Philippines

SEB MERCHANT BANKING – COUNTRY RISK ANALYSIS January 25. 2013

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Unexpected strong growth has prompted analysts to declare the Philippines one of the best performing Asian economies in 2012 second only to China and with one of the best prospects going forward. That is much thanks to strengthened political stability and regained economic resilience due to improved fundamentals.

Country Risk Analysis

Growth shifts up*. There are reasons to believe that the unexpected strong performance of 2012of more than 6% economic expansion can be the beginning of a period of reasonably high and stable growth. For the first time in two decades the country has an elected President, Mr. Aquino, who is not only competent but also respected for integrity. Apparently unassailable on moral grounds, the elite has decided to accept Mr. Aquino's leadership and pay put to filibuster tactics aimed at defending vested interests or prevent government attempts at improving tax compliance. After fifteen years in Parliament, new "sin taxes" passed into law late 2012, despite opposition from the powerful sugarcane and tobacco lobby.*

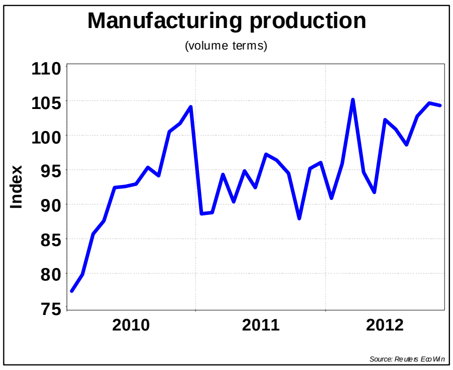
Having used his first two years in office to stamp out mal-governance of the previous administration now under investigation for fraud and election rigging, time has come to kick-start delayed infrastructure projects. The seven new projects rolled out over recent months have presented an impetus to growth which exceeded 7% in Q3, only a sliver behind China. Since long, poor infrastructure has been the country's Achilles' heel, while other fundamentals -- healthy external balances, strong reserves, sound banks and shrinking government debt – have strengthened and combined with diversification into exports of business services.

That does not mean all plain sailing from here on. Two years is a short track record and upcoming mid-term elections next May could make the President lame duck for the rest of his term ending 2015. Also, the G3 dominates Philippines' export markets, presenting possible headwinds. Conversely, hubris and hot capital inflows could blow the country off course. Left unchecked, accelerating loan growth and property market heating in Manila could be early signs of future imbalances. So far, however, inflation expectations appear well anchored within the central bank's 3-5% target. The potential for the maritime border conflict with China to escalate beyond control remains a far-fetched but no longer an ignorable tail risk.

Over the past year the Philippines have been rewarded highest non-investment grade by all agencies based on improvements to economic fundamentals and political stability. We fully support this and note the growing number of observers who predict investment grade in a medium term scenario.

Recent economic developments

A rising star? The unexpected result from the July-September period of 2012, showing GDP expanding by more than 7% yoy (year-on-year) prompted market enthusiasm, not so much for the sake of the result itself, but because it beat expectations by at least a percentage point. It also combined with hopes of growing political cross-party consensus for clamping down on tax evasion and large scale corruption. Most estimates are now for growth to exceed 6% in 2012, up from 3,9% in 2011. While such an outcome would not be unprecedented, it is now seen as the beginning of a trend.



Private consumption and government spending were the main drivers in 2012 supported by buoyant exports despite global headwinds. Private consumption rose on upbeat sentiment and low interest rates underpinning demand for new housing and autos. Growing job-offers in the formal sector also nurtured the feel good factor despite unchanged unemployment officially at 7% and underemployment exceeding 22% according to ILO. In late 2012, following a hiatus of more than a year, the government finally pulled all stoppers and launched seven new major government projects, most of them related to the country's dilapidated physical infrastructure, including bridges, ports and high ways in support of construction and other investment activities. Investments are still low, though, representing only 22% of nominal GDP blamed on the Philippines' restrictive regulation environment and traditionally weak investor climate.

