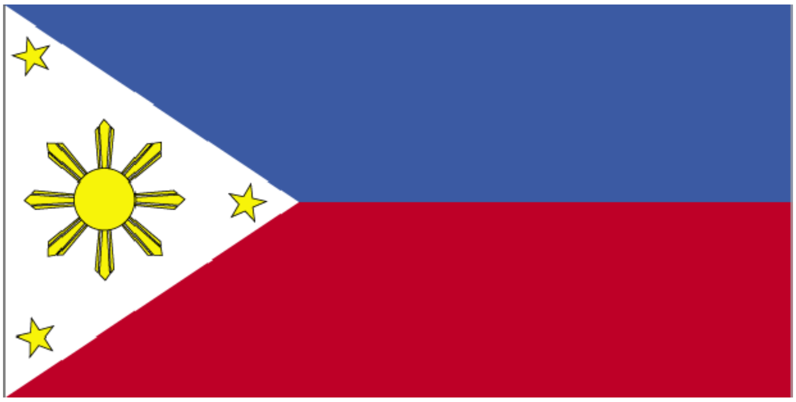
Country report **PHILIPPINES**



Summary

The Philippine economy continues to face strong headwinds from the weakening global economy. Economic growth is estimated at 3-4% in 2012, due to lower demand from developed markets, although strong domestic demand and a pick-up in government spending will help mitigate some of the effects. President Aquino's landslide victory in the general elections of 2010 has resulted in a relatively stable political environment, but the lack of a legislative majority hinders the implementation of much-needed reforms. Additionally, achieving a sustainable reconciliation with two major insurgent groups remains a key challenge. Meanwhile, the government tries to uphold its commitment to fiscal consolidation, whereas the decelerating economy calls for both fiscal and monetary stimulus. The balance of payments is in good shape due to robust remittance inflows from overseas Filipino workers. Consequently, the Philippines enjoy a remarkably comfortable external position.

Things to watch:

- The external sector's exposure to uncertain global demand
- Negotiations with two prominent insurgent groups
- Tricky balancing act between fiscal consolidation and economic stimulus

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Philippines

National facts	
Type of government	Republic
Capital	Manila
Surface area (thousand sq km)	300
Population (millions)	99.9
Main languages	Filipino
	English
Main religions	Roman Catholic (81%)
	Muslim (5%)
	Evangelical (3%)
Head of State (president)	Benigno Aquino
Head of Government	Benigno Aquino
Monetary unit	Peso (PHP)

Economy		2011
Economic size	*bn USD*	*% world total*
Nominal GDP	225	0.33
Nominal GDP at PPP	390	0.49
Export value of goods and service:	61	0.28
IMF quotum (in m SDR)	1019	0.47
Economic structure	*2011*	*5-year av.*
Real GDP growth	3.7	5.0
Agriculture (% of GDP)	13	13
Industry (% of GDP)	32	32
Services (% of GDP)	56	55
Standards of living	*USD*	*% world av.*
Nominal GDP per head	2208	21
Nominal GDP per head at PPP	3835	31
Real GDP per head	1336	16

Social and governance indicators	rank / total
Human Development Index (rank)	112 / 187
Ease of doing business (rank)	136 / 183
Economic freedom index (rank)	107 / 179
Corruption perceptions index (rank)	129 / 183
Press freedom index (rank)	140 / 178
Gini index (income distribution)	44.0
Population below $1.25 per day (PPP)	18%

Foreign trade			2010
Main export partners (%)		*Main import partners (%)*	
US	15	Japan	12
Japan	15	US	10
Netherlands	14	China	9
Hong Kong	11	Singapore	8

Main export products (%)	*2011*
Electronic products	62
Garments	3
Coconut oil	2
Petroleum products	2
Main import products (%)	*2011*
Capital goods	32
Mineral fuels	16
Chemicals	9
Manufactured goods	7
Openness of the economy	*2011*
Export value of G&S (% of GDP)	27
Import value of G&S (% of GDP)	33
Inward FDI (% of GDP)	0.4

Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Economic Structure and Growth

