Philippines

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Despite the devastations of the super typhoon Yolanda late 2013, solid growth will not be disrupted unless inflation begins to pose risks to economic stability prompting sharper than envisaged central bank reactions. Politics will remain calm and stay so thru presidential elections in 2016 even though the popular incumbent is barred from running. Improved resilience is likely to prevail.

Country Risk Analysis

Solid growth continues: The strong performance of 2013 when the economy achieved an almost all-time high of 7,2% expansion will not be repeated in 2014 but growth well above 6% should be within reach. That will be propelled by booming exports thus upholding healthy external balances including on the current account in support of a strong reserve level high enough to cover more than 12 months of merchandise imports.

Strong fiscal stance while monetary policies could face challenges: The fiscal stance has improved markedly since government finances were on the brink of collapse about a decade ago. The budget deficit is well below 2%/GDP while government debt has declined to 45%/GDP , strong in comparison with most peers. Monetary policies, by contrast, have come under scrutiny as the central bank appeared to be procrastinating in response to recent inflationary pressure driven by rapidly rising food prices. They have pushed headline inflation to the upper target limit of 5% for the present year undermining the chance that inflation can be lowered to 3% next year. Other oft-cited concerns with financial implications, will likely prove within the capacity of the financial system to handle on its own. Such include last year's property market boom and the long-standing issue of loan concentration due to the conglomerate character of the industrial sector. Banks are liquid, well capitalized and generally strong with few bad loans.

Longer term growth prospects look overall good: The country has an underutilized mining potential with a PDV estimated at five times annual GDP and a potentially significant demographic dividend. However, weak infrastructure and unreliable power supply are hampering efforts to exploit these advantages. In contrast, recent political calm under Pr. Aquino in office since 2010 has helped improve the business environment. While that could be much related to himself, a person with an untainted back-ground, observers point out this may be to overrate his importance. His success has partly been determined by reform efforts of his predecessor while his own contribution, to purge the bureaucracy of unsavory elements, cannot be all overturned under a new president in 2016 when the incumbent is constitutionally barred from running for re-election.

With the recent upgrade to BBB by S&P due to much improved economic and financial metrics, the sovereign is now well within investment grade, an assessment that increasingly applies also to country risk.

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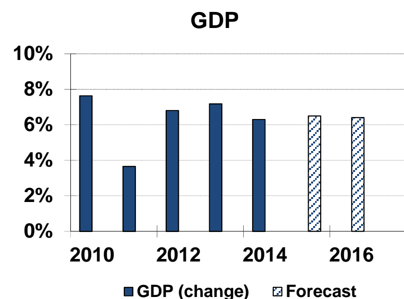
SEB

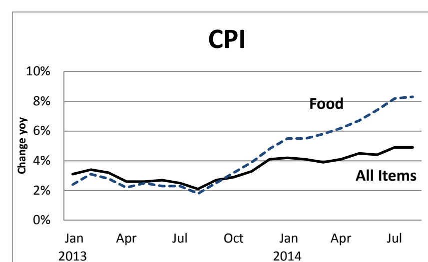
Recent economic developments

The economy recovers from the worst typhoon in decades: In late 2013 eastern parts of the Philippine archipelago were hit by an unusual severe tropical storm, a typhoon given the local nick-name Yolanda. Hundreds of thousands of people were made homeless in a less developed part of the country. Despite this event, economic expansion ended at an all-time high of 7,2%, but in return shaved off 1pp (percentage point) of first quarter growth in 2014 due to lost output from the devastated areas. Already in Q2 the economy recovered to a rate of 6,4% expansion year-on-year (yoy) and high-frequency data including money and credit growth, consumer and business sentiment now point to continued acceleration in the second half of the year. That raise prospects for the whole year result to end in the range of 6,5-7% according to latest estimates of the Banko Sentral Philippinas (BSP – the central bank).



Exports and investments lead the upswing: In Q2 exports grew a spectacular 22% yoy and is poised to spearhead growth for the current year. Investments, in the past usually the weak performer of the economy, could grow by almost 8% on the back of reconstruction works and provided the government is able to speed up infrastructure projects while sharp monetary tightening is avoided toward year end. Investment demand is also assumed strong enough to offset the apparent cooling of residential construction activity in Q1-Q2 after the housing market came to the brink of overheating in 2013. Private consumption, in contrast, is expected to could exert a drag in relative terms, expanding at less than 6%. That is despite robust remittances from Filipinos working abroad raising the country's gross national income (GNI) by an exceptionally high 15% above GDP. They are important for private consumption in particular for big ticket items like vehicle purchases which rose by a whopping 40% yoy in the January-June period.