The external sector solidifying gains: For almost a decade the annual current account balance has ended in a healthy surplus of around 2-6% of GDP. In 2011, it declined to 3% of GDP and the surplus for 2012 is likely to end around 2% of GDP reflecting accelerated import growth toward year end. Despite global headwinds, in particular affecting Philippine electronics which dominate more than half of total exports, merchandise exports held up quite well rising almost 5% yoy. However, a significant part of that was related to weak base year effects and the drop in Japanese import demand following its natural disaster of 2011, a one-off event unlikely to be repeated. Overall that meant a stable trade deficit of around 1% of GDP in 2012 which was compensated by strong services exports, including business services and tourism, and above all income transfers from the 10 million Philippines working abroad -- representing 25% of the national workforce.

External debt shrinking to a third of GDP. The string of annual surpluses on the current account balance has supported the gradual decline in the external debt ratio

Box 1: The Philippine Business Process Outsourcing (BPO) industry.
The basis for the recent success of the Philippine BPO industry started with the deregulation of the sector in 1993 which laid the basis for competition among several players. Today Philippine call centers employ 400,000 persons, but other services, including medical transcription, back-office processes, software and other IT services, have also been growing very fast to almost 250,000 employees. In 2010, the non-voice BPO sector counted for 20% of export revenues, up from 15% only four years earlier. According to the World Bank (December 2012, Philippine Economic Update) this development has been much supported by *low labor costs, a large English speaking workforce and a service oriented culture*. The Bank refers to projections showing a doubling of the size to 1.3 million employees and $25 bn. annual export revenues.

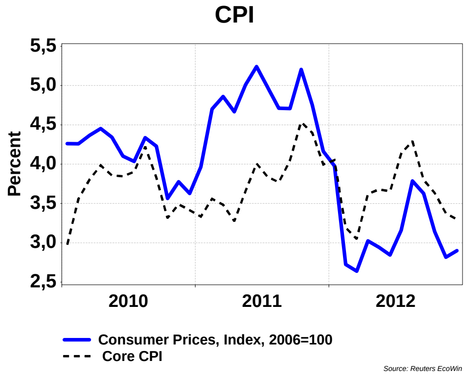
to an estimated 32% of GDP. At the same time it has also allowed the Bangko Sentral ng Pilipinas (BSP - central bank) to accumulate $75 bn. of reserves, enough to pay for 12 months of imports or 10 times short term debt. Last year that achievement was crowned by growing portfolio investment inflows, including to the local stock and treasury markets as foreign investors took advantage of improved growth prospects and attractive interest differentials. That was augmented by reduced perceived credit risk following sovereign rating upgrades by Standard&Poors and Moody's Investor Service. Foreign direct investments (FDI) also rose sharply in the first 9 months of the year but from a very low level compared with peers. Restrictive regulations, corruption and uncertainties regarding the sharing of responsibilities between local and central authorities continue to mar the investor climate including for otherwise rich mining opportunities and agriculture.

Policies

Fiscal policies maintain steady course. Due to weak budget execution but also improvements to tax compliance, budget deficits of recent years have ticked in much below expectations. In 2011 it decreased by 1,5 percentage points (pp) to 2% of GDP. In 2012, the deficit is likely to rise to 2,4% due to more effective spending execution but still come in some 0,2 pp better than first expected as tax revenues appear on course to improve by 0,3pp of GDP. The latter may seem a trifle in the big picture but is still an important sign that the government's campaign against tax evasion is beginning to bear fruit. At less than 13% of GDP, government tax revenues remain the lowest among peers leaving limited space for government investment projects.

Government debt shrinking to 50% of GDP. Low budget deficits have kept the primary balance in positive territory for several years and helped reduce the government debt ratio to 50%/GDP down from 74% in 2004. That does not include potential contingent liabilities for government enterprises, including power companies, but neither are large government financial holdings of some 8%/GDP accounted for. Sustained and successful debt management has helped extend average maturity and reduce the share of foreign liabilities to about half of the total.

Monetary policies face up to challenges. The Asian crisis in 1998 prompted a steep deleveraging among Philippine banks. That process has now reversed and in 2012 bank credits expanded at a more rapid clip of 14% yoy (at end September), outpacing nominal GDP growth. As a result, the share of bank loans in the economy has increased but at less than 40% that share is still very low. Last year's gradual easing of monetary policies in line with receding inflation pressure propelled loan demand for housing while capital inflows boosted liquidity among banks in support of more credit extension. In total, BSP lowered its policy rates by 100 bsp to 3,5% pa. That had a parallel effect on prime rates but soaring domestic treasury and equity markets suggest that the cuts did little to deter portfolio investors. On that background observers mull the danger that monetary policy formulation could face mounting challenges going forward. With core inflation well anchored within the central bank's 3-5% annual inflation target, BSP has won the battle for confidence so far but should now guard against becoming a victim of its own success lest confidence evaporates.



