

PHILIPPINES

Recent Economic Developments

The Philippine economy has been buffeted by a number of shocks in 2005, including: political uncertainties, the related resignation of key cabinet level economic officials on July 8 and impeachment charges filed against President Arroyo—that were dismissed by the House of Representatives on September 6; rising global energy prices; and sharply lower, El Nino related, growth in farm output. Economic growth has understandably slowed under these conditions, to 4.7 percent in the first half of 2005 from over 6 percent in the same period last year.

Notwithstanding these shocks, the economy has exhibited considerable resiliency. Third quarter growth is thought to have strengthened as agriculture rebounds. A surge in worker remittances has limited the slowdown in the growth of personal consumption and boosted the current account surplus. Foreign direct and portfolio investment have increased significantly relative to 2003-04, and gross reserves have risen to record highs in recent months. The public sector deficit has been reduced, and following uncertainty over the implementation of the expanded VAT (EVAT), the Supreme Court's rejection in October of all challenges to the law has improved the prospect of a more robust tax effort in 2006.

Growth in the first half of 2005 was driven by the service sector, which accounted for about half of total output, and grew by 6.6% followed by industry (4.4%) and agriculture (0.9%). Each of the three sectors exhibited growth below last year's levels. Within services, the major drivers of growth were telecommunications, business process outsourcing, and financial services. The non-performing loan ratio in the banking system returned to single digits after nearly seven years amidst greater consolidation and restructuring, and a pickup in lending to consumers and the service sector. Within industry, mining growth jumped to 13.9% in the second quarter of 2005 following a Supreme Court ruling upholding liberalization in the mining sector. On the demand side, personal consumption slowed to 4.9% compared to 5.8% last year, with strong growth of remittances countering the adverse impact of surging oil prices. Fixed capital growth swung from 5.1% in 2004 to -5.5% in the first half of 2005. Growth in export and import volume also slowed, the former reflecting a decline in electronics demand.

Table 1: GDP growth and contribution to growth

	Growth				Contribution to growth			
	2003	2004	1Q05	2Q05	2003	2004	1Q05	2Q05
GDP	4.5	6.0	4.6	4.8				
Agriculture	3.2	4.9	-0.1	1.8	0.6	1.0	0.0	0.3
Industry	3.6	5.2	4.2	4.6	1.2	1.7	1.3	1.6
Service	5.8	7.1	7.1	6.1	2.7	3.3	3.3	3.0

On the demand side, personal consumption slowed to 4.9% in the first half of 2005 compared to 5.8% in 2004, with 22% growth of remittances countering the adverse impact of surging oil prices. Fixed capital growth swung from 5.1% in 2004 to -5.5% in the first half. Investment in durable equipment fell to -7.5% in the second quarter of 2005 from an average growth of 7% in the previous 11 quarters. Export volume growth in the first half of 2005 also slowed to 2.2% reflecting a decline in electronics demand in the second quarter. Import growth,

on the other hand, dropped to 0.9%. The terms of trade continued to fall due to both higher oil prices and rising prices of raw materials.

Inflation had risen to about 8.5% year-on-year during February through May before falling to 7% by September. Supply shocks—most notably the surge in world oil prices—are the primary causes of higher inflation. The central bank (BSP) has responded by raising its key policy rates by 25 basis points on three occasions in 2005 (April, September and October). Its overnight borrowing and lending rates now stand at 7.5% and 9.75%, respectively. The market determined 91-day Treasury-bill rate however remains below 6%. Money supply (M3), which breached BSP's target and expanded by 15.0% to P2.3 trillion as of the end of August, is expected to slow due to the recent rate increases.

