PHILIPPINE ECONOMIC OUTLOOK 2006

Speech for Philam Asset Management, Inc and Standard Chartered Bank

Roberto F. de Ocampo

Makati Shangri-La, 21 February 2006

Good evening ladies and gentlemen! First and foremost, I would like to thank Philam Asset Management and Standard Chartered Bank for inviting me to speak at this economic briefing. Occasions like these are always a good time to take stock of the current situation and gear up for the new challenges of the coming year. My presentation tonight will begin with a brief analysis of the economic performance of the Philippines for 2005, before proceeding to our fearless forecast for 2006.

(Next slide)

2005 was quite a challenging year for the Philippine economy. Though the year started on an optimistic note, with the peso and stock market hitting new highs in March thanks to the passage of crucial fiscal measures, the economic mood turned sour at the end of the summer. As usual, the economic slowdown was caused by the country's political condition. The administration was rocked by a self-inflicted crisis of legitimacy that began in May and remained at the forefront of everyone's mind for most of the second and third quarters. Though much of the political noise has died down, many political questions remain unresolved, with nary a solution in sight in the near term.

On top of the political crisis, the country also suffered from a fiscal hangover caused by the massive government spending realized in 2004 – which "coincidentally" was an election year. The possibility that the Philippines would go the way of the Argentinean default spooked a number of investors, especially when the political crisis caused or merely coincided with, depending on what you believe, the non-implementation of the extended Value Added Tax law.

The domestic economy was definitely not aided by the negative external environment. Global oil prices continued to escalate throughout the year, moving from around \$42 to \$62 per barrel. Demand for the country's exports, particularly electronics, remained sluggish. Moreover, the country's agricultural sector, heavily dependent on favorable weather rather than on irrigation, recovered very slowly from last year's El Niño.

(Next Slide)

Despite the many challenges, the economic performance of the Philippines was surprisingly resilient. The country's GDP grew by a respectable 5.1% for the year 2005, buoyed mainly by a strong rebound in growth during the last quarter of the year. The economy's performance in 2005 was slower than the 6.0% growth of 2004, and was pulled down mainly by the weaker performance of the agricultural sector.

(Next Slide)

The slowdown in the Philippine economic performance was mimicked by the weaker economic performance of our Asian neighbors, with the exception of tsunami-hit Indonesia and Sri Lanka. While our economic performance in 2004 pushed us to the middle of the pack among our counterparts, our 2005 performance has placed us back down among the laggards, surpassing only South Korea in GDP growth performance. This statistic alone showcases how our chaotic politic atmosphere is contributing to our inability to attain our economic potential.

(Next Slide)

Despite all of the challenges faced by the country in 2005, many other economic indicators point towards positive developments for the country. The most palpable development on everyone's mind is the sudden strengthening of the local currency from more than 56 pesos per US dollar to its current level between 51.50 – 52.00 pesos. This development is associated mainly with the phenomenon in the next slide.

(Next Slide)

In 2005, remittances from overseas Filipino workers grew by an astonishing 25% year on year to more than US$10 billion. Much of this can be attributed not only to greater deployment of Filipino workers, but also to OFWs gaining access to higher paying jobs, particularly in the health care and professional services sectors.

(Next Slide)

Proceeding to the government sector, the budget deficit is also showing signs of coming under control. The better-than-expected reduction of the deficit in 2005 was achieved in spite of disappointing collection totals from the two main revenue-gathering agencies: the Bureau of Internal Revenue (BIR) and the Bureau of Customs (BOC). The shortfall was compensated for by better-than-expected returns from the Bureau of the Treasury, mostly due to a large saving on interest payments, the largest category of government expenditure, because of lower than forecast domestic interest rates.

(Next Slide)

The country's local stock market has also returned to an upbeat mood after moving sideways during the middle part of the year. Overall, the market performed credibly last year, with the Phisix rising by around 15% throughout 2005. More importantly, there was an increase in average monthly trading value by around 85%, indicating the return of portfolio investors to the country.

