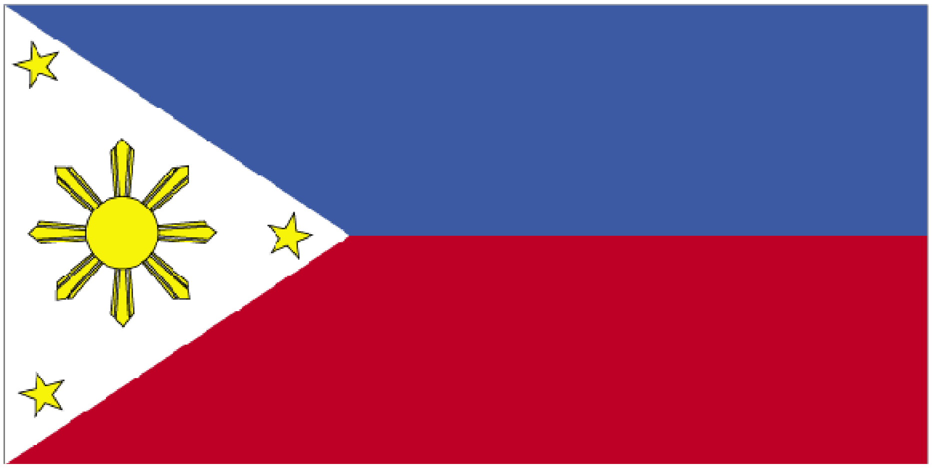
Country report **The Philippines**



Summary

The Philippine economy is estimated to grow by 5-6% in 2011. The triple disaster in Japan could adversely affect this estimate, as the country has deep trade and investment links with the Philippines. While the political situation has become more stable, the domestic security situation remains tense as two large terrorist groups still pose a significant threat. Fiscal consolidation efforts could be more successful if revenue-enhancing reforms are pushed through. As inflation is creeping higher, monetary policy will tighten this year. The balance of payments position is sound, as remittance inflows have proven to be a robust support. As a result, the external position is very healthy.

Things to watch:

- Negotiations with the two prominent terrorist groups
- Fiscal consolidation efforts
- Rising inflationary pressures

Author: **Ashwin Matabadal**
Country Risk Research
Economic Research Department
Rabobank Nederland

Contact details: P.O.Box 17100, 3500 HG Utrecht, The Netherlands
+31-(0)30-21- 61601
A.R.K.Matabadal@rn.rabobank.nl

Philippines

National facts	
Type of government	Republic
Capital	Manila
Surface area (thousand sq km)	300,000
Population (millions)	98.0
Main languages	Filipino
	English
Main religions	Roman Catholic (81%)
	Muslim (5%)
	Evangelical (5%)
Head of State (president)	Benigno Aquino
Head of Government	Benigno Aquino
Monetary unit	Peso (PHP)

Economy		2010
Economic size	*bn USD*	*% world total*
Nominal GDP	189	0.30
Nominal GDP at PPP	353	0.47
Export value of goods and services	64	0.35
IMF quotum (in mln SDR)	880	0.40
Economic structure	*2010*	*5-year av.*
Real GDP growth	7.3	4.4
Agriculture (% of GDP)	14	14
Industry (% of GDP)	31	31
Services (% of GDP)	55	54
Standards of living	*USD*	*% world av.*
Nominal GDP per head	1889	19
Nominal GDP per head at PPP	3531	30
Real GDP per head	1255	16

Social and governance indicators	rank / total
Human Development Index (rank)	102 / 179
Ease of doing business (rank)	140 / 181
Economic freedom index (rank)	104 / 179
Corruption perceptions index (rank)	171 / 180
Press freedom index (rank)	139 / 169
Gini index (income distribution)	44
Population below $1 per day (PPP)	13%