Can inflation become a party buster? Since the beginning for the current year prices have grown faster than the 4% policy target and accelerated to almost the upper target limit. That may have several causes including overhang from the 5% peso depreciation of 2013 and higher utility prices including for electricity. But the main driver is food prices that count for almost half of the consumer basket and have accelerated since early 2014. The fact that inflation expectations remain well anchored around 4% according to recent BSP surveys and that core inflation is well contained around 3% provide some solace. High capacity utilization in industry at 83%, against a normal of 80%, however, could challenge steady core inflation before too long.



Declining unemployment: In 2013 unemployment fell from 7,7% to 7% of the workforce and underemployment dropped to 18% as total employment rose 4,5% to 39 million jobs. However, in a market with a large informal sector such estimates may not be very precise. While at face value these results look acceptable, the IMF still warns of risks that future job creation fall short of labor supply. The latter is growing rapidly for demographic reasons and due to real wage increases. The minimum wage was hiked by almost 6% in 2014, exceeding the increase in the costs of living. Still, wage developments have so far remained reasonably modest, unlike peers such as China and Indonesia.

Real estate market cooling? Following steady price rises at some 8% a year since 2009, the real estate market heated up last year and prices accelerated to 13%. That

prompted some observers to ring alarm bells even though it was noted that the new prices still left the average below the level before the Asian crisis in 1998. However, cited numbers apparently refer to only two cities, Makati and Ortigas within metro Manila, and may as such be far from representative for the national market. By another metric it has been noted that in early 2014 the housing authority reportedly issued fewer licenses to sell housing units, a sign of possible market cooling dovetailing well with other reports of subsiding construction activity.

The current account balance remains in robust surplus. The predominantly export led growth so far this year has helped strengthen external balances. Propelled by a more competitive exchange rate and stronger demand in key markets, including the US, exports have fired on all cylinders including textiles and furniture, machinery, agro-products and even electronics. The share of the later item has been in decline over several years and at 26% dropped to half of its level in 2010. But that has actually been seen as a welcome contribution to a more diversified export composition. Tentative signs are now of a revival including for semiconductors. With about 8-9% growth of exports in the first half of the current year exceeding the pace of imports by a distinct margin, the trade deficit is set to shrink. Combined with continued strong remittances inflows and exports of business services this should ensure the current account remains in a robust surplus of 3-4% of GDP in line with last year's 3,5% result.

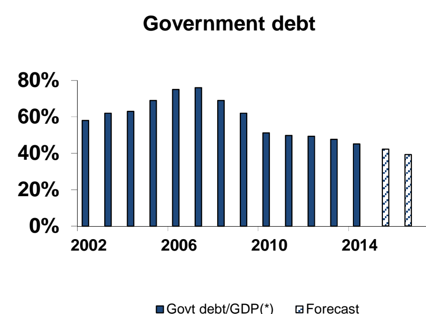
Capital inflows fail to boost reserves. Foreign direct investments (FDI) have been growing at a high clip in recent years and reached almost $4bn in 2013, doubling the level of only 4 years earlier. Based on the development so far, that achievement could well be matched in 2014. Nonetheless, the combined current account surplus and net FDI inflows failed to boost reserves in the January-June period, suggesting net portfolio outflows made up the balance. Such outflows may have been prompted by the exclusion of trust companies and other non-banks from access to the BSP's Special Deposit accounts (SDA) in late 2013 and also profit taking in the stock market where a price-earnings ratio above 21 had made Philippine share values some of the most elevated in the region.

But at 15 months import coverage reserves are still ample. Reserves of more than $72bn. of last August were still more than adequate to cover the country's needs even under reasonable worst case scenarios. Standing at 2.7 times the emerging market adequacy metric of the IMF they could pay for 15 months of projected imports or three times all short term external liabilities by remaining maturity. By another oft-cited measure, reserves exceeded external loans by 7% making the Philippines an unusual net creditor country in regard of its still low GDP per capita of only $2700.