Public Finance

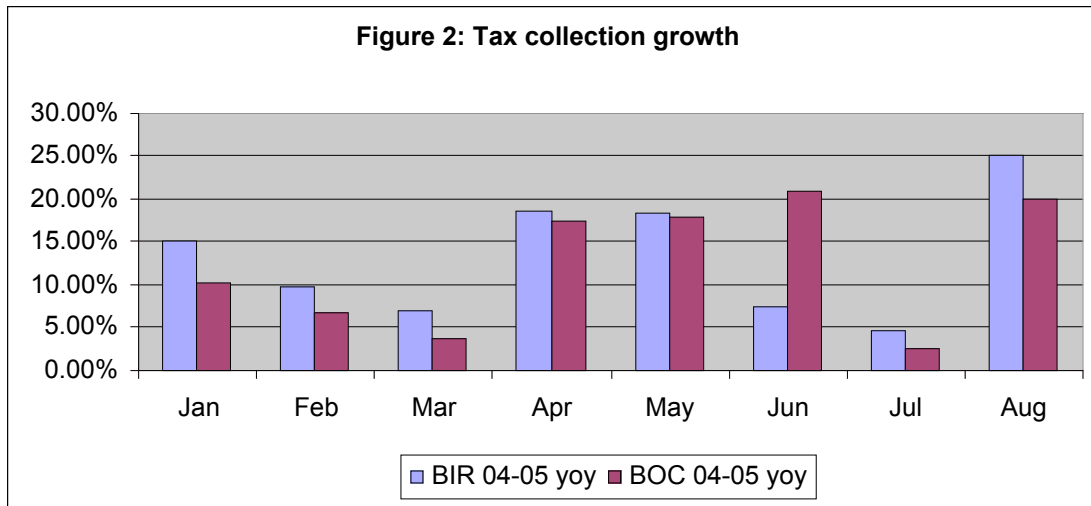
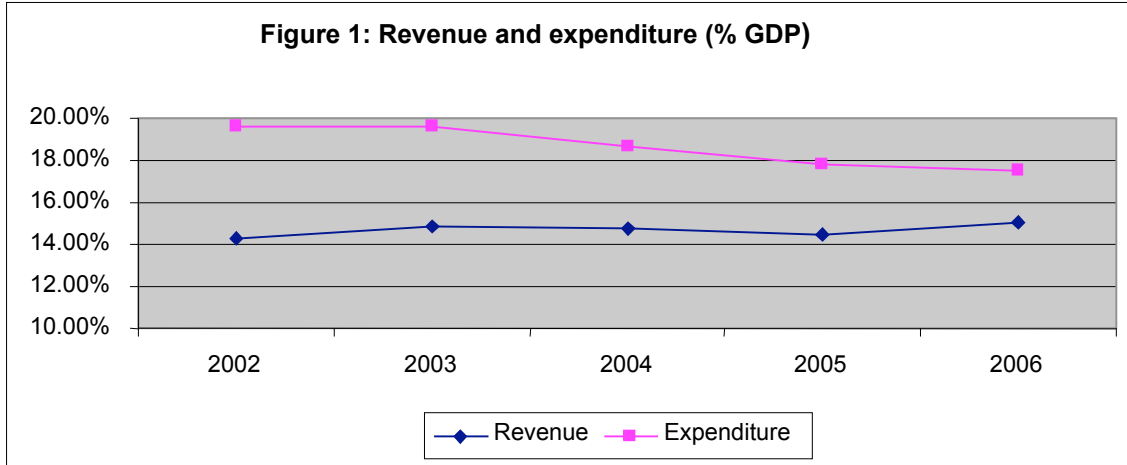
Policy and administrative reforms initiated. Following the president's declaration of a state of fiscal crisis in August 2004, the government has enacted a series of measures: a law increasing the excise tax on cigarettes, tobacco, and alcohol, lateral attrition for revenue agencies, and the comprehensive tax reform package of 2005 which includes among others the removal of exemptions from the VAT of oil, power, medical and legal services, an increase in corporate income tax from 32% to 35% and reverting to 30% in 2009, and authority for the president to increase the VAT rate from 10% to 12% in January 2006 upon satisfaction of certain conditions prescribed by law¹. Certain excise, franchise and common carrier taxes were repealed in favor of the expanded VAT (EVAT). In tax administration, the government launched a tax evasion campaign called 'Run After the Tax Evaders' (RATE) which aimed to file high profile tax evasion charges every week and an anti-corruption campaign called 'Revenue Integrity Protection Service' (RIPS). At the same time, programmed government expenditures for 2005 continued to decline in real terms.