Banking sector in good shape. Observers commend the Philippine banking system for overall strong capitalization well above the national minimum of 12%, healthy profits and shrinking levels of non-performing loans to less than 5% of the total reflecting prudent credit policies over many years. The banking system is still fragmented, though, but BSP has been active in promoting consolidation. Last year, that catalyzed the drop in the number of banks by more than 4% to around 750, many of them active only within a narrow geographical perimeter. As such, the system represents only limited contingent liability on the government, unusual among regional peers. In another demonstration of strength, the BSP has not been compelled to extend a general depositor guarantee, unusual even in a global context.

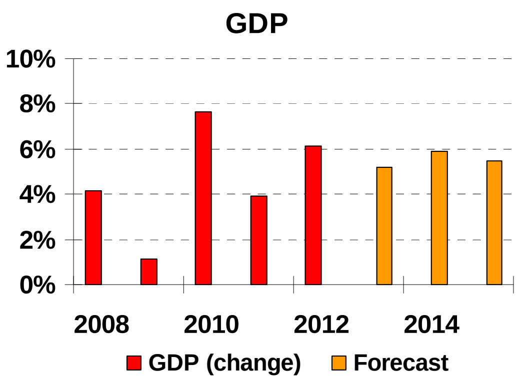
Political events

A silent transformation in the offing? With no elections and in an otherwise stable parliamentary situation, the political agenda was low on events in 2012 except for the fact that the president continued to instil confidence among a widening circle of potential contenders. Since many years political analysts have lamented the adverse environment of a polity dominated by a handful of wealthy families in Manila. While that is still the modus operandi, signs are emerging that the president's campaign against corruption and tax evasion is about to produce results. In late 2012 and after 15 years, the sugarcane and tobacco lobby gave up its resistance to the "sin tax" bill in Parliament. Slowly rising tax revenues as a share of GDP are another hopeful sign of improved tax compliance. The recent decision to roll out new public infrastructure projects was presumably taken on basis that the most egregious cases of corruption and graft are about to be overcome.

Continued weak investment environment. Over the last three years, the Philippines' ranking in Transparency International's Corruption Index has improved by 34 notches and the World Bank's Governance Indicator has presided over an improvement of similar magnitude. Those are notable achievements but the Philippines are still clearly in the weakest half of all countries worldwide on these and similar indicators, worse than regional peers including Thailand and China, but at par with or better than India and Indonesia. In the World Economic Forum's Global Competitiveness Report it has also jumped by 20 places from the 85th in 2010 to the 65th in 2012. That said, the Philippines continue being plagued by weak investor perceptions. Many of these could be reduced by easing of strict restrictions on foreign direct investments which not only deter foreign capital inflows but also provide fertile grounds for malgovernance and corruption.

Rising external threats balanced by improved internal security. Last October, the government signed a framework agreement with the Moro Islamic Liberation Front (MILF) as a roadmap for a final peace agreement. Hopes are this will open for new investments to exploit rich mineral deposits in the southernmost part of the archipelago where rebels so far have hindered economic development. Geopolitical tail risks, by contrast, built up in 2012 during a standoff between an outdated Philippine warship and three modern Chinese coast guard vessels over fishing rights in a maritime region claimed by both countries as a part of their economic zones. China has ongoing border conflicts with most of its neighbours and the Philippines could be caught in rising regional insecurity should any of them get out of control.