The Philippines is often perceived as a laggard among its high-growth South East Asian neighbors. As a result of ongoing political instability, the country failed to undergo the structural transformation towards industrial manufacturing that has served as a catalyst for growth for many of its Asian peers. Although some success was achieved through the establishment of a competitive electronics sector in the 1990s, it failed to spur wide-spread industrial development in related sectors. As a result, the Philippines missed out on significant productivity gains experienced by rapidly industrializing countries. Instead, Philippine growth relied largely on services, a trend augmented by the striking expansion of Business Process Outsourcing (BPO) services over the last seven years. As such, the services sector dominates the economy, contributing 56% of GDP, while the industrial sector comprises a mere 32% of GDP. Additionally, although agriculture employs over one-third of the workforce, it produces just 13% of GDP, partially due to operational inefficiencies. The country's exposure to natural disasters has been the main hindrance on agricultural production as typhoons and floods frequently hamper crop yields. This results in fluctuating food prices and commensurate rates of inflation, as food amounts to 50% of the country's CPI basket.

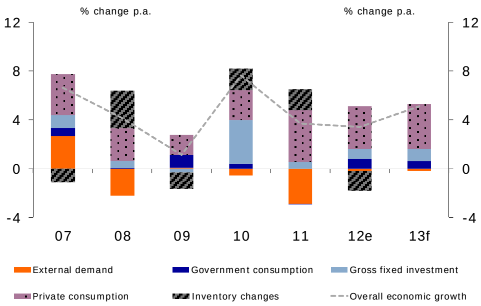
In addition to environmental disadvantages, there are a number of structural weaknesses that challenge the Philippine business environment. A history of political instability and a high level of corruption discourage investment in the Philippine economy by foreign investors. The investment climate is further hampered by a largely inflexible labor market, low-quality education, legal uncertainty and frequent power supply problems. Finally, the country lacks a well-developed and comprehensive infrastructure, something this 7107-island archipelago desperately requires. Consequently, the Philippines scores poorly on the World Economic Forum's *Global Competitiveness Report* with an overall ranking of 75, lagging behind neighbors such as Thailand (39), Indonesia (46), and India (56). It should be noted though, that this ranking has improved markedly in recent years.

Despite unfavorable initial conditions, the Philippine's economy has been accelerating rapidly on the back of a booming services sector and strong domestic demand. In the period 2000-11, growth averaged 4.7%, well above 2.9% average growth in the 1990s and 1.7% in the 1980s. After a stellar 7.6% growth rate in 2010 (somewhat exaggerated by base effects), the economy slowed to 3.7% in 2011 against the backdrop of weak external demand, severe government underspending and supply chain disruptions after the natural disasters in Japan and Thailand. Amid a struggling global economy, Philippine household consumption, fueled by overseas remittances and lower lending rates, has shown great resilience, increasing by 6.1% in 2011. With almost one-tenth of its total population working overseas, the domestic economy is highly dependent on remittances. The dependency on remittances could pose a threat as it exposes the Philippine economy to changing sentiment towards migrant workers. While the risk of a backlash against migrant workers is likely to increase in tandem with unemployment levels across the developed world, the impact on remittances has been limited so far. In the first quarter of 2012, overseas remittances robustly grew by 5.4% year-on-year.

We expect the economy to grow by 3-4% in 2012, supported by robust domestic demand and a pick-up in government spending. The external front, however, presents significant downside risks to this scenario, as the Philippines' main export destinations are the currently struggling industrialized markets. Both the European sovereign debt crisis and the sluggish recovery of the US continue to fuel uncertainty in demand. Next, the dependence on regional productions chains make Philippine exports susceptible to supply chain disruptions. Especially the electronics sector, which relies heavily on imports from those countries, incurred considerable losses due to interruptions up the supply chain.

