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Philippines

SEB MERCHANT BANKING – COUNTRY RISK ANALYSIS **September 25, 2019**

Analyst: Rolf Danielsen. Tel : +46 8 763 83 92. E-mail : rolf.danielsen@seb.se

A growing track record of reasonably strong macro metrics would make Philippines an obvious candidate for a further country risk upgrade but for continued delays to the implementation of ambitious infrastructure programs needed to solve bottlenecks and bolster economic performance. We also note that ongoing reforms have seemingly so far failed to improve investor perceptions of the country as an attractive place for business.

Country Risk Analysis

Failed implementation of the government's large-scale infrastructure program in the first half of the current year, is now likely to bring economic growth down to 5.7% for 2019, 0.5pp (percentage points) lower than last year. That will be accompanied by a moderate budget deficit of about 2.5%/GDP and lower inflation around the 3% target while the current account deficit stays almost unchanged from last year at 2.5%/GDP. Reduced growth performance is therefore something the Philippines can well afford, but it is still paramount that investors do not lose confidence in the political system's ability to deliver.

Recent years' widening of the fiscal deficit to a still moderate 2.3%of GDP is set to increase slightly in 2019 to 2.5% of GDP assuming a forceful pick-up in government expenses to make up for lost grounds in the first half of the year. This is despite a successful effort to raise the tax take mainly through improved tax administration and collection which has much helped to increase the government's revenue base thereby expanding the fiscal room for public sector investments. That is inasmuch as a moderate sovereign debt level of some 40%/GDP is not threatened by contingent liabilities as long as the banking system stays reasonably healthy.

Monetary policies have underpinned this result by keeping the rate of inflation close to the target – 3% a year – with only limited regard to the exchange rate which has gradually strengthened without threatening the country's competitiveness. Structural reforms, in return, have so far failed to convince investors that the country is on course to throw off a legacy of corruption and red tape.

After mid-term elections in last May strengthened the position of the ruling party of Pr. Duterte, political stability and calm should now prevail until next presidential elections in 2022 when the incumbent is constitutionally barred from running. His controversial war on the drug cartels and other crime has so far not deterred investors, neither have continued terrorist attacks in the southernmost islands of the archipelago. -- In the longer term, we continue to hold out the Philippines' prerequisites including a thriving and entrepreneurial young population which continues to grow fast without so far overwhelming the country's ability to create jobs including in the BPO industry.

The rating agencies have reacted with positive comments on the outlook for the sovereign. In last April, S&P raised its rating one notch to BBB bringing it at par with other agencies. Country risk, however, remains somewhat hampered by indications of weak investor confidence.

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Recent economic developments

Failed implementation of the government's large- scale infrastructure program in the first half of the current year, is now likely cut economic growth down to 5.7% for the whole year, 0.5pp (percentage points) lower than last year. In return that will aid the external balance to stay almost unchanged from last year at 2.5%/GDP deficit on the current account. That is on the back of softer imports and despite global headwinds for exporters but underpinned by high reserves. They cover more than eight months of imports or the entire external debt of the country. Reduced growth performance this year is something the Philippines can well afford, but it is still paramount that investors do not lose confidence in the political system's ability to deliver.

Growth starting to trail: Following a streak of robust growth ending with 6.5% annual expansion of 2018, good economic performance has started to show signs of fatigue and reached only 6% in the second half of the year. The slowing continued into the early 2019 and for the whole year estimates are for slightly softer activity reaching only 6.1% yoy (year-on-year), 0.1pp (percentage points) weaker than the year before saved only by some cautious pick-up toward year-end. While still strong compared to most peers, the reasons for the apparent trailing could be seen as more ominous. Since the beginning of the current year, real investments -- in particular for government infrastructure projects -- have suffered a serious collapse. First, the government was not able to pass a new budget law through Congress with the effect to arrest allocations to many public sector construction projects. Then, second quarter mid-term elections limited the pre-election dispersion of public money, while uncertainty over a new tax-code held many private investors back. In the event first quarter investments dropped by a substantial 27% yoy.

Second quarter disappoints: Hopes for a second quarter rebound did not fully materialize and in June the production index for industries was still on a declining trend down more than 10% yoy. Softening household demand, 0.5pp down to 5.6% yoy on failing consumer confidence while growing global headwinds for the manufacturing industry have compounded the problems. Only a steep fall in import demand has generated a positive contribution from net exports to GDP upholding estimates of an economic expansion for the whole year at 5,7% provided a boost to investment demand kicks in in the second half of the current year.