Outlook:

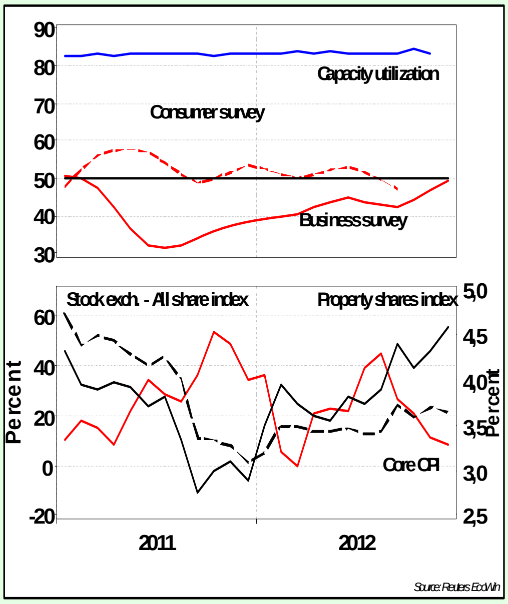


The risk to the 6,1% growth estimate for 2012 is probably on the upside and like most other observers we foresee a solid momentum continued for at least some years going forward. In 2013, growth would probably cool somewhat to 5.2% but then rise again in 2014 as the global recovery gains strength. That is not only based on expectations of global growth stabilizing around a higher level than seen in recent years, but also on domestic political consolidation and accelerating reforms. In such a scenario the fiscal and the external current account balances would not set limitations. It is also notable that in a few years' time the demographic dividend will kick in to place the country in the position where China was some 20 years back in terms of dependency ratios and the workforce.

Downside risks to this scenario include

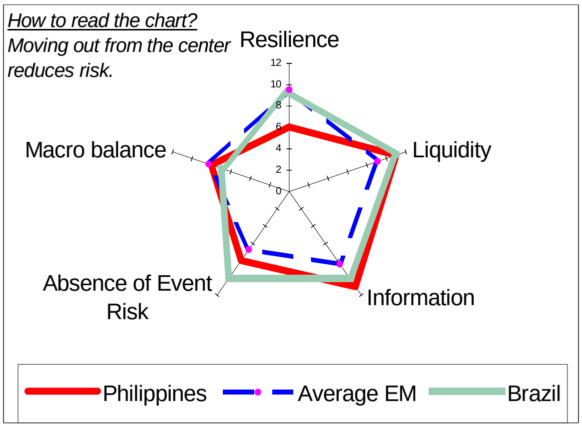
- Lower growth among main export markets countries, in particular the G3 countries and China which all-together represent about 55% of total exports.
- Domestic political events: mid-term elections for seats in the Senate (upper house of Parliament) and local gubernatorial posts could end with a weaker support basis for the president to reduce political rally for himself and – eventually -- his anointed successor. Because the Constitution bars the president from re-election the second half of his/her term in office may leave him/her in a lame duck situation. However, observers point to very high approval ratings for the president -- at 85% -- and believe that militates against such an event.
- Overheating: while such presents a short term upside risk to growth, the medium to longer term risk could be clearly negative including for credit worthiness. (Conf. Box 2)

Box 2: Threat of overheating?
Accelerating credit growth and rising capital utilization are fledgling signs of overheating in any economy. A buoyant stock market led by property shares and rapidly rising prices in segments of the housing market – the central bank reports 9% price rise for luxury apartments in Manila over the past year – amplifies the warning signals. However, with well-behaved inflation (including declining core inflation and expectations according to BSP surveys), consumer demand still uncertain and business sentiment just about to break out of contraction territory (below the 50-mark), signs of overheating are not manifest. We believe that monetary policy so far has been well balanced and expect the BSP to tread cautiously in 2013, keeping the interest rate weapon in reserve rather to steer exchange rate expectations should capital inflows become unmanageable.



Our main scenario has also upside risks, in particular should the Philippines be able to capitalize fully on the upbeat prospects for the global out-sourcing industry for business services. (Conf. Box 1). However, as the country's capital base is unlikely to sustain a higher GDP growth rate than 6% at least in the medium term, such upside risk is limited. Any expansion of GDP at a rate beyond 6% would probably be at the cost of price stability or of net income receipts as fewer Philippines would go abroad for jobs. (For a more detailed analysis of these scenarios with quantitative assessments based on estimates from the OEF global model pls. see Appendix 1.)