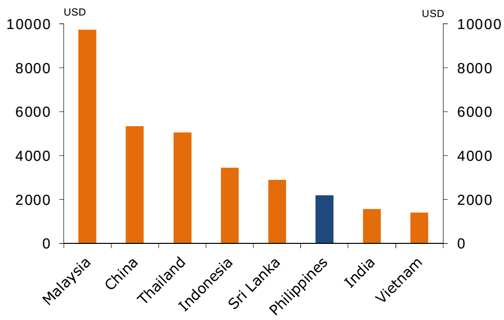
The banking sector continues to perform well amid the increasingly volatile international market. Exposure to spillovers from global financial disruptions is limited as total foreign exposures of domestic banks amount to just USD 1.9b, which is only 1.1% of total assets. Still, contagion could occur through pullbacks of credit by European banks, whose lending amounts to nearly 10% of GDP (approximately USD 22.5b). Fortunately, Philippine banks are well-equipped to absorb external shocks as system-wide capital adequacy ratios more than double the Basel II standard of 8%. The comfortable spread above the international minimum induced the Bangko Sentral Pilipinas (BSP, central bank) to accelerate the implementation of the higher capital requirements as laid down in the Basel III agreement. The new standards will now come into force in 2014, rather than being introduced progressively through the end of 2018. As such, the new schedule underscores the banking sector's credibility in a period of uncertainty in the global financial system.

Chart 1: Growth performance



Source: EIU

Chart 2: Nominal GDP per capita 2011



Source: EIU

Political and social situation

Under the 1987 constitution, the Republic of the Philippines is governed based on a separation of powers between the executive presidency, a two-tier legislative body and an independent judiciary. The legislative body, the Congress, is modeled after the US model, consisting of a directly-elected House of Representatives and Senate. In May 2010, President Benigno Aquino convincingly won the general election, promising to fight corruption and tackle poverty. With 42% of the votes, Aquino beat the second-place candidate by a record margin and created a strong mandate for political stability, something that has been lacking in most of the preceding decades. Two years into his presidency, Aquino still enjoys high approval ratings stemming from a strong commitment to his anti-corruption campaign.

The implementation of the government's reform agenda has been less convincing. Political effectiveness has been limited as the administration faces effective political opposition. This is largely the result of the fact that Aquino's Liberal Party governs without a legislative majority in either house of Congress. Fortunately for the government, mid-term elections are scheduled to be held in May 2013 and are expected to strengthen the administration's position as parties aligned with the president tend to perform well. Additional opposition stems from former president Gloria Arroyo, who has been a key target of the president's anti-corruption campaign. Arroyo remains influential in Congress and both the court system and the bureaucracy are dominated by her appointees. However, this May, Aquino enjoyed a symbolic victory over Arroyo when Renato Corona, Chief of Justice and Arroyo's highest-ranking ally, was found guilty of corruption. The conviction not only opens up the possibility of litigation against Arroyo, but may also provide a political boost for the government's reform agenda.

Meanwhile, poverty remains widespread and desperately requires the government's attention. The recent acceleration of economic growth failed to result in substantial income per capita increases and has not been inclusive. Real per capita GDP growth over the past decade averaged 2.9% annually, a slower pace than most emerging markets at the lower middle income level have tended to achieve. Nominal GDP per capita was USD 2208 in 2011, lagging behind neighboring countries such as Indonesia and Thailand (Figure 2). The subdued increase of per capita income is partly the result of persistently high population growth rates, which is something this government needs to address. Additionally, income inequality remains high, as reflected by a Gini index of 44% in 2010.

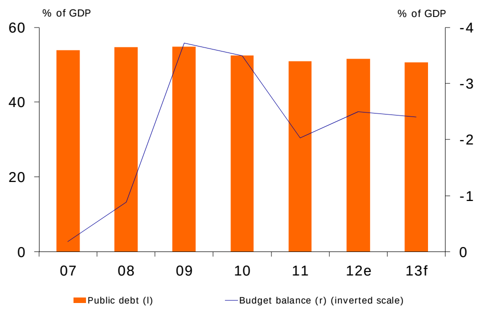
The security situation, especially in the southern islands, remains volatile due to the presence of a number of insurgent groups, each with different aims. Violent clashes between government forces and rebels as well as bombings and kidnappings continue to undermine domestic safety, although escalations have been less frequent recently. Despite the president's pledge to achieve peace with the two most prominent insurgent groups, the Moro-Islamic Liberation Front (MILF) and the New People's Army (NPA), the prospect of a sustainable reconciliation, especially with latter, remains bleak. Peace negotiations with the MILF this May resulted in a 10-point agreement that is hoped to be the basis for a final peace deal to end the decades-long insurgency. Optimism, however, should be kept in check because, although the MILF portrays itself as the sole representative of Filipino Muslims, there are various other powerful stakeholders that have not been included in the peace talks. Negotiations with the NPA started in 1986 already, but progress has been piecemeal due to deeply ingrained distrust and the fact that the NPA is listed as a terrorist group by both the US and the EU.