Price pressure moderates: The cooling of domestic demand has helped moderate domestic price developments underpinned by tightening of monetary policies. Last fall a confluence of adverse price developments, including higher global oil prices, caused the monthly inflation rate to spike, reaching a peak of 6% in September and subsequently prompting the authorities to raise policy rates. This had the desired effect to temper price pressure which has so far in the current year moderated to around 3% on an annual basis, well within the target range of 2-4% annual growth.

Labor markets remain strong: Despite the gradual cooling of economic expansion, the unemployment rate has continued declining to 5% of the labor force, while the rate of underemployment has dropped to a low of 13%, down 2pp from last year. That means the participation rate continues to grow from 61% of the working age population estimated in 2018 at a slightly faster clip than population growth. Still, there are deep pockets of unemployment in many places. Almost two thirds of the unemployed are males in the age of 15-24 years.

External balances and rising reserves: The softening of domestic investment demand saw imports of capital goods weaker than expected with the result to narrow the trade deficit in the first half of the current year. That was despite struggling

manufacturing exports including of electronics which dominate 60% of the total reflecting the general weakening of global demand but also the downturn in the recurring market cycle of electronic products. For the rest of the year, by contrast, estimates show a surge in imports including of capital goods to see the gap between imports and exports widening again. While part of that should be offset by a rising services balance – already in the January-June period tourist arrivals were up by more than 12% – the current account balance will still suffer a small deterioration by 0.1%/GDP to end at -2.4%/GDP or $9.4bn.

Capital flows leaves the balance of payment in positive territory: As in previous years most of the shortfall will be covered by non-debt incurring capital flows, in particular (FDI) foreign direct investments. Last year they came in at less than $6bn. down almost $1bn below the result of the year before. To arrest that trend the government is considering measures to cajole foreign investors to putting real money into the economy. Assuming that succeeds, many observers are willing to hike estimates of FDI inflows in the current year, mindful, though, that many investors could also be deterred by the recent sharp weakening of various indexes reflective of the Philippines investment climate. (Conf. below.)

Strong reserves continue to rise: Taking into account scheduled repayment of outstanding external debt, we estimate a positive balance of payment by the end of the current year of some $8bn. That should raise the level of official reserves in the hands of the central bank to $77bn, sufficient to pay for 8 months of imports or the country's total foreign debt of which only a fifth is short-term.

Policies:

Growing fiscal shortfall: Recent years' widening of the fiscal deficit to a still moderate 2.3%of GDP is set to increase slightly in 2019 to 2.5% of GDP provided a forceful pick-up in government expenses to make up for lost grounds in the first half of the year. That is despite a successful effort to raise the tax take to increase the government's revenue base thereby expanding the fiscal room for public sector investments. In support of the fiscal stance is a successful monetary policy which has brought inflation down to 3% in the current year. Structural reforms, by contrast, have so far failed to convince many investors that the country is on course to throw off a legacy of corruption and red tape following recent poor results of the widely cited "ease of doing business" indicator and the "corruption prevention index".

Moderate fiscal deficits set to continue. Delayed passage of the 2019 budget and the spending ban during the elections forced the government to operate on a re-enacted appropriation bill and hold back the implementation of key programs and projects in the first several months of the year. As a result, budget implementation halted with the result to narrow the estimated deficit in the first half of the year. In last June, however, expenditures accelerated as the government rolled out the last tranche of the salary standardization adjustments and tentative signs appeared of restarted infrastructure spending under the five-year public sector program for a total of 160bn. when accomplished in 2022. Social security spending is also poised for an increase as the Universal Health Care bill gradually comes into effect in the rest of the year. This combines with continued reductions of the subsidy bill to deliver a budget balance in a 2.5%/GDP deficit, little changed from recent years' average.

Improved tax take: Sustained efforts over several years stretching back to former Pr. Aquino III, to strengthen revenue and tax administration have now been crowned with a consistent expansion of the government's revenue base, to more than

16%/GDP, a far cry from the 12-13% level it struggled to maintain at the beginning of the present decade. This has much expanded the fiscal space inasmuch as it has combined with a stabilization of the sovereign debt/GDP ratio around 40%. More gains can be expected as the first tax reform package implemented last year takes hold and is complemented by more tax hikes by the middle of 2020.

Sound financing and debt composition: As in previous years, the fiscal deficit will be financed by a combination of domestic and international debt issuance. In the first quarter of the current year, the government took the opportunity to issue $1.5bn in global capital markets and may continue approaching international investors through the rest of the year to maintain a share of 30% of its total debt denominated in foreign currencies on which the greater part is on longer terms.

