POTENTIAL OUTPUT AND SCARRING EFFECTS[1]

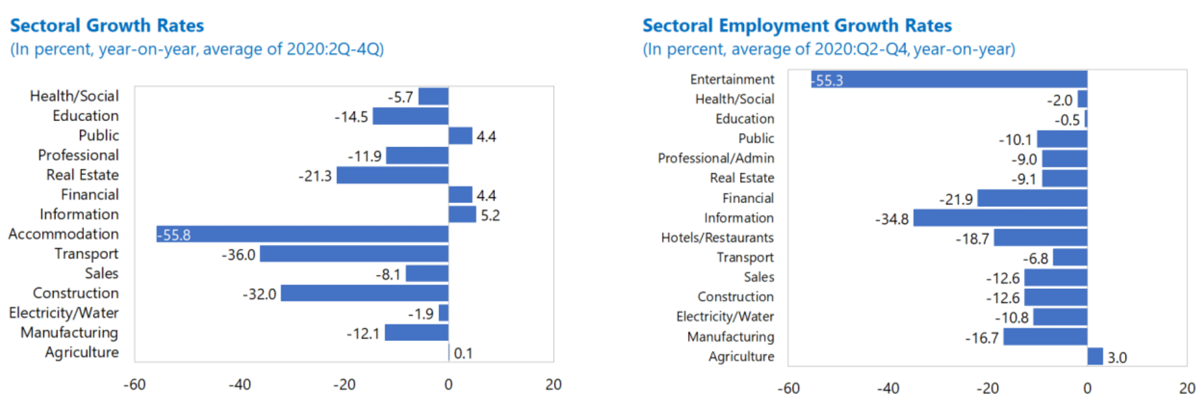
The COVID-19 pandemic led to a major economic downturn in the Philippines that could inflict longer-lasting adverse effects on the economy. These scarring effects reflect persistent pandemic effects on tourism and a few other service sectors, lower investment, skill losses from high un- and underemployment, and increases in poverty. Expansionary fiscal policy to stimulate demand and investment, measures to resolve a possible corporate debt overhang after the pandemic, and labor market policies to encourage sectoral reallocation would help to mitigate the extent of economic scarring.

A. Recent Developments

1. **The COVID-19 pandemic led to a major economic downturn in the Philippines, although a rebound is now underway**. Economic activity was negatively affected by the disruption to supply from the pandemic and containment measures. Real GDP in 2020 decreased by 9.6 percent and unemployment rate rose to 10.4 percent in 2020 from 5.1 percent in 2019. With the easing of containment measures and policy support, economic recovery started in the second half of 2020. However, the COVID-19 impact has not yet been reversed, and a second wave of COVID-19 infections emerging in 2021 has slowed down the recovery. The real GDP level in the first quarter of 2021 was still 4.2 percent lower than it was in the same quarter of last year. The unemployment rate also remained at 8.2 percent in first five months of 2021.

2. **The sectoral impacts of the COVID-19 pandemic have not been symmetric**. Nonessential and contact-intensive services, including tourism, entertainment, and transportation services, have been most severely and persistently affected. Other sectors, including construction and

Figure 1. Sectoral Growth and Employment



Sources: Philippine Statistics Authority; Haver Analytics; and IMF staff estimates.

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manufacturing, have also suffered reflecting declining demand and impact from containment measures. In contrast, output in the information, financial services, and public administration has increased during the pandemic, although employments in these sectors have also decreased. Some unemployed workers seem to have moved into employment in agriculture. Since preference changes and social distancing by the pandemic are expected to be maintained in the near term, sectoral reallocation could become crucial to recover the growth momentum.

3. The financial health of firms may have markedly deteriorated in the pandemic. Philippine firms entered the pandemic with generally adequate debt service capacity and moderate balance sheet vulnerabilities. The profitability of firms deteriorated sharply in 2020 due to the pandemic, while the interest coverage ratios (ICRs) of most firms remain relatively stable. Nevertheless, the liquidity shortfall and stress inflicted by the deep recession may have increased insolvency risks in some firms. The adverse impact would be uneven, with the micro, small and medium enterprises particularly vulnerable. According to the assessment in the recent FSAP, distress to the large nonfinancial corporates in terms of increases in the shares of debt-at-risk and firm-at-risk could be widespread even in the baseline and sharply rise in adverse scenarios.[2]

4. Headline inflation rates rose to an average of 4.4 percent in the first half of 2021, and core inflation rates recorded an average of 3.3 percent in the same period. Inflation in 2020 was relatively stable (annual average of 2.6 percent), but inflation started to increase in the second half of the year, mainly due to transportation bottlenecks and food supply shocks. In an economic recession, inflation and output typically decrease in tandem because aggregate demand declines below the full capacity of the economy. However, in the COVID-19 pandemic, strict containment measures and social distancing have affected both the supply capacity and demand, which has enabled price increases despite output declines and economic slack. In other words, relatively high inflation could potentially be a sign of declines in potential output, which is the highest level of real GDP sustainable over the longer term with stable inflation.