Economic policy

The Philippine government faces a challenge as it tries to uphold its commitment to fiscal consolidation, while the global economic downturn asks for both fiscal and monetary stimulus. The Philippines have incurred persistent fiscal imbalances over the past decades, which, unfortunately, did not lead to adequate spending on infrastructure, education and health services. However, in the years prior to the global financial crisis of 2008, robust economic growth and a series of tax reforms provided room for improvement. Between 2003 and 2007, the fiscal deficit, as a percentage of GDP, decreased from 4.4% to 0.2% and public debt came down from 73.8% of GDP to 53.9% of GDP over that same period. In response to the global financial crisis, the government issued an extensive stimulus package, allowing the deficit to surge to 3.9% of GDP in 2009. Since then, the government has returned to its path of consolidation as the deficit shrunk to 2.0% of GDP at the end of last year. While the commitment to consolidation has been lauded by credit rating agencies, the cutback in public spending led to subdued economic growth in 2011. In 2012, the government announced their resolution to boost economic growth by fast-tracking public spending, while at the same time adhering to a deficit of 2.6% of GDP in 2012 and 2.0% of GDP in 2013 and the years thereafter. To achieve this ambitious goal, a substantial increase in tax revenues will be required, the collection of which has proven challenging in the past. Furthermore, the increased tax burden will adversely affect domestic demand.

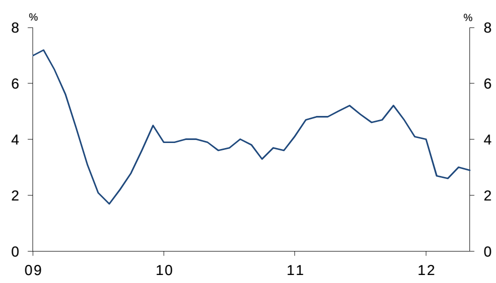
An inefficient tax system, constrained by a narrow tax base and a low level of compliance, has resulted in average revenues of only 15-16% of GDP over the past five years, leaving much room for improvement (OECD tax revenue averaged 34% over the same period). As such, policy reforms are needed to plug holes in the tax system, allow for the indexation of certain taxes to inflation and to increase excise taxes to levels on par with international standards. While these issues have been under discussion for many years, Aquino's administration has acknowledged the urgency of tax reforms and its efforts are starting to pay off. Long overdue changes to liquor and tobacco taxation are now expected to pass by Congress in the upcoming months, raising tax revenues by an estimated USD 1.4b annually. Alternatively, the government aims to boost tax revenues by improving the business climate. Ambitious public-private partnerships are introduced to boost much needed investment in infrastructure, but reforms are required to address the country's unreliable power sector, complicated business procedures and legal uncertainty.

Chart 3: Public finances



Source: EIU

Chart 4: Inflation (CPI)



Source: National Statistics Office Philippines

Meanwhile, the BSP has provided accommodative monetary policy to help mitigate the effects of an uncertain external environment. Last year, inflation averaged a high 4.8% due to rising fuel and commodity prices and was further exacerbated by the adverse effects of the typhoons on the domestic food supply. This year however, inflation has decreased quickly as a result of moderating growth and stabilizing food prices, cumulating in 2.9% year-on-year inflation in May 2012. With inflation on a downward path, the BSP lowered its main policy rates, the repo and repo reverse rate, in both January and March by 50bps in total, to 4.0% and 6.0% respectively. We expect monetary policy to continue to be accommodative, as the inflationary outlook remains favorable and downside risks to growth persist.