(Next Slide)

Even the country's bond market has been showing signs of improvement. The spreads on Philippine government bonds have been tightening, decreasing to less than half of their level from last year. This showcases the greater confidence of domestic and international investors in the diminished default risk of the Philippine government.

(Next Slide)

Even the country's inflation rate seems to be easing. Inflation rates have diminished over the final quarter of the year. Although inflation is expected to suffer from a slight uptick beginning this month due to rising oil prices and the implementation of the increased VAT of 12%, the stronger peso is expected to somewhat temper this inflation.

(Next Slide)

Overall, things seem to be looking up for the Philippines coming into 2006. Fitch and Standard & Poor's have recently revised their outlook for the country from negative to stable, with only Moody's taking a more wait-and-see attitude by retaining their negative outlook for the Philippines. The implementation of the 12% VAT is expected to further boost tax collections and lower the government budget deficit even further. If the La Niña weather patterns are not too destructive, the country's agricultural sector is expected to bounce back from its major slump in performance during the past year. The national government has projected increased worldwide demand for the country's main agricultural export crops such as banana, coconut, pineapple, mango and abaca.

According to a Bear Stearns study, electronic exports should rise by at least 5%-8% in 2006, as many electronics companies have recently invested in expanding their capacity. In fact, according to their data, the slight increase in foreign direct investments was driven by a 70% increase in electronics investments in 2005. Though a number of electronics assemblers moved their operations to China, the more high-value added electronics and semiconductor operations have remained in the Philippines and these companies are the ones embarking on an expansion path.

Even businessmen are riding on this upbeat mood, with the latest Bangko Sentral ng Pilipinas Business Expectation Survey recently registering a dramatically higher level of optimism for the country's prospects.

(Next slide)

Before one begins rejoicing about the country's positive economic prospects, one should take a sobering assessment of the country's medium- and long-term growth potential. One must only be reminded of the heady days of January and February 2005, when a surging peso and stock market also seemed to indicate a strong economic turn-around for the country, before the scandals of May and June overtook the positive economic developments. In fact, many questions still remain. Indeed, are things as good as they look? More importantly, why are these economic gains not being felt by the general population?

(Next slide)

The fact is that with or without political crises, many challenges remain in the Philippine economic arena. For one thing, the country's investment climate is still unable to attract substantial amounts of foreign direct investment. Net FDI inflows in the country remain far from the levels achieved as late as 2002. We are all too familiar with the reasons for this: deteriorating physical infrastructure, inconsistent investment rules with the Clark incentives brouhaha as just one among many examples, bureaucratic snafus, peace and order problems, expensive electricity prices, the list goes on and on. Truly much work has to be done, if the government desires to achieve a more substantial and sustainable economic growth rate in the near term.

(Next slide)

In addition, the currency appreciation does not seem to be sustainable. The strength of the currency could be explained as an offshoot of tightening BSP regulations that are designed to course more remittances through official channels. In addition, in the past year, much portfolio investment funds have entered the Philippine markets. According to the

BSP, the country has experienced a five-fold increase in portfolio investment in 2005 as compared to 2004.

The surge in portfolio investments can be attributed to excess liquidity in the global markets. The European Central Bank and the Bank of Japan have been pumping money into their respective economies in hopes of improving the economic performance of their respective countries. In the past year, money supply reportedly grew by 9.8 percent in Australia, 11.2 percent in Britain, 6.6 percent in the United States, and 8.5 percent in the Euro area. That is a lot of new money being pumped into the entire global financial system, a substantial fraction of which is entering the Asian region to countries such as China, Thailand and Malaysia, with the Philippines also on the receiving end of these funds. To illustrate this point, some economists have pointed to the fact that the rise and fall of the Philippine stock market index have been in step with the rise and fall of stock market indices in the Asia Pacific region. Though the entry of portfolio investments is a good sign for the country, it must be borne in mind why these funds are generally termed as 'hot' money: they can flow out of a country as quickly as they flow in.