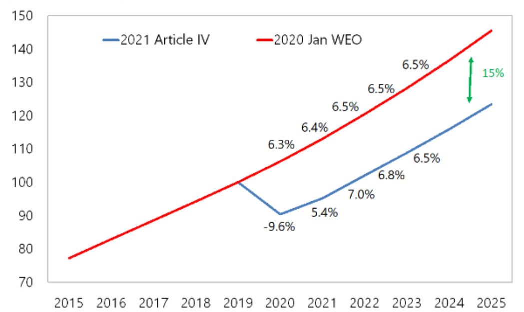
B. Economic Outlook and Scarring Effects

5. GDP growth is projected at 5.4 percent for 2021 and 7.0 percent for 2022. The economy has started to recover, but a prolonged virus outbreak could hinder fast recovery in 2021. The government also temporarily tightened containment measures in April and May 2021, given the surge in new daily cases. While the authorities aim to secure 148 million doses of vaccine in 2021 to meet its target of inoculating about 70 percent of the country's population within the year, the program is still in the early phase. The economy is projected to rebound in 2022, led by the infrastructure push and increased domestic and external demands.

[2] IMF, 2021, *Philippines: Financial System Stability Assessment*, IMF Country Report No. 21/74.

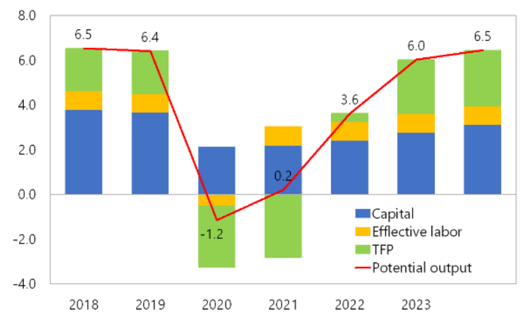
6. Potential output is estimated to have declined by 1.2 percent in 2020 due to effects of pandemic and containment measures.[3] Total factor productivity (TFP) decreased significantly (contributing around −2.8 percentage point to the reduction in potential growth) through the supply constraints from containment measures and social distancing. The economy could not exploit its capital and labor as it usually did before the pandemic. Many business activities have also been halted under enhanced community quarantine. Some workers lost their jobs due to weak health condition or social distancing. The large recession in 2020 also lowered potential output through the sharp decline in investment (−27 percent) and the high unemployment rate (10.4 percent). The decline in effective labor may have contributed as much as 0.5 percentage point to lower potential output growth in 2020. Capital accumulation is expected to have contributed only around 2 percentage points to potential growth, which is significantly lower than usual (average 3.4 percentage points in 2015–2019).

Output Levels in the WEO
(2019 GDP = 100)



Sources: WEO; and IMF staff estimates.

Potential GDP Growth
(In percent, adjusted for inflation)



Sources: IMF staff estimates.

7. Potential output growth is expected to remain low for several years due to economic scarring before returning to the previous trend rate of 6.5 percent in the medium term. It may take several years for the structural changes triggered by the pandemic to be absorbed and resources to be redistributed. For instance, contact-intensive services (e.g., tourism) are likely to suffer from low demand and bear the extra cost for the operational changes for some time. Bankruptcies of business could increase due to financial stress leading to some loss of firm-specific capital and knowledge. Sectoral reallocation may incur some losses in productivity since growing sectors may require different types of capital and the technology embodied in new capital. If high unemployment rates persist, discouraged workers may not return fully to the labor market. Worsened inequality and poverty during the pandemic also hinder human capital accumulation over the medium term. Accordingly, the real GDP level in 2025 is projected to be 15 percent below that of the pre-COVID-19 path (January 2020 WEO).

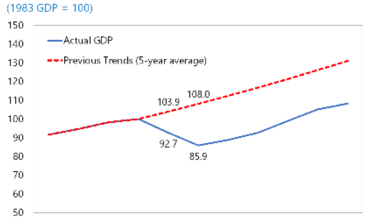
[3] Medium-term projections for the actual and potential GDP growth rates, investments and employments are based on the IMF WEO projections. The capital share is assumed to be 0.6 following the BSP (2015). The projection for human capital is an extension of Barro and Lee (2013) using educational returns in Duval and Maisonneuve (2010). The pandemic impact on the employment is assumed at 30 percent of initial shocks in the crisis, considering experiences in the Asian financial crisis, and a slight delay of educational attainments in 2020 is also assumed.

8. The early quelling of the virus spread could help the economy to overcome scarring from the pandemic. The second wave of virus infections may have peaked in April 2021, and the government could achieve its target of inoculating to about 70 percent of total population as scheduled. As the advanced economies come out of the pandemic gradually, the external demand may recover fast. The envisaged infrastructure push in 2021 and structural reforms will also support economic recovery. Nevertheless, uncertainty about virus dynamics and vaccine availability is still present. The economic recovery could possibly be bumpy until herd immunity against COVID-19 will be achieved through vaccination.