The value of the Philippine peso (PHP) is mostly being driven by global market sentiment, although its movement versus the USD has been fairly stable compared to other emerging market currencies. Both the Greek elections and the Spanish banking deal put downward pressure on the currency as traders and investors rebalanced their focus towards safe haven assets, such as the

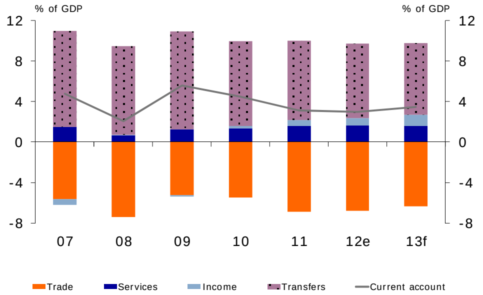
USD and Treasuries. Although the impact on the currency's volatility has been limited thus far, the recent European debt dynamics did prompt the BSP to express a commitment to curb excessive currency movements if needed.

Balance of Payments

The current account is in good shape as surpluses have averaged 4% of GDP over the past 5 years. The healthy condition is largely attributed to a remarkably sound transfer balance, which continues to be fueled by remittance flows from overseas Filipino workers. Although these remittances have proven to be highly resilient during economic downturns, the dependency on these inflows exposes the balance of payments to changing sentiment towards migrant workers. The trade balance is the main drag on the current account. In 2011, merchandise exports fell by 7% to USD 47.2b, largely due to a plunge in global electronics demand. With electronics making up 60% of exports, the Philippines lack a well-diversified export basket to mitigate headwinds from its main trading partners. Imports, mainly consisting of capital goods and fuel, meanwhile rose by 1.5% to USD 62.7b, due to higher oil prices and increased demand for durable consumer goods. Finally, a positive services balance has been supported by rapidly increasing receipts from the booming Business Process Outsourcing industry. Largely as a result of the trade balance, the current account fell from a surplus of 4.5% of GDP in 2010 to 3.1% of GDP in 2011. For 2012, the current account surplus is expected to contract to about 2.6% of GDP, reflecting uncertainty concerning the global market's recovery.

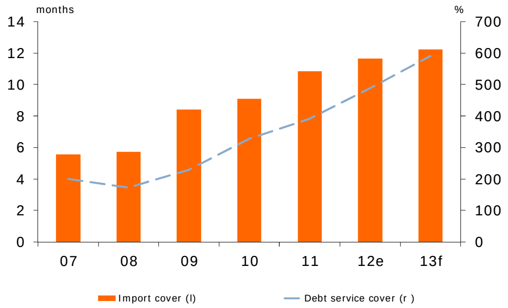
Although net FDI and portfolio inflows are positive, their relatively low levels underline the aforementioned deficiencies in the investment environment. The positive net capital inflows and robust remittances have resulted in record-high reserve accumulation. Total foreign exchange (FX) reserves grew to USD 67b in 2011, a 21% increase from 2010.

Chart 5: Current account



Source: EIU

Chart 6: Liquidity position



Source: EIU

External position

The current account balance's solid track record over the past years has resulted in a sound external position. FX reserves increased rapidly from a low USD 20b in 2006 to a record USD 67b in 2011. The prospect for 2012 looks bright as the FX reserves are expected to surpass total foreign debt for the first time, a welcome development. While FX reserves are estimated to rise to about USD 76b, total foreign debt is expected to decrease from USD 72b to USD 68b, which amounts to nearly 50% of GDP. Furthermore, the structure of foreign debt is healthy as only 7.7% comprised of short-term debt in 2011. With FX reserves resulting in an import cover of 11 months and a debt-service cover of 390%, the Philippines presently enjoy a very comfortable liquidity position.