Foreign trade			2010
Main export partners (%)		*Main import partners (%)*	
US	18	Japan	13
Japan	17	US	12
Netherlands	10	China	9
Hong Kong	9	Singapore	9
Main export products (%)			
Electronic products			53
Garments			3
Coconut oil			1
Petroleum products			1
Main import products (%)			
Capital goods			26
Mineral fuels			16
Manufactured goods			6
Chemicals			8
Openness of the economy			
Export value of G&S (% of GDP)			34
Import value of G&S (% of GDP)			38
Inward FDI (% of GDP)			1.1

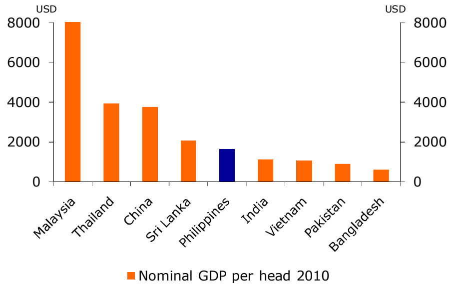
Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Economic structure and growth

In the 16th century, the Philippines was conquered by Spain. The country remained a Spanish colony until 1898, when it was ceded to the US following the Spanish-American war. In 1942, the country was occupied by the Japanese, but US forces fought together with Filipinos during 1944 and 1945 to regain control. In 1946, the country finally attained its independence. After 20-years of political stability under the rule of Ferdinand Marcos, which ended in 1986, the Philippines has been experiencing ongoing political turmoil. Despite political turmoil, the economy has grown robustly. In the past ten years, GDP growth averaged 4.5%. Unfortunately, a large portion of the population did not profit from these robust growth rates. Poverty worsened due to a unequal distribution of income (the Gini coefficient is 44) and a high population growth rate. Nominal annual income per capita is still very low at USD 1,889. The development level of the economy remains low. The economy is plagued by an unreliable power supply system, as blackouts are frequent. The dismal state of the country's infrastructure further hinders the business operating environment. The country's vulnerability to natural disasters is high, as inundations and typhoons are frequent and inflict serious damage to large parts the country each year.

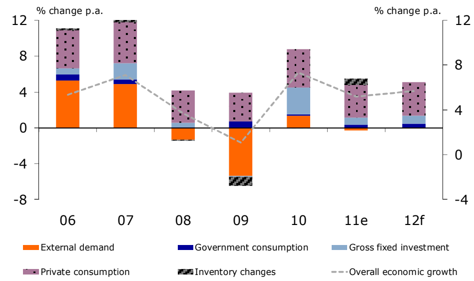
The services sector dominates the economic structure, contributing 55% to GDP. This is followed by the industrial sector with 31% and the agricultural sector with 14%. The industrial sector supports the large electronics sector. This sector is important since electronics are by far the country's largest export product, making up 53% of total exports. These products are mainly shipped to the US, Japan and the Netherlands.

Chart 1: Income level



Source: EIU

Chart 2: Growth performance



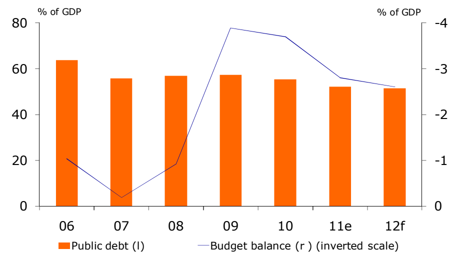
Source: EIU

The Philippines imports mostly capital goods and mineral fuels. Its largest import partners are Japan, the US and China. The economy is not very open compared to its regional peers, as the country's openness amounts to only 72% of GDP. As such, the economy depends relatively strongly on domestic demand for its growth. This demand has spurred economic growth only due to extremely robust remittance inflows. Money sent back home from the 4-5 million overseas Filipino workers has been a backbone for household consumption, even during the global financial crisis. Unlike its regional peers, the Philippine economy escaped a technical recession during the crisis by posting only one quarter of negative growth. The economy grew by 1.1% yoy in 2009, and rebounded strongly in 2010, growing by a stellar 7.3%, although some base effects exaggerate this figure. Even so, we expect the economy to grow by 5-6% in 2011, as domestic private consumption remains strong. A downside risk to this scenario is the possible negative consequences of the disaster in Japan. Over 30% of total foreign investment in the Philippines comes from Japan, and this could be retracted to support domestic rebuilding. Also, exports could suffer, as 17% of total exports go to Japan, and electronics exports could be affected due to possible supply disruptions of electric components from Japan.
The banking system has weathered the global financial well since it had no direct exposure to US subprime-related assets and no domestic credit boom financed by offshore bank borrowing existed. Instead, we observe a modest credit growth, sound capitalization, with a relatively low ratio of non-performing loans.

