in the opposite direction.

No nation has developed without a strong and active government. The fiasco of the 1970s and 1980s made many Filipinos wary of an active government. Moreover, it is difficult to defend a more activist government in the midst of a corruption scandal. Yet the reality is that our needs are so great that only the government can provide them. The corruption scandal must be addressed swiftly. This means developing and implementing the mechanisms to prevent a repetition. But once this is done, we must understand that without a government that provides the public goods that we need, the country will not advance. This will imply a “government deficit” (= “private sector surplus”). Nothing wrong with this. Quite the opposite.