Philippines

Selection of economic indicators	2007	2008	2009	2010	2011	2012e	2013f
Key country risk indicators							
GDP (% real change pa)	6.6	4.2	1.1	7.6	3.7	3.4	4.9
Consumer prices (average % change pa)	2.8	9.3	3.2	4.1	4.8	3.6	4.8
Current account balance (% of GDP)	4.8	2.1	5.6	4.5	3.1	2.6	2.7
Total foreign exchange reserves (mln USD)	30211	33193	38783	55363	67290	76480	87370
Economic growth							
GDP (% real change pa)	6.6	4.2	1.1	7.6	3.7	3.4	4.9
Gross fixed investment (% real change pa)	5.2	3.2	-1.7	19.1	2.7	4.5	4.9
Private consumption (real % change pa)	4.6	3.7	2.3	3.4	6.1	5.0	5.3
Government consumption (% real change pa)	6.9	0.3	10.9	4.0	-0.7	8.0	5.6
Exports of G&S (% real change pa)	6.7	-2.7	-7.8	21.0	-3.8	3.3	6.4
Imports of G&S (% real change pa)	1.7	1.6	-8.1	22.5	1.9	2.4	7.1
Economic policy							
Budget balance (% of GDP)	-0.2	-0.9	-3.7	-3.5	-2.0	-2.6	-2.4
Public debt (% of GDP)	54	55	55	52	51	50	49
Money market interest rate (%)	3.4	5.2	4.2	3.5	1.3	2.2	3.9
M2 growth (% change pa)	10	15	7	11	7	7	9
Consumer prices (average % change pa)	2.8	9.3	3.2	4.1	4.8	3.6	4.8
Exchange rate LCU to USD (average)	46.1	44.3	47.7	45.1	43.3	43.0	43.5
Recorded unemployment (%)	7.3	7.4	7.5	7.3	7.0	6.9	6.7
Balance of payments (mln USD)							
Current account balance	7112	3627	9358	8924	7078	6530	7410
Trade balance	-8391	-12885	-8842	-10966	-15450	-15820	-17270
Export value of goods	49512	48253	37610	50748	47231	50230	55740
Import value of goods	57903	61138	46452	61714	62681	66060	73010
Services balance	2249	1160	2114	2939	2238	2470	2710
Income balance	-899	105	-193	347	1293	1700	2880
Transfer balance	14153	15247	16279	16604	17642	18180	19090
Net direct investment flows	-620	1285	1604	1226	770	900	1300
Net portfolio investment flows	7194	-54	-3884	1338	6516	2100	2240
Net debt flows	4611	-3140	476	8300	-2860	-2610	-930
Other capital flows (negative is flight)	-7512	2081	-862	-1658	1426	1560	560
Change in international reserves	10786	3799	6692	18130	12930	8480	10590
External position (mln USD)							
Total foreign debt	66040	64995	63116	72337	72268	68500	66640
Short-term debt	7084	7001	4002	6295	5588	5050	5710
Total debt service due, incl. short-term debt	15147	19284	16881	16876	17242	16080	14880
Total foreign exchange reserves	30211	33193	38783	55363	67290	76480	87370
International investment position	-29066	-27433	-15369	-10589	n.a.	n.a.	n.a.
Total assets	66831	65486	77166	96127	n.a.	n.a.	n.a.
Total liabilities	95897	92919	92535	106715	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	-5.6	-7.4	-5.3	-5.5	-6.9	-6.2	-6.3
Current account balance (% of GDP)	4.8	2.1	5.6	4.5	3.1	2.6	2.7
Inward FDI (% of GDP)	2.0	0.9	1.2	0.9	0.4	0.4	0.5
Foreign debt (% of GDP)	44	37	37	36	32	27	24
Foreign debt (% of XGSIT)	83	82	89	82	83	74	66
International investment position (% of GDP)	-19.5	-15.7	-9.1	-5.3	n.a.	n.a.	n.a.
Debt service ratio (% of XGSIT)	19	24	24	19	20	17	15
Interest service ratio incl. arrears (% of XGSIT)	5	5	5	4	2	2	2
FX-reserves import cover (months)	5.5	5.7	8.4	9.1	10.8	11.7	12.1
FX-reserves debt service cover (%)	199	172	230	328	390	476	587
Liquidity ratio	151	141	169	172	176	185	191

Source: EIU