Gains from revenue measures still pending, however. The comprehensive tax reform law (EVAT) passed in May 2005 would have added an additional P20 billion to revenue in 2005 and P84 billion in 2006 (as estimated by the government) but its implementation was suspended by the Supreme Court on its first day of implementation in July after some legislators and business groups petitioned to declare the law unconstitutional. In September, the Supreme Court upheld the legality of the EVAT but petitioners filed an appeal. On October 18, the Supreme Court upheld the constitutionality of the EVAT with finality, paving the way for its implementation. The tax on tobacco, cigarettes and alcohol enacted late last year has so far failed to realize its projected P15 billion additional intake as collections from cigarette companies actually fell by 7.4% in the first half. Tobacco collections were below their 2004 level by P837 million.

Deficit reduction nonetheless. In the first nine months of 2005, the national government deficit reached P108.5 billion, well below the 2004 pace. Rare surpluses were recorded in April, June and August. Anti-evasion and anti-corruption campaigns may have improved the incentive to pay taxes although only one tax evasion case out of almost 30 outstanding cases has opted for settlement. Tax revenue to GDP is not expected to increase appreciably in 2005, however. January to September revenues reached P589.5 billion, modestly exceeding the target of P580.4 billion. Spending was contained at P698 billion, below the programmed P726.2 billion. At the

¹ A provision in the law mandates the President to increase the VAT rate to 12% from 10% in January 1, 2006 if the budget deficit exceeds 1.5% of GDP or the VAT collection exceeds 2.8% of GDP.

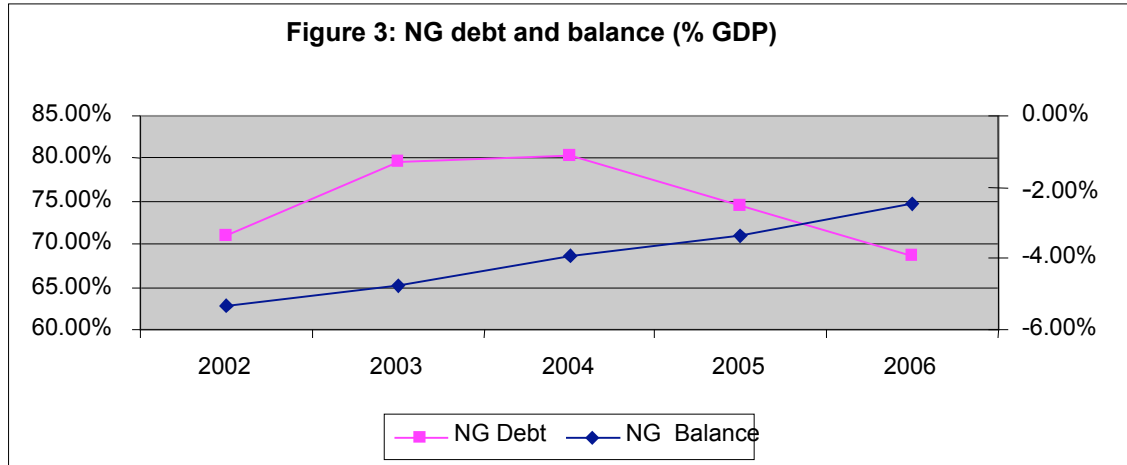
treasury, some P14.9 billion savings in interest payments were realized due to lower cost of borrowings. The government's full year target aims to reduce the deficit to below P180 billion in 2005 (3.4% of GDP) from P187 billion in 2004 (3.9% of GDP), owing to higher non-tax revenue and reigning in of expenditures. Despite the aforementioned setbacks, the government hopes to reduce the deficit to as low as P160 billion (3.0% of GDP).



The consolidated public sector (CPSD) posted a deficit of P41.62 billion for first half, down from P94.23 billion in the same period last year. The GOCC2 deficit was primarily trimmed by upward adjustments in electricity tariffs in late 2004 by nearly one peso per kWh and a smaller adjustment in April 2005. Another rate increase of 0.71 per kWh before the end of the year has been filed before the Energy Regulatory Board. These are targeted to eliminate NAPOCOR's, the government-owned power corporation, operational deficit in 2006. Surpluses recorded in government financial institutions, pension funds and BSP also contributed to the lower CPSD.