Policies:

Fiscal policies have been subject to tough consolidation since the government found itself at the brink of a debt crisis in the early 2000s. Structural policies have also made progress over the last decade, but often against resistance from vested interests in key areas including production of electrical power. Monetary policies, by contrast, have turned "very accommodative" in IMF language, even though it may be argued that global liquidity conditions left the central bank with few choices.

Growing revenues and weak budget execution keeps the deficit low: In 2013, the budget deficit shrank by almost one pp. to 1.4% of GDP as the government failed to increase expenses by more than half of the 12% growth target. Growing revenues also contributed as the tax take climbed to more than 13% of GDP. But by other measures, that is still unimpressive compared with most peers and for a country with screaming

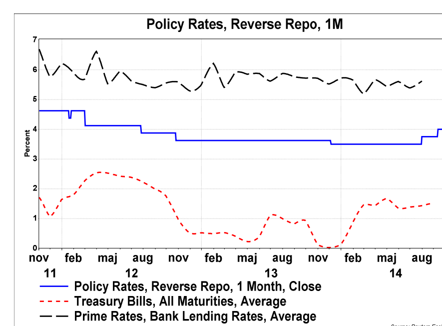


infrastructure needs and a poverty problem entrapping about a third of the population. For the current year the government aims at speeding up budget execution in line with its medium term planning. That should stabilize the general government deficit at around 2% of GDP including about 1%/GDP for post-disaster reconstruction works.

Paying back debt: Despite a slightly higher budget deficit for 2014 a small primary surplus remains. That will ensure continued decline in the sovereign debt ratio to 36%/GDP at the end of the current year, representing a marked improvement from the more than 70%/GDP peak reached in 2004. In recent years, its average maturity has been successfully lengthened to more than 10 years. By contrast, more than a third of it remains denominated in USD or other foreign currencies exposing the government to adverse exchange rate changes. That does not seem to have deterred investors so far this year judged by the success of recent treasury auctions. Also, the CDS spread has continued falling to a very low 84 bsp. in last July, presenting more evidence of investor confidence.

Monetary policy facing new challenges: In the spring of 2013, the Philippines was still struggling with excess liquidity from previous years' steep rise in reserves reflecting mainly short term capital inflows as investors took advantage of attractive interest rates offered by an increasingly stable financial system. To deter private investors including non-residents from using BSP's main sterilization tool, the Special Deposits Accounts (SDA) as a repository for excess cash, access had been restricted to banks only, specifically excluding non-banks like trust units. Interest had been cut to 2% pa. When global financial turbulence struck in the following summer under the "Fed-tapering" debate, Philippine banks weathered the storm better than most peers and still found themselves left with too much liquidity in the financial system.

BSP is cautious not to favor shadow banking: In 2013, a booming property market followed by accelerating inflation toward year-end presented a call to nip growing price pressure in the bud. High credit and money growth in the range from 20-30% continued into early 2014 and exasperated the problem. Regarded as a too blunt instrument that might kill off too much useful investments, BSP's policy rates were first left unchanged even though they were clearly falling into negative territory in real terms. In return, the BSP chose instead to raise banks' reserve requirement in two steps by 100bsp in each and the interest on SDA by 25bsp to 2,25%. The reason for being cautious was in part the fear of greater hikes driving credit intermediation into the shadow banking market -- a fledgling developments that had already seen light in the mortgage market.



Rising prices put more pressure on policies: All these measures, however, had withdrawn less liquidity than the restriction on access to the SDA had released in 2013. Eventually, after the monthly CPI turned markedly up in last July and August approaching the upper ceiling of the target range for 2014, BSP hiked also its policy rates by a total of 50bsp[1], although still leaving real policy rates innegative territory. Should price pressure not abate soon the BSP could face a crucial moment in order to maintain investor confidence in the country's financial stability. Mitigating the challenge is the fact that the recent surge in prices is largely related to food, representing 40% of the consumer basket. As such it likely reflects temporary adverse supply conditions. So far financial markets have remained calm.

The exchange rate regime: The IMF describes the exchange rate as "market determined" while it may be as appropriate to name it "managed floating" with emphasize on "managed". For several years the BSP lent against the wind and

[1] to 4% pa and 5,5%pa for the reverse repurchase rate and the repurchase rate respectively.

intervened to prevent too rapid intervention and did that longer than necessary resulting in today's burgeoning reserve level and excess bank liquidity.