Monetary policies on a steady course: The central bank – *Bank Sentral Philippinas* (BSP), has underpinned the fiscal stance by keeping the rate of inflation close to the target – 3% a year -- with a margin of error of 1pp on each side. That has been accomplished with only limited regard to the exchange rate. As a result, this has gradually strengthened without threatening the country's competitiveness. Moderate credit demand, however at only 10.5% yoy in last June – in line with the rate of expansion of the nominal economy – has combined with even more moderate money growth to prompt the BSP to begin a gradual monetary easing. So far in the current year, it has cut policy rates by 50bsp to 4.25%pa. and banks' reserve requirements by 200bsp while indicating more could be in store. These actions have been welcomed by many observers and are hopefully not premature. BSP's own business outlook and consumer expectations surveys from earlier this year, showed improvements of sentiment for a second consecutive quarter.

Investors unfazed by reform progress: In return, structural reforms have so far failed to convince many investors that the country is on course to throw off a legacy of corruption and red tape as reflected in recent poor results of the widely cited Ease of doing business survey and the corruption index. While the latter has improved, it is still far behind peers with a ranking of 99 from the top among 180 countries of the Transparency International Corruption index. On the other hand, the World Bank's Ease of doing business has simply plunged in the last couple of years to the worst 35th percentile – 124th rank from the top among 180 countries compared with the 69th percentile average for other similarly rated low investment grade countries. While that may also reflect other countries getting ahead faster, it should be taken as a clear warning that investors are disappointed by the speed of structural reforms in the Philippines.

Politics:

Political calm is likely for the next three years: Mid-term elections in last May strengthened the position of the ruling party of Pr. Duterte securing a super majority of 22 out of 24 electable seats in the Senate, the Parliament's upper chamber. Political stability and calm should now prevail until next presidential elections in 2022 when the incumbent is constitutionally barred from running as the Constitution allows only one-term presidencies. His controversial war on the drug cartels and other crime has so far not deterred investors much, neither have continued terrorist attacks as they are largely contained to the southernmost islands of the Archipelago. In foreign policy the President seems to have toned down his erstwhile blustering of a more pronounced rapprochement to China.

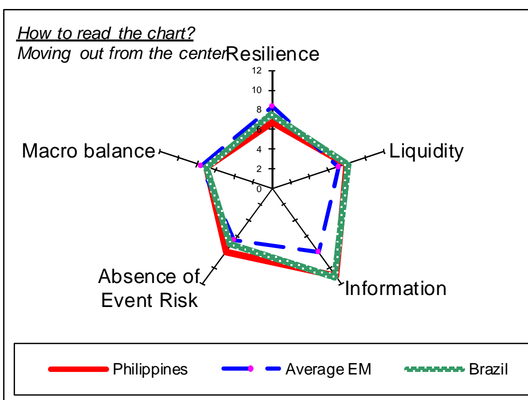
Outlook:

Positive outlook: For the next few years, most observers pencil in continued robust growth of around 6% a year. That is strong although somewhat trailing compared with the Philippines' recent history. Such growth should be accompanied by continued recent twin – fiscal and external – balances in line with experience of recent years, thereby keeping a lid on inflation expectations and forestalling destabilizing credit developments.

Unpredictable down-side risks: However, this scenario is vulnerable to development outside the control of the country. First of all, there is a continued risk that the US-Sino trade spat could get out of control. Being reasonably well diversified in its foreign trade, the Philippines is not likely to be among the worst hit. By contrast, the simmering negative investor sentiment of recent months toward emerging markets in general could easily hit the Philippines even though that sentiment mainly reflects uncertainty over policy making in major advanced countries, i.e. flight to haven syndrome.

In the longer term we continue to hold out the Philippines' prerequisites including a thriving and entrepreneurial young population which continues to grow fast without so far overwhelming the country's ability to create jobs much supported by the fast growing BPO (Business Process Outsourcing) industry.

Key ratios	**2019**
Population (mill.)	102
GDP/capita ($)	3416
GDP (change)	5,7%
Inflation	3,0%
Curr.Acc. Balance/GDP	-2,4%
Reserves/imports (months)	8,4
Budget balance/GDP	-2,5%
Government debt/GDP	38%



External ratings:
Fitch: BBB
S&P: BBB+
Moody's: Baa2

Peers:
India
Indonesia
Mexico

Graph: The pentagon shows resilience as the soft area of the Philippines' credit worthiness compared with the average of emerging markets. Its liquidity, macrobalance and information are among its stronger sides.