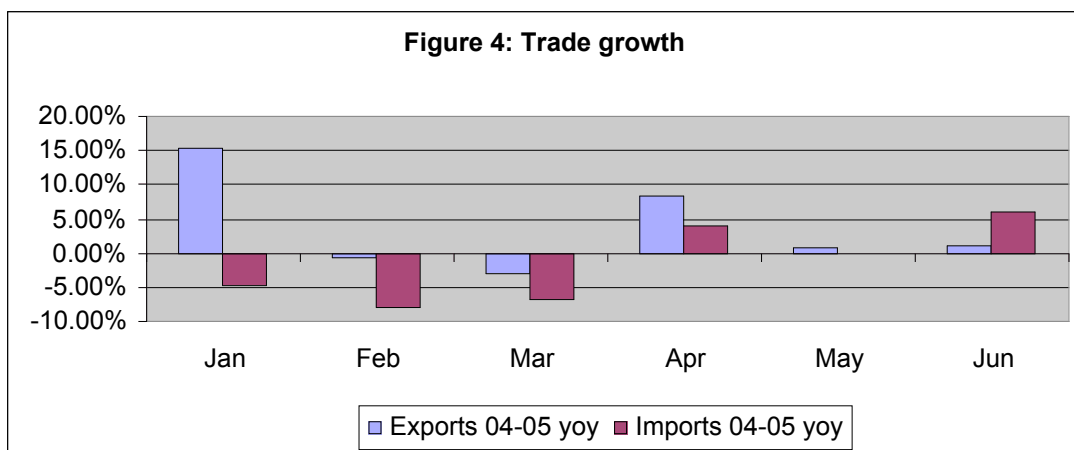
² Government-owned and controlled corporations

Public debt-to-GDP ratios remain high. National government debt reached P3.89 trillion or 76.6% of GDP in June from over 80% as of the end of 2004. Domestic debt declined by 1.3% due to net redemption of government securities made by the national government. Non-financial public sector debt, which increased rapidly during 2001-03, reached about P4.6 trillion or about 96.1% of GDP in 2004 down from 101.3% in 2003.



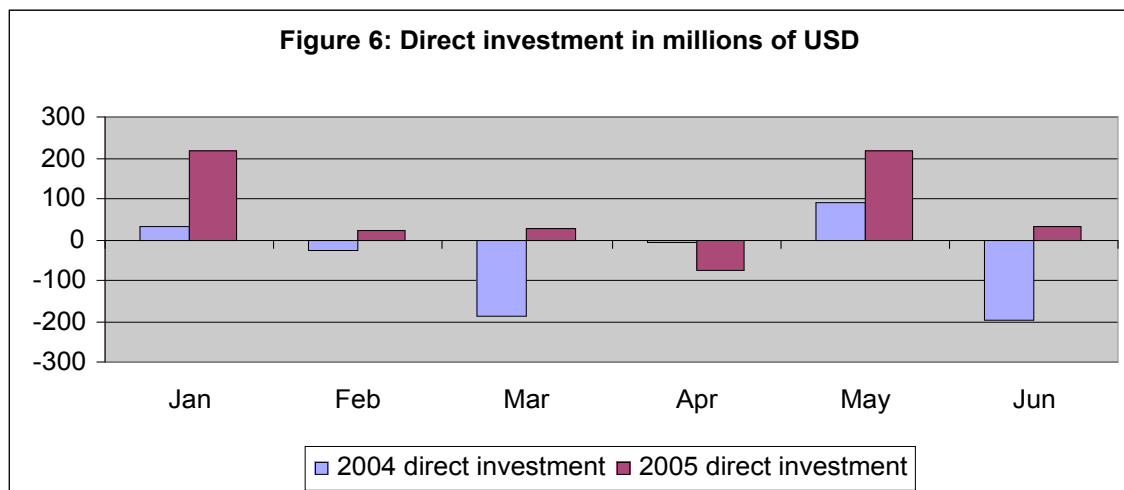
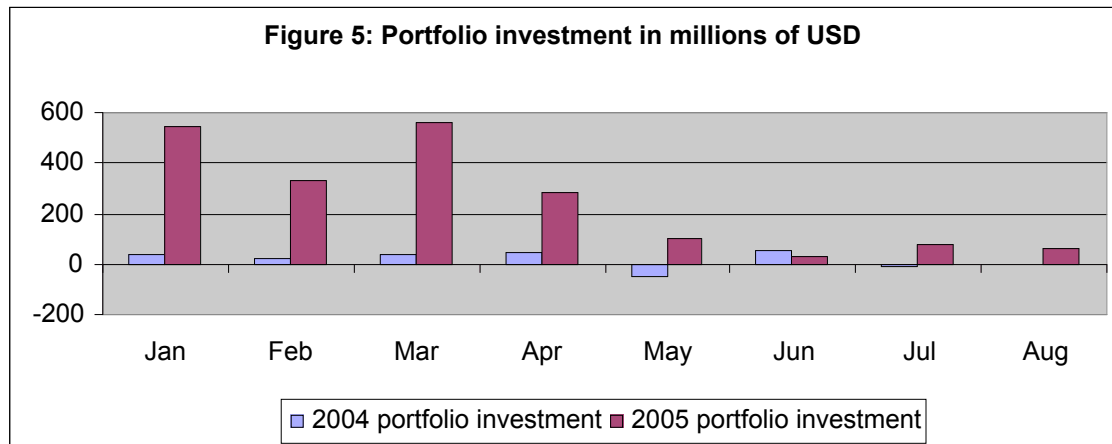
External Sector