Sound banks provide comfort: Observers describe Philippine banks as fundamentally sound with high capitalization, healthy funding, strong liquidity and low and declining level of bad loans. The system is still underdeveloped and comprises less than 40% of GDP in terms of assets. . As a result it represents a quite limited contingent liability on the sovereign implying higher probability of support. Nevertheless, concerns have been raised regarding banks' exposure to the housing markets and also loan concentration in particular vis-à-vis the corporate sector. We believe the latter is the more important not least in terms of size, lack of transparence and high degree of interconnectedness between various financial institutions. Since January 1, 2014, banks are required to be Basel III compliant. That puts them under stricter regulations and helps mitigate above-mentioned concerns.

Structural reforms -- the power sector: The Philippines has a long history of unreliable power supply. Several years ago privatization was replaced with a regulatory framework. Unfortunately, that has proven too strict to attract sufficient capital for new generating capacity. For example, during a period of supply constraint in 2013 the Supreme Court issued a restraining order against price increases already approved by another authority, the Energy Regulatory Commission. Such apparent inconsistency should probably be viewed in light of market fragmentation which may give rise to monopoly powers as was allegedly the case with the company in Manila. Fears are now that the situation could worsen before getting better. New projects that should have come on-line in 2015 will be delayed, while one of the Philippines' biggest suppliers is scheduled for maintenance shut-down for six months. Rolling black-outs have in many places become the norm with the effect to deter investors in industry and manufacturing.

Politics:

The untainted president comes under attack: Under the incumbent, president Aquino, in power since 2010 Philippine politics have enjoyed an unusually calm period. Whereas his predecessor, Pr. Gloria Macapagal, was deeply disrespected in many quarters for alleged election fraud and suspect business practices of her family, the present incumbent is remarkably untainted. It was therefore to some surprise when he was subjected to allegations of having misappropriated budgetary means by using allocation left over from previous budgets to speed up the economy in real time. While there were no accusations of corruption the case may nevertheless have left spots on his reputation. It has, however, not passed unnoticed that the issue was raised after the President last year deprived members of the national assembly of what in effect were pork barrel allocations over the budget.

Next presidential elections scheduled for 2016: As the Constitution does not permit re-election of the president speculations are growing about possible candidates for next elections in June 2016. So far most bets are on the present vice president, Mr. Binay, who is electable. His background may not be as spotless as the incumbent's, but he is regarded as well fit for the job and a person who is unlikely to overturn all the good work under Mr. Aquino's term in office. In general, observers point out that the contribution of Mr. Aquino is often overrated. Most of the reforms that have supported the economy of recent years were set in motion already under the presidency of Ms. Macapagal, while Mr. Aquino reaped the benefits. As such, there is a continuity that should be able to survive the next change of president.

The China factor: The external security situation vis-a-vis China over marine borders in the West Philippine Sea (the eastern part of the South China Sea adjacent to the Philippines) has intensified over the last 12 months period. Manila's response, including reaffirmed support from and closer military cooperation with the US including the possibility of formalized US military presence in the Philippines are likely to have been perceived in Beijing as a more unfriendly posture from Manila. In the longer term that could have negative consequences for the Philippines' security

situation should its protector, the US, at some point be tied down by military conflicts in other places, for instance in the Middle East or in Eastern Europe. The alternative, by contrast, might have been perceived as an invitation to Chinese assertiveness.

Outlook:

Robust medium term growth: Our main scenario for the Philippines is a gradual recovery with growth well above 6% for the entire current year before accelerating slightly to 6,5% in 2015 -- somewhat above the estimated long term potential. That would be spearheaded by exports and investments with buoyant remittances supporting private consumption around 5,5-6% annual growth. The current account will remain in surplus while ongoing real appreciation of the peso due to higher inflation than in main trading partners may erode competitiveness and pave the way for a gradual but not alarming weakening of the external position.

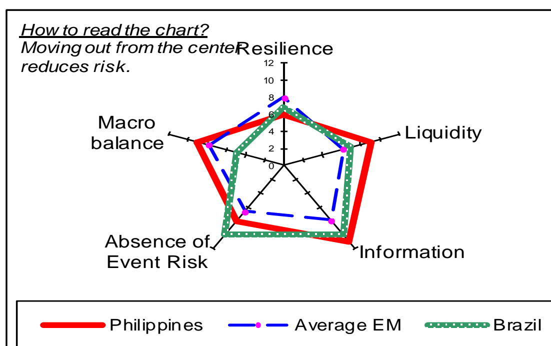
In the longer term, growth will increasingly reflect favorable demographics provided matching job-creation. In the absence of the latter – that is a ”demographic curse” – the likely result is not social disaster. Widening income gaps, however, could again lay the grounds for a return of populism and unstable politics, but that is not the most likely scenario for the current decade. It is also noted that the country has a huge underutilized mining potential with a PDV estimated at several times annual GDP. However, weak infrastructure and unreliable power supply still hamper efforts to exploit these advantages.