Political and social situation

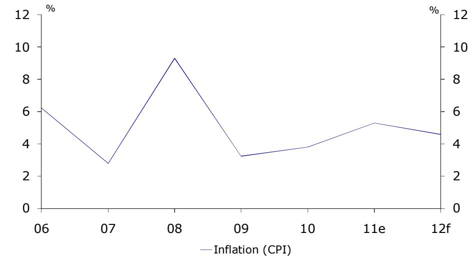
President Benigno Aquino III has been in power since the May 2010, when he won the general elections as leader of the main opposition party, the Liberal Party (LP). He secured a landslide victory with 42% of the votes, which has given him a decisive mandate that bodes well for political stability. President Aquino III won the approval of the electorate by promising to tackle corruption, to restore credibility of the judiciary and congress and to fight poverty. His first move towards these goals was sound, as he appointed a cabinet of experienced and skilled members.
However, actually succeeding to meet these goals during his six-year term will be a huge challenge. First of all, the LP lacks a legislative majority in either house of parliament, and the court system and bureaucracy remain dominated by former president Arroyo's appointees. Also, Aquino's lack of proven leadership skills are a concern, despite his skilled cabinet members. His popularity does not stem from a sound track record, but rather from his election pledges and his legacy. His mother, Corazon Aquino, is the country's late president and was well-loved among the population. The president thus faces huge expectations to live up to his family name, which will work against him if he fails.

Chart 3: Public finances



Source: EIU

Chart 4: Inflation



Source: EIU

The social situation suffers from a dismal security situation, although this has improved in recent years. Terrorism is a significant problem, as the activities of two major terrorist groups continue. The New People's Army (NPA), continues to wage war after 40 years, campaigning to establish a Maoist state in the Philippines. President Aquino III has succeeded in easing the tensions with the NPA via peace talks. He has shifted the focus in the government's anti-insurgency program from a military offensive meant to rapidly eliminate the NPA to a more co-operative strategy. Tensions remain high with the Moro-Islamic Liberation Front (MILF), the second-most prominent terrorist group. Under the previous government, peace talks had commenced between former president Arroyo and the MILF, and had led to a temporary truce in June 2010. However, splinter factions of the MILF ignored this truce, which consequently has been suspended ever since. Aquino has not yet approached the MILF to re-engage in any peace talks.

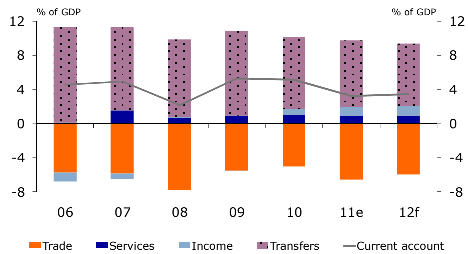
Foreign policy is conducted through the Association of South East Asian Nations (ASEAN), via which the Philippines maintains close ties with its neighbours. Terrorism and security issues dominate these ties, as well as the relationship of the Philippines with the US, which is heavily involved with counter-terrorism efforts in the southern islands.