(Next slide)

Lastly, the rise in the peso-dollar exchange rate has been largely attributed to this year's surge in OFW remittances. Like what was said earlier, 2005 saw a 25% increase in remittances from overseas workers. What is particularly interesting about this phenomenon is that there is a level of seasonality to these funds: OFW's tend to remit the most money during the Christmas season in December and the school enrollment season in May. As such, the Philippines generally experiences a seasonal currency appreciation that peaks from February to May of each year. This current currency upsurge may be just the continuation of an annual trend that should last for a few more months before easing.

(Next slide)

Strong inflation generated by the implementation of E-VAT could have a dampening effect on consumer spending. Last year's E-VAT implementation pushed consumer spending growth to only 1% and 8% respectively in the last two quarters.

(Next slide)

The Philippines still has much to do to improve its overall economic competitiveness. In the latest World Competitiveness Yearbook report, a global study conducted by the Swiss business school, IMD, in partnership with the AIM Policy Center, the Philippines ranked 49th among 60 economies. Though this was an improvement from 2004's 52nd place ranking, the country remained among the cellar dwellers, especially when compared to its Asia Pacific neighbors. Though the country saw a strong improvement in its 2005 business efficiency, governance and infrastructure issues remained as the main hindrances to the country's overall competitiveness.

(Next slide)

There is a strong disconnect between the good news that we have seen in the previous slides and the general economic malaise that is felt by the population at large. Much of the economic growth being reported by the government has not been felt by the masses. The slow growth in agriculture, still one of the leading employers of the country, is one culprit. Another is the low direct investment rate of the country. A previous study we conducted at AIM has highlighted the excess liquidity and low credit growth being experienced by most Philippine banks because of the shortage of good investment opportunities in the country. Falling investments and agricultural growth translates to lower job generation, which has not been helped by the high inflation caused by the increase in world oil prices and the higher Value Added Tax rates.

(Next slide)

Nonetheless, 2006 has the potential, with a stress on the word potential, for becoming an economically buoyant year for the Philippines because of the following growth drivers. Again, we have to stress the word potential, as these growth drivers are predicated on the performance of the national government.

First and foremost among the growth drivers is the improved VAT collections and the fiscal reforms. With the government targeting a balanced budget by 2008, the country would seriously benefit from a government with enough funds to implement improvements in education, health, housing and other social sectors. The credit ratings outlook upgrade by Fitch and Standard and Poor's is a step in the right direction and is already encouraging investors to take another look at the country.

Secondly, there are a number of foreign and local investors ready to implement massive infrastructure development programs that would greatly improve the decaying transport network of the country and improve the overall efficiency of the economy. Among these major infrastructure developments are the North Rail project, Subic-Tarlac expressway, the Northeast Luzon Expressway, LRT-7, the Panay and Mindanao railroads, among others. In addition, the long overdue privatization of the country's power sector could infuse much needed revenue and expertise into our expensive electricity sector. These massive investment projects could have a multiplier effect throughout the country, even while these projects are being constructed.

The mining sector is another booming sector in-waiting. The Philippines is literally sitting on a goldmine and would benefit tremendously from foreign capital and expertise in reviving this dormant industry. There are a host of other booming sectors in the country: the Business Process and IT outsourcing industry has growing tremendously over the past few years, already exporting close to US$2 billion worth of services. In fact, our sponsors AIG and Standard Chartered Bank, are among the many foreign companies that are globally benefiting from this new industry. The country is also experiencing growth in the tourism sector, with another record-setting number of tourists expected to visit the Philippines this year. The country's finance industry has also grown significantly in the past year and is expected to continue growing in the coming year.

(Next slide)

However, these growth drivers can only succeed in driving the economy if they are implemented properly – otherwise the story of the Philippines would remain as the story of unfulfilled promise.