Risks to the medium term scenario: On the upside, stronger growth in the US could give an impetus through greater exports and stronger investor sentiment. On the downside there are two main risks:

Unexpected inflation: Recent food price inflation could prove more persistent than expected by the authorities, opening up for policy mistakes in terms of too soft or too hard responses from the central bank. That would take some shine off the much improved reputation of the country’s economic management but not enough to derail its finances. These are presently so robust in terms of moderate government debt, large reserves and sound banks that the country can sustain a hit or two.

Collapse in China: The second risk is a financial collapse in China followed by an economic slump lasting several years. The risk of such an event is not overwhelming but at a loosely estimated 10% also too big to ignore according to one of our data providers, Oxford economics. Such a crisis is likely to engulf the entire region with the effect to trim the growth rates of many countries. Because of its openness the Philippines would be vulnerable and suffer a set-back for at least two years with growth down to less than 2% in that period. Although painful, that is still a blow the country should be able to weather.

Key ratios	**2014**
Population (mill.)	97
GDP/capita ($)	2857
GDP (change)	5.9%
Inflation	4.3%
Curr.Acc. Balance/GDP	3.4%
Reserves/imports (months)	13.0
Budget balance/GDP	-1.8%
Government debt/GDP	45%



External ratings:
Fitch: BBB-
S&P: BBB
Moody's: Baa3/pos

Peers:
Brazil
Indonesia
Latvia

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

Appendix:

The banking system

Sound banks:: Observers describe Philippine banks as fundamentally stable with high capitalization (18% capital adequacy ratio), a healthy funding situation and strong liquidity as reflected in a loan to deposit ratio of only 64% (end 2013). Last year non-performing loans shrank further to 2,7% of the loan book, and they were fully covered by banks' own specific reserves.. The system is still underdeveloped and comprises less than 40% of GDP in terms of assets. As a result it represents a moderate contingent liability on the sovereign implying high probability of support should a rescue operation ever become necessary. As of last January, all banks were required to comply with Basel III international supervision standards. As such the Philippines became one of the first countries in the region to demand full Basel III implementation.

Moderate exposure to real estate: Concerns have been raised about banks' involvement in the Philippine real estate market. While BSP regulations requires banks to observe a loan to value ratio of maxium 60%, reports have emerged of banks piercing this limit by up to 20 pp. Beyond mortgage lending banks are also exposed to developers which in turn use funding from banks to extend house loans to customers. At only around 20% of total credit extension, of which about two thirds to households, banks real estate exposure is still in its infancy. The rating agencies commend the BSP for making domestic banks subject to rigorous stress tests as of the current year with focus on banks' exposure to the real estate market, lest new signs of overheating should come as a surprise to lenders.