Economic policy

The government issued a costly stimulus package in 2009, equivalent to 4.1% of GDP, to combat the negative effects of the global financial crisis. However, the fiscal position has been on a positive trend since, as the government embarked on a path of fiscal consolidation. While the budget deficit was 3.9% of GDP in 2009, it is forecasted to post a deficit of 2.8% of GDP in 2011. As a result, public debt will improve to 52% of GDP in 2011 from 55% in 2010. This is only a small improvement, more substantial improvements could be achieved if structural reforms to broaden the revenue base are pushed through. Total revenues are historically very low in the Philippines. Over the last five years, these have averaged only 15-16% of GDP. The government could increase revenues by broadening the tax base, making tax collection more efficient, implementing the indexation certain taxes to inflation and by curtailing tax evasion and avoidance. While these measures have been under discussion for many years, there have been little results as political conflicts have hampered progress on tax reforms. Improving the investment climate should also be a top priority to boost tax revenues. The government should also tackle the poor infrastructure, power sector problems, weak financial markets and complicated business procedures, but has made little progress so far. Overall, there is more to be gained by boosting revenues in a structural manner rather than by suppressing expenditures.

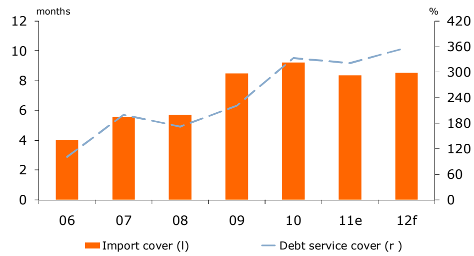
The Bangko Sentral Pilipinas (BSP), the country's central bank, has commenced to tighten monetary policy this year. The main policy rates, the repo and reverse repo rate, were most recently raised in March 2011, both by 25bps to 6.25% and 4.25% respectively. Inflation has risen to over 4% in April, on the back of both higher food and commodity prices as well as strong

Chart 5: Current account



Source: EIU

Chart 6: Liquidity position



Source: EIU

domestic demand. We expect monetary tightening to continue this year, as the BSP stated its target inflation range of 3-5% is at risk. We agree that risks of upward inflationary pressures have increased, as it is estimated inflation will average 5.3% in 2011.

Balance of Payments

The current account is healthy as it has posted an average surplus of 4.4% of GDP over the past five years. In 2011, it is estimated to post a surplus of 3.2% of GDP. The main support of the current account is the transfers balance, with a 7.8% of GDP surplus expected in 2011.
Remittances inflows of the 4-5 million overseas Filipino workers are very strong. Even during the global financial crisis, they proved very resilient as these workers are spread over across various regions and work in various sectors, making for a well-diversified overseas labour force.
The main drag on the current account is the trade balance, estimated to record a 6.5% of GDP deficit in 2011. Imports mostly constitute of capital goods, but the Philippines is also a large importer of rice and oil. As the latter two are necessary imports, this makes the import basket very inflexible. Exports have been on a moderating trend this year, and grew by a modest 4% yoy in March 2011. The disaster in Japan could negatively affect supply for Philippines electronic products, which is the country's most important export product. However, supported by demand from the US, China and Japan, we expect export growth to remain positive this year.
As the current account balance is positive, external financing is not needed. While net FDI and portfolio inflows are positive, these could be substantially higher if the government advances the investment climate by improving the operational environment. The surplus on the current account will result in a higher stock of FX-reserves, which are forecasted to rise by EUR 3.7bn to EUR 59bn at the end of 2011.

External position

The sound position of the balance of payments over the years has resulted in a healthy external position. Total foreign debt amounted to EUR 63bn in 2010, while FX-reserves stood at EUR 55bn. At the current pace, it is forecasted the stock of FX-reserves will exceed total foreign debt in 2012, a favorable development. A positive aspect of the structure of foreign debt is the fact that only 18% is comprised of short-term debt. The amount of total foreign debt is expected to remain equal in 2011. The liquidity position is sound, as FX-reserves cover more than 9 months of imports and the debt-service cover is 333% (end-2010).