The current account surplus rose sharply in the first half of 2005 driven by remittances and cushioned the slowdown in electronics exports. Export growth fell to 3.6% through June (4.1% through August), as electronics exports barely expanded, notwithstanding a near doubling of electronics exports to China. Import growth was also a modest 3.8% despite surging prices for fuel imports. For the first half, the trade deficit widened by 5%. Remittances from overseas Filipino workers jumped 22% in the first half of 2005 to \$4.88 billion. As a result, the current account surplus in the first half rose to \$1.12 billion (2.5% of GDP) from \$152 million in the first half of 2004.



Portfolio and direct investments recover from last year's election jitters. Portfolio investments from January to June 2005 recorded net inflows of \$2.1 billion, versus only \$114 million reported for the same period last year, and negative net inflows in both 2003 and 2004.

Net inflows have, however, slowed in recent months. Foreign direct investment expanded to \$495 million in the first half from \$170 million a year ago. Business outsourcing, financial services, and mining were among the sectors receiving overseas funds. Registered investments with the BOI, however, began to decline in the third quarter. Foreign capital flows thus appear to be sensitive to political uncertainties and also responsive to positive signals from the prospect of fiscal reform. The decision of the Supreme Court to liberalize mining also brought in close to \$350 million as of September 2005. Gross international reserves reached a record of \$18.6 billion at the end of September, aided by a balance of payments surplus of \$2.7 billion through September 2005.



Financial Markets. By February 2005, the peso had rebounded to 53.9 to the dollar, its strongest in the last two years. The stock market composite index reached a five-year high in March 2005, aided by a surge in portfolio inflows in the first quarter. Currency and stock markets declined in July following allegations of vote rigging and corruption against the President and family members, and the resignation in protest of key cabinet officials. Since early July, equity prices have recovered partially whereas the peso recently strengthened beyond its July level. Interest rates for Treasury bills and bonds did not increase significantly during this period, notwithstanding the persistence of higher than targeted inflation—and the 91-day Treasury bill remained below 6% as of mid-October.

Market access remains reasonable despite credit outlook downgrades. Spreads on foreign currency bond issues rose in the middle of 2005 after credit rating agencies downgraded the Philippine's credit rating outlook from stable to negative citing heightened political uncertainty and the failure of the government to implement the EVAT at that time. Additional global bond issuances in May and September yielded \$750 million and \$1 billion, respectively, effectively completing the national government's external commercial borrowing for 2005. The relative ease of global bond issuance indicated continued market access even at long maturities despite recent downgrades of the Philippine's credit rating by international credit rating agencies to three notches below investment grade. The recent 10-year global bond issue in September was priced at a spread of 410 basis points over the 10-year U.S. Treasury bond, indicating the considerable potential in interest savings from lowering investor concerns.

Labor Market: Lower unemployment but higher underemployment and increased migration. The unemployment rate fell to 7.7% from 11.7% a year ago³ but underemployment rose to 20.5% from 17.6%. About 900,000 additional jobs were created in the past year, of which 540,000 jobs were in the farm sector. At the same time, the number of Filipino workers deployed overseas in the first seven months of 2005 increased by almost 20%.