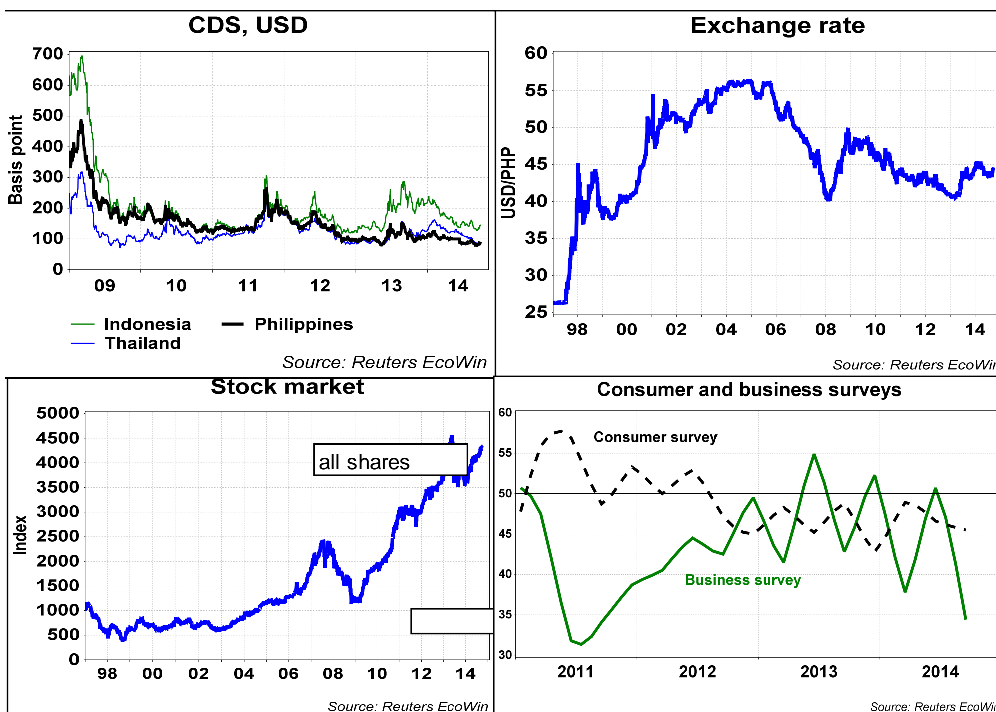
Lingering concerns about corporate leverage and loan concentration: Private debt has increased fast and has reached an estimated 55% of GDP dominated by corporate borrowing. Although a growing part of that debt is now being raised in the bond market banks remain an important funding source for the enterprise sector. The IMF notes that "In view of the conglomerate structure of the economy, large bank exposures to single borrowers can create systemic risks.". We believe that in view of its size, that risk may be as important as housing market risk for banks. A recent approval of the law allowing additional foreign bank entry into the domestic market could over time increase competition and help reduce concentration risks.

Key data:	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**
GDP (mill.US$)	200	224	251	272	287	324	362
GDP/capita (US$)	2135	2352	2585	2757	2857	3172	3490
GDP (change)	7.6%	3.7%	6.8%	7.2%	6.3%	6.5%	6.4%
Investments/GDP	21%	20%	20%	21%	22%	23%	23%
Budget balance/GDP	-3.5%	-2.0%	-2.3%	-1.4%	-1.8%	-1.4%	-1.1%
Govt debt/GDP(*)	51%	50%	49%	48%	45%	42%	39%
CPI inflation (%)	4.1%	4.7%	3.2%	2.9%	4.3%	3.8%	3.8%
Money demand (%)	10%	9%	7%	24%	23%	5%	7%
Stock prices	93647	95272	96934	98619			
Interest rates	4.2%	4.6%	4.0%	2.4%	2.2%	3.7%	4.7%
Exch. Rate ($)	45.1	43.3	42.2	42.4	43.9	42.4	41.7
Trade/GDP (%)	45%	43%	45%	40%	40%	38%	37%
Oil price (Brent)	$80	$111	$112	$109	$107	$103	$106
Millions US $							
Export of goods	36 773	38 277	46 386	44 737	48 378	50 941	54 815
Imports of goods	53 631	58 704	65 310	63 262	67 007	72 405	78 277
Other:	24 038	26 069	25 875	27 949	28 306	31 694	33 355
Current account	**7 180**	**5 642**	**6 951**	**9 424**	**9 677**	**10 231**	**9 893**
(% of GDP)	3.6%	2.5%	2.8%	3.5%	3.4%	3.2%	2.7%
FDI (net)	-1 641	-342	-959	218	-25	-56	-75
Loan repayments	-8 341	-6 311	-2 725	-3 785	-6 099	-7 725	-8 883
Net other capital flows	11 655	18 744	1 729	-305	-4 271	5 561	8 897
Balance of payments	**8 854**	**17 733**	**4 996**	**5 552**	**-719**	**8 011**	**9 831**
Reserves	44 533	62 266	67 262	72 814	72 095	80 106	89 937
Total debt	58 876	60 930	61 252	62 783	65 074	67 449	69 910
o/w short term debt	5 435	6 744	7 932	8 545	8 762	8 914	9 049

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

Rating history				
Fitch (eoy)	BB	BB+	BB+	BBB-
Moodys	Ba3	Ba2	Ba1	Baa3

Type of government:
Next elections 2016 Presidential
Other:
Latest PC deal 1994 (active)
Recent IMF programs 1998 Stand-By



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