Philippines

Selection of economic indicators	2006	2007	2008	2009	2010	2011e	2012f
Key country risk indicators							
GDP (% real change pa)	5.3	7.1	3.7	1.1	7.3	5.2	5.7
Consumer prices (average % change pa)	6.2	2.8	9.3	3.2	3.8	5.3	4.6
Current account balance (% of GDP)	4.5	4.9	2.2	5.3	5.2	3.2	3.5
Total foreign exchange reserves (mln USD)	20025	30211	33193	38783	55361	59080	66100
Economic growth							
GDP (% real change pa)	5.3	7.1	3.7	1.1	7.3	5.2	5.7
Gross fixed investment (% real change pa)	3.9	10.9	2.7	-0.4	17.1	4.4	4.7
Private consumption (real % change pa)	5.5	5.8	4.7	4.1	5.3	4.6	4.9
Government consumption (% real change pa)	10.4	6.6	0.4	10.9	2.7	5.0	5.3
Exports of G&S (% real change pa)	13.4	5.5	-2.0	-13.4	25.6	5.8	6.0
Imports of G&S (% real change pa)	1.9	-4.2	0.8	-1.9	20.7	6.3	6.0
Economic policy							
Budget balance (% of GDP)	-1.0	-0.2	-0.9	-3.9	-3.7	-2.8	-2.6
Public debt (% of GDP)	64	56	57	57	55	52	51
Money market interest rate (%)	5.3	3.4	5.2	4.2	4.0	4.5	4.8
M2 growth (% change pa)	21	10	15	7	11	14	15
Consumer prices (average % change pa)	6.2	2.8	9.3	3.2	3.8	5.3	4.6
Exchange rate LCU to USD (average)	51.3	46.1	44.3	47.7	45.1	43.4	43.9
Recorded unemployment (%)	8.0	7.3	7.4	7.5	7.3	7.2	7.0
Balance of payments (mln USD)							
Current account balance	5347	7119	3633	8552	9721	7430	8760
Trade balance	-6732	-8391	-12885	-8878	-9535	-15090	-14910
Export value of goods	46526	49512	48253	37510	52233	58030	65560
Import value of goods	53258	57903	61138	46388	61768	73120	80480
Services balance	137	2249	1160	1539	1894	2090	2430
Income balance	-1255	-892	111	-69	1302	2430	2810
Transfer balance	13197	14153	15247	15960	16060	18000	18420
Net direct investment flows	2818	-620	1285	1589	1600	1680	1950
Net portfolio investment flows	2836	7194	-55	2666	6347	4190	3610
Net debt flows	-2194	4611	-3147	-3993	-753	-1590	-910
Other capital flows (negative is flight)	-4335	-7519	2083	-2122	1213	-9010	-6380
Change in international reserves	4472	10786	3799	6692	18128	2710	7020
External position (mln USD)							
Total foreign debt	60282	65910	64856	63097	63704	63790	62890
Short-term debt	5009	7084	7001	6646	9109	9720	10440
Total debt service due, incl. short-term debt	19876	15147	19279	17579	16619	18370	18500
Total foreign exchange reserves	20025	30211	33193	38783	55361	59080	66100
International investment position	-31489	-28717	-27141	-16463	n.a.	n.a.	n.a.
Total assets	50423	66831	65486	75255	n.a.	n.a.	n.a.
Total liabilities	81912	95548	92627	91718	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	-5.7	-5.8	-7.7	-5.5	-5.1	-6.5	-5.9
Current account balance (% of GDP)	4.5	4.9	2.2	5.3	5.2	3.2	3.5
Inward FDI (% of GDP)	2.5	2.0	0.9	1.2	1.1	0.9	1.0
Foreign debt (% of GDP)	51	46	39	39	34	28	25
Foreign debt (% of XGSIT)	85	83	81	90	72	64	58
International investment position (% of GDP)	-26.8	-19.9	-16.2	-10.2	n.a.	n.a.	n.a.
Debt service ratio (% of XGSIT)	28	19	24	25	19	19	17
Interest service ratio incl. arrears (% of XGSIT)	6	5	5	4	3	2	2
FX-reserves import cover (months)	4.0	5.5	5.7	8.5	9.2	8.3	8.5
FX-reserves debt service cover (%)	101	199	172	221	333	322	357
Liquidity ratio	130	151	141	164	173	164	166

Source: EIU