Key ratios	**2012**
Population (mill.)	100.3
GDP/capita ($)	2574
GDP (change)	6.1%
Inflation	3.1%
Curr.Acc. Balance/GDP	2.9%
Reserves/imports (months)	12
Budget balance/GDP	-2.4%
Government debt/GDP	49%



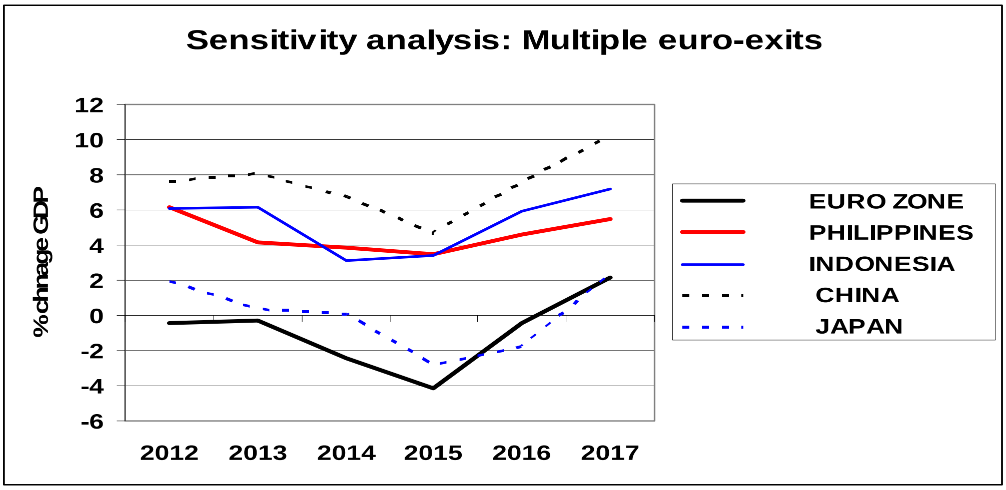
External ratings:
Fitch: BB+
S&P: BB
Moody's: Ba2

Peers:
Brazil
Indonesia
Latvia

Graph: The pentagon shows the soft areas of the Philippines' creditworthiness compared with the average of emerging markets as being resilience. It is stronger on liquidity, information and event risk.

Appendix 1: Sensitivity analysis

Euro breakdown: Based on the OEF model this scenario shows possible consequences of a euro-zone break up in 2014. It would have severe effects on the euro-zone itself, reducing GDP by a total of 6% over two years, hitting in particular Italy and Spain, but also France, even though that country is expected to remain in the zone. Second, it would hit world growth but not as hard as the global financial crisis in 2009. The Philippines would se annual growth dropping some 2 percentage points (pp) from the baseline, in line with Indonesia, while China and Japan would be hit somewhat harder. The Oxford Model is a global econometric model that integrates international real economic and financial parameters.



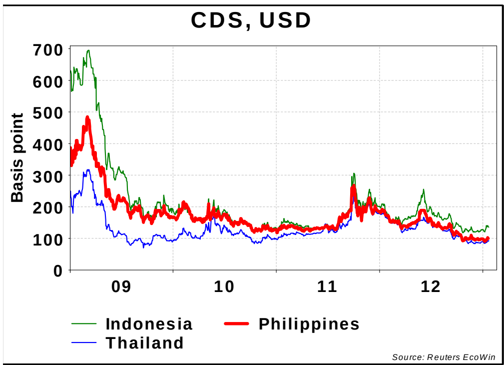
China slowdown: Shocking China's GDP growth by around 1 pp. in the Oxford Model by reducing Chinese investment demand, lowers the Philippines' GDP growth by around 0,1pp. annually over three consecutive years. That suggests a greater impact than reported in BSP's Third Quarter Inflation Report.