Table 2: Official poverty measures: 1994-2003

	1994	1997	2000	2003
<i>Population</i>				
Incidence	41.1	33.0	33.0	30.4
Gap	13.9	10.3	10.6	9.4
Severity	6.4	4.4	4.5	4.0
<i>Household</i>				
Incidence	40.6	28.1	27.5	24.7
Gap	13.9	8.4	8.0	7.1
Severity	6.4	3.5	3.2	3.1
Gini coefficient	0.4507	0.4881	0.4822	0.4678
Threshold	8,885	9,843	11,451	12,267
Legend	<div style="display: flex; align-items: center;"> <div style="width: 15px; height: 15px; background-color: #008000; margin-right: 5px;"></div> Estimates based on published poverty thresholds </div> <div style="display: flex; align-items: center; margin-top: 5px;"> <div style="width: 15px; height: 15px; background-color: #ffff00; margin-right: 5px;"></div> Figures based on revised methodology, gap and severity are preliminary </div>			

Poverty Modestly Reduced. Partial and official poverty estimates using a revised methodology revealed a decline in the incidence of poverty between 2000 and 2003. Based on annual per capita income thresholds of P12,267 in 2003, the number of poor declined from 25.4 million in 2000 to 23.5 million in 2003, or from 33% to 30.4% of the population. Both rural and urban poverty are reported to have declined over this period: rural from 18.6 million (47.7%) to 17 million (43.6%); urban from 6.8 million (17.8%) to 6.2 million (16.5%). Poverty incidence

³ The July figure is based on the new definition of unemployment in use by the statistics office since April 2005. Under the new definition, people unavailable for work, or those who are available for work but are not looking for work, are stricken off the unemployment and labor force counts. Under the old definition, the July rate stood at 10.9%.

remains high in Mindanao and low in Metro Manila and the surrounding regions. Inequality, as measured by the Gini coefficient, also declined from 0.4822 to 0.4678 in the same period. The new methodology, however, makes time series comparison with pre-2000 figures difficult as pre-2000 figures have not yet been adjusted. Provincial-level statistics are not yet available while poverty gap and severity figures are still preliminary as of writing.

Financial Sector

The banking system is witnessing consolidation and restructuring and some growth in lending to the private sector. Loans of commercial banks rose by 6.4% to P1.6 trillion as of June 2005. Leading this growth were consumer and household loans and loans to the service sector.

Asset quality of the banking system has improved. After nearly seven years, the non-performing loan (NPL) ratio of the commercial banks returned to single digits as banks continued to finalize sales transactions which were approved by the BSP before the SPV Act of 2002 expired in April 2005. The NPL ratio, which had peaked at 18.81% in October 2001, had improved to 9.54% as of July 2005, down from the previous month's ratio of 10.95%. This was a result of a reduction in NPLs by P30 billion and a 1.7% growth in total loan portfolio. As of June 15, 2005, P75.7 billion of non-performing assets (NPAs) had been transferred under the SPV Act. Applications for certificate of eligibility are pending for another P21 billion of NPAs. However, the majority of these deals have been for NPLs, whereas the repossessed assets continue to remain unchanged (over P200 billion) on the books of banks. The BSP has indicated its support for extension of the SPV Act by another two years and estimates that the extension may facilitate the disposition of an additional P100 billion of NPAs. However, considerable variance in the sellers demand price for the assets and discounted prices anticipated by prospective buyers may continue to limit sales for the repossessed assets (which are primarily real estate properties).

The banking sector has witnessed acceleration in consolidation and restructuring over the past few months. Notably, the majority private owner of the semi-private PNB was able to gain sole control of the bank by buying out the shares held by the National Government and the Philippine Deposit Insurance Corporation. The PNB transaction followed two other consolidating transactions in the past month. This consolidation of the banking sector is seen by market analysts as a positive step as it would lead to greater capitalization of the surviving entities and improve the potential for business expansion through further diversification of lending portfolios based on individual strengths of the merging entities. A successful merger could also lead to an efficient surviving entity and could have positive implications for the market ratings of the surviving entity. Market analysts anticipate these trends to continue as key industry players try to maintain their respective rankings by increasing market capitalization through consolidation.