Despite the passage of new tax laws, it remains a great challenge for the government to collect the taxes that are mandated in the law books. As everyone in this room knows, the main problem with the Philippine government tax collection process is not the lack of tax legislation but their implementation. Estimated tax leakage from the original VAT law ranges from about 26-38%. Other economists figured that in a country with almost 7 million employees and 3 million credit card holders, it is strange that only around 2 million people file their income taxes.

Even with the increased tax intake, it is difficult to see an improvement in the quality of government expenditure. For one thing, at least 36% of government revenues are utilized solely for interest payments on government debt. Another substantial proportion of government revenues is spent in the payment of salaries and benefits for a bloated bureaucracy. Given these built-in expenditure items, how much money will actually be left for needed infrastructure improvement programs?

Despite the urgency of the infrastructure deficiency of the country, the government does not seem to be in a hurry to implement these much-needed infrastructure projects. Anyone coming from abroad would only have to look to the right upon landing at the Ninoy Aquino International Airport to notice the presence of an unused world-class terminal rotting nearby.

Even the renewed mining industry is faced with renewed opposition from the Catholic Church, and it seems that the Church is getting a sympathetic nod from the government. The government has recently been making conflicting statements on the status of this sector, much to the dismay of potential foreign investors.

The privatization of the power sector remains in limbo, five years after the passage of the reform law that mandates a three-year timeframe for the implementation of at least 70% of the privatization program. At present, only 3% of the power assets have been sold, with hardly any real timetable for the sale of the rest of the assets.

(Next slide)

The global scenario for 2006 is also fraught with major risks. The first is that a continued escalation of problems in the Middle East could produce another spike in the price of oil. Another potential risk factor is the spread of bird flu, which could potentially produce effects that are much worse than that of the 2002 SARS outbreak. Even if the Philippines remains bird-flu free, an outbreak among our neighbors would spell disaster for certain sectors, such as poultry, tourism, hotel & restaurants and air travel.

(Next slide)

Of course, the largest wrench in the Philippine economic motor remains the country's fractious political system. Philippine national elections are scheduled for 2007 and there are currently two major political forces vying for a say in how these elections will be contested. One set is pushing for the continuation of mid-term elections, while another is lobbying for constitutional change that would make the 2007 elections a contest for parliamentary seats instead. Both of these options require at least one year of preparation, making June of 2006 a critical date to watch. Of course, one could say that there is a third political force that is vying for a total revolution of the system. It would be impossible to predict where this type of political change would lead to. Parliamentary or presidential system notwithstanding, it remains difficult for me to see any real initiatives leading to an improvement in the way the country is governed.

(Next)

Therefore what is our outlook for 2006? My fearless forecast can be characterized as being fraught with cautious pessimism. Though there has been much improvement in the country's economic situation from the previous months, the unresolved political overhang means that there will be no substantial improvement in the way the country is governed. Even barring the escalation of the present political crisis, the Philippines remains in the same economic situation that allows the country to grow in a stable but unremarkable manner. If the government is unable to produce substantial improvements in its fiscal position, the currency could possibly slide by the end of the remittance season and fall back towards last year's levels. In essence, the country will likely muddle through 2006, as it did in 2003, 2004 and 2005.

It must be said that there is a way out of this growth malaise. For almost fifty years, economists spoke of a Hindu rate of growth to describe the unremarkable but stable economic performance of the Indian economy. When the country began implementing economic reforms in earnest about 10 years ago, the Indian economy started charging forward and is currently growing at an 8% clip, with a potential to grow by 10% in the near term. India, with its colorful and chaotic democracy, highly literate English-speaking workforce, surging outsourcing industry, large diaspora and strong remittances inflows could serve as a model for the Philippines. If we were to follow this economic model, then someday perhaps, my Philippine economy presentations would describe the country's economic outlook as more than just muddling through.

Thank you very much.

For RFO's Reading Copy only

Extended VAT on Gasoline, Power, etc: + 12% VAT:

Government Projected Increase	PhP75-86 billion each year
Fitch estimate	PhP60 billion