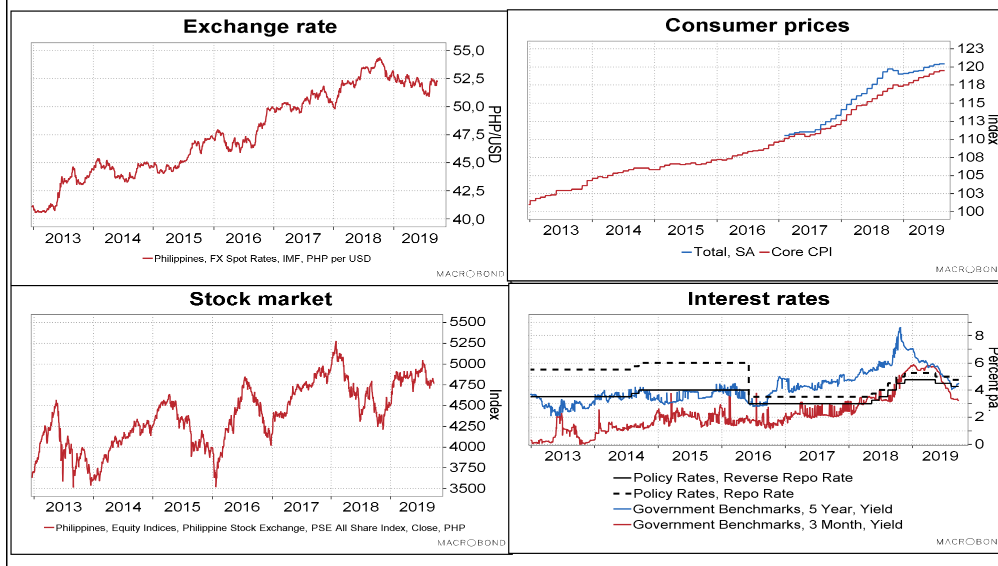
Key data:	2014	2015	2016	2017	2018	2019	2020	2021
GDP (mill.US$)	285	293	305	313	331	370	413	461
GDP/capita (US$)	2837	2870	2943	2982	3100	3416	3760	4135
GDP (change)	6,1%	6,1%	6,9%	6,7%	6,2%	5,7%	5,9%	5,5%
Investments/GDP	21%	24%	28%	29%	31%	32%	31%	31%
Budget balance/GDP	-0,6%	-0,9%	-2,4%	-2,2%	-2,4%	-2,5%	-2,8%	-2,9%
Govt debt/GDP(*)	45%	44%	41%	41%	40%	38%	38%	37%
CPI inflation (%)	3,6%	0,7%	1,3%	2,9%	5,2%	3,0%	3,1%	3,0%
Money demand (%)	21%	9%	12%	13%	12%	10%	9%	9%
Stock prices	100311	101916	103515	105113	106711			
Interest rates	2,2%	2,5%	2,5%	2,6%	3,8%	4,0%	4,1%	4,0%
Exch. Rate ($)	44,4	45,5	47,5	50,4	52,7	52,0	51,5	50,4
Trade/GDP (%)	41%	38%	40%	46%	47%	45%	44%	42%
Oil price (Brent)	$99	$52	$44	$54	$71	$63	$62	$62
Millions US $								
Export of goods	49 824	43 197	42 734	51 864	51 673	52 327	55 318	59 762
Imports of goods	67 154	66 505	78 283	92 371	100 710	105 653	113 725	123 512
Other:	28 086	30 574	34 351	38 344	49 037	53 326	58 407	63 750
Current account	**10 756**	**7 266**	**-1 198**	**-2 163**				
(% of GDP)	3,8%	2,5%	-0,4%	-0,7%	-2,3%	-2,4%	-2,3%	-2,2%
FDI (net)	-1 014	99	5 883	6 546	5 854	6 320	6 717	7 444
Loan repayments	-4 477	-7 410	-7 772	-8 226	-9 146	-11 193	-12 588	-13 673
Net other capital flows	-7 912	1 703	5 501	1 133	-49	7 167	12 290	15 382
Balance of payments	**-2 647**	**1 658**	**2 414**	**-2 710**	**-3 342**	**2 294**	**6 419**	**9 153**
Reserves	70 167	71 825	74 239	71 529	69 382	77 237	80 870	89 816
Total debt	78 074	75 850	76 687	72 941	74 766	79 415	82 988	86 615
o/w short term debt	15 629	13 990	14 367	14 526	13 050	14 267	14 847	15 344

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

Rating history

Fitch (eoy)	BB+	BB+	BBB-	BBB-	BBB
Moodys	Ba2	Ba1	Baa2	Baa2	Baa2

Type of government:
Next elections 2022 General
Other:
Latest PC deal 1994 (active)
Latest IMF programs 1998 Stand-By



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