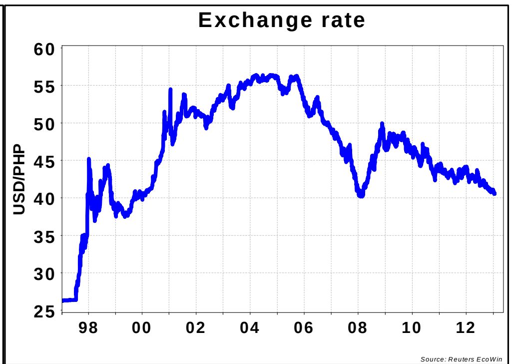
Key data:	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**
GDP (mill.US$)	173	169	200	225	250	273	293	318
GDP/capita (US$)	1915	1829	2131	2355	2574	2770	2923	3115
GDP (change)	4.2%	1.1%	7.6%	3.9%	6.1%	4.2%	5.9%	5.5%
Investments/GDP	19%	19%	21%	20%	20%	21%	20%	20%
Budget balance/GDP	-0.9%	-3.7%	-3.5%	-2.0%	-2.4%	-2.4%	-1.9%	-1.8%
Govt debt/GDP(*)	52%	54%	51%	50%	49%	47%	45%	43%
CPI inflation (%)	8.2%	4.2%	3.8%	4.7%	3.1%	4.0%	4.9%	5.1%
Money demand (%)	9%	12%	10%	9%	8%	10%	10%	10%
Stock prices	2626	2474	3526	4188				
Interest rates	5.5%	4.5%	4.2%	4.6%	4.0%	3.7%	4.4%	4.9%
Exch. Rate ($)	44.5	47.6	45.1	43.3	42.2	41.2	42.5	43.2
Trade/GDP (%)	63%	50%	56%	49%	47%	47%	47%	47%
Oil price (Brent)	$97	$62	$79	$111	$112	$105	$109	$113
Millions US $								
Export of goods	48 253	37 610	50 748	47 494	50 913	54 828	59 495	63 570
Imports of goods	61 138	46 452	61 714	63 013	65 881	74 142	79 608	85 538
Other:	16 512	18 200	19 888	22 507	22 286	23 043	25 526	29 661
Current account	**3 627**	**9 358**	**8 922**	**6 988**	**7 318**	**3 730**	**5 413**	**7 694**
(% of GDP)	2.1%	5.5%	4.5%	3.1%	2.9%	1.4%	1.8%	2.4%
FDI (net)	1 285	1 604	682	1 253	707	950	896	847
Loan repayments	-8 219	-6 379	-9 527	-12 265	-12 665	-13 012	-13 370	-13 741
Net other capital flows	10 468	-1 733	8 777	21 757	9 331	14 319	14 705	14 885
Balance of payments	**7 161**	**2 851**	**8 854**	**17 733**	**4 691**	**5 987**	**7 644**	**9 685**
Reserves	32 828	35 679	44 533	62 265	66 956	72 943	80 588	90 273
Total debt	65 387	63 821	68 879	74 053	76 755	79 556	82 459	85 467
o/w short term debt	7 032	5 127	5 435	7 075	7 245	7 419	7 597	7 779

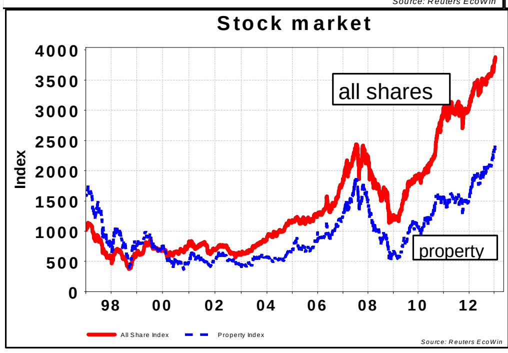
Source: OEF (Oxford Economic Forecasting) and SEB estimates.
(*) Ecluding public enterprises

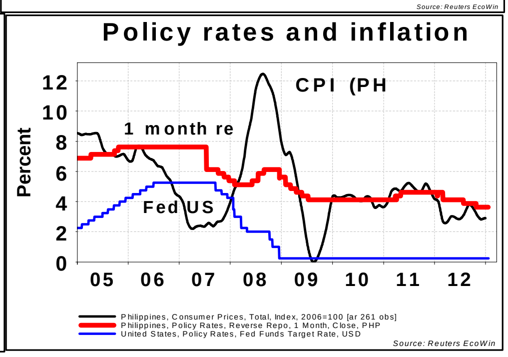
Rating history					
Fitch (eoy)	BB	BB	BB	BB	BB+
Moodys	BB	BB-	BB-	BB+	BB+

Type of government:
Next elections 2014
Other:
Latest PC deal 1994 (active)
Recent IMF programs 1998 Stand-By









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