9. The projected medium-term output losses for the Philippines are in line with past experiences, both globally and domestically. It is widely believed that large and long recessions could cause GDP to fall much below pre-recession trends for many years, whereas GDP may catch up the trend in small recessions. The long-lasting effects of deep recessions are mainly due to significant declines in the growth of productivity and the capital stock. A persistent increase in unemployed or discouraged workers, along with the sectoral reallocation and loss of human capital, also accounts for such long-lasting effects. A large literature has tried to estimate the effects of large recession on the potential output. For example, Heimberger (2020) argued that the losses in potential and actual output by the global financial crisis are almost perfectly correlated in EU countries, based on the EU Commission's forecast. Output levels after the Global Financial Crisis (GFC) and other recessions have generally been estimated to be between 4 and 9 percent below the pre-recession trends (e.g., Martin and others 2015, Ball 2014). There is a global concern that the COVID-19 pandemic could have long-lasting negative effects on the economy, as in past deep recessions.

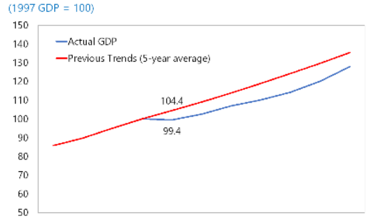
10. The past experience in the Philippines also support the notion of losses in potential output level after large recessions. Both in 1984 and 1985, the GDP decreased by about 7 percent. By 1990, the output level was about 21 percent below the pre-crisis output trend, which is calculated based on the 5-year average growth rate before the crisis. The Asian financial crisis in 1997 was another event with a fall in potential output. In addition to the GDP decrease in 1998 (−0.5 percent), the economy struggled with a weak growth momentum for several years before growth finally recovered. In contrast, the impact of the GFC on the Philippines was relatively small, with growth decelerating from 4.3 percent in 2008 to 1.4 percent in 2009. Subsequently, actual output caught up with the previous trend level.

Output Levels Around 1984
(1983 GDP = 100)



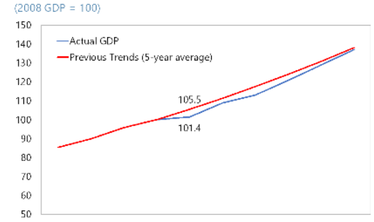
Sources: Philippine Authorities; Haver Analytics; and IMF staff estimates.

Output Levels Around 1998
(1997 GDP = 100)



Sources: Philippine authorities; Haver Analytics; IMF staff estimate.

Output Levels Around 2009
(2008 GDP = 100)



Sources: Philippine Authorities; Haver Analytics; IMF staff estimate.

C. Policy Recommendations

11. The severity of COVID-19 impact calls for active fiscal action to support the recovery and build productive capacity. With a debt-to-GDP ratio below the EM average, Philippines has the fiscal policy space to support the recovery and avoid a premature consolidation. A premature withdrawal of stimulus could risk unravelling the incipient recovery, leading to a deeper recession that would aggravate scarring. Increased spending in public works and transportation could create more jobs especially by continuing with construction of projects already at advanced stages. A renewed infrastructure push in emerging growth areas such as digitalization, healthcare, and climate change can help with the post-pandemic reorganization of the economy while also boosting medium-term productive capacity.

12. Measures to resolve the possibly large corporate debt overhang after the pandemic, while adapting to structural change, will be crucial. The government should provide targeted support to the viable firms, while facilitating the exit of unviable ones for efficient reallocation of resources. The credit guarantee scheme would encourage banks to lend to corporates by mitigating credit risks to lenders. In the case of systemically important corporates, equity injections by the government could also be considered. The scale of the COVID-19 shock and potential for larger spillovers from bankruptcies than in normal recessions would argue for providing more liquidity and solvency support than usual, except for firms that were already insolvent before the crisis began. The GUIDE Bill, currently under parliament consideration, would provide additional financial resources to government financial institutions to assist firms with temporary solvency issues due to the pandemic.

13. Labor market policies should encourage sectoral reallocation while protecting the vulnerable. Active labor market policies, including retraining programs that help workers acquire new skills, could reduce skill mismatch and support reallocation of workers. To encourage firms to hire new workers, well-designed and targeted subsidies for hiring may be effective. More flexible labor regulation (e.g., dismissal procedure, minimum wage) could also facilitate the relocation of labor. Ensuring adequate safety nets for workers, including more coverage of informal workers, would be essential to protect those most impacted by the economic dislocation.

14. The economic reform momentum should be intensified to boost growth after COVID-19. The planned introduction of the national ID system and implementation of the financial inclusion initiative would complement the ongoing social assistance programs by facilitating the identification of eligible households and delivery of cash aid. Effective implementation of the ease of doing business and CREATE laws would help alleviate the burden of MSMEs hit by COVID-19 and promote new businesses. Further lifting of restrictions on inbound foreign direct investment could help rekindle investment and employment. The planned digitalization of public administration should also be accelerated. In the medium term, more resources and incentives for climate change adaptation and mitigation will be needed to induce more investment and changes in emission patterns.

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