Simultaneously asset disposition under the SPV Act is accelerating and some significant transactions have already been finalized. More than 130 asset management companies have been registered. Proposals to extend the validity period of the SPV Act could contribute in maintaining progress in NPL resolution. Accompanying these positive trends are also regulatory and developmental measures by BSP and the PSE to improve functioning of capital markets—such as regulations to reduce risk in trading of debt securities and exploration of new debt instruments such as REITs.

The future of the proposal for the establishment of a credit information bureau - which is expected to lower transaction and lending costs and improve access to credit - and Amendment of the BSP Charter - which is expected to strengthen legal protection for bank supervisors in performing their duties and improve the framework for resolving problem banks – remain in

limbo as political events seem to have relegated their finalization to a lower priority. Meanwhile, the regulators continue to strengthen their supervisory and regulatory framework. The BSP has presented the exposure draft of its New Risk-Based Capital Adequacy Framework, which lays out the guidelines for the local adoption of Basel 2 beginning in 2007. The BSP Monetary Board has also approved guidelines regarding adoption of the Philippine Financial Reporting Standards (PFRS) and Philippine Accounting Standards (PAS), which are based on the International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS), for reporting of annual financial statements beginning January 1, 2005. In line with the amended PDIC charter requirements, the BSP and the PDIC have also developed an MOA to establish an overall framework for the BSP and PDIC to effectively supervise banks through joint examination.

The Philippines' first fixed income exchange, Philippine Dealing and Exchange Corp. (PDEX), made its debut on March 28, 2005. The key owners of the PDEX are Banker's Association of the Philippines (38%), the Philippine Stock Exchange (12.2%), and two technology and infrastructure providers (10% each). This exchange is seen as an important establishment for the development of the country's capital market and the electronic trading platform is expected to improve the liquidity and efficiency of the Philippine fixed income market by enhancing price discovery and transparency, and creating a more level playing field by providing anonymity to trading participants. The initial launch involved automation of the existing fixed income inter-dealer market for government securities and a centralized screen based PDEX is expected to launch the fixed income inter-dealer order-driven system (FI-IODS) by end of September. A public order-driven platform for the fixed income exchange will be launched subsequently. An independent securities custodial system, that would improve investor protection and reduce market malpractices and overall systemic risk, is however, yet to be finalized.

Corporate Sector

Corporate profitability improved in the first half of 2005. Leading listed companies had better profit performance in the first half of 2005 over the same period in 2004. The average Return on Equity of companies included in the MSCI Index is projected to be around 12.6% in 2005 as compared to 11.2% in 2004. Firms in the services sector and in particular in the transport and communications sector recorded the best improvements in sales and profitability. In 2005, there was no significant change in the financial health of listed companies. For all listed companies taken together, the debt-equity ratio and current ratio remained stable at around 0.7 and 1.33 respectively. The upward trend in corporate profitability is expected to continue for the rest of 2005 on the back of continued growth in private consumption that is supported by robust growth in remittances.

However, prospects for private investment led growth are not as bright. Total investments decreased 3.2% in the second quarter of 2005 with investments in durable equipment declining 4.4% having declined 9.7% in the first quarter of 2005. BSP and Makati Business Club surveys of private business investment intentions and confidence suggest that firms remain cautious on account of structural impediments such as poor infrastructure and uncertain regulatory setting and because of short term political and fiscal risk factors. This is also borne out by BSP data on Equity FDI registered with BSP.

Portfolio investments display greater robustness. Net inflows of foreign portfolio investment stood at about \$1.9 billion during Jan-July. About 60% of these funds were deployed in the Stock Exchange. This enabled the Philippines Composite Index to show a positive trend of

6.3% year-to-date notwithstanding adverse political and economic developments that substantially wiped out strong gains registered in the first quarter of this year.

Firms in the services sector registered the best performance. The services sector registered strongest growth of 6.1% in the second quarter of 2005 following a 7% growth in the first quarter. Transport, storage and communications (9.7%) alongside financial services (10.5%) led growth in the services sector. Demand for mobile phone services sustained 15.9% rise for the communications sub-sector during the quarter. The call center sub-sector maintained its growth performance; call center revenues grew by 5.3% in the second quarter following a 4.6% growth in the first quarter of 2005. Along with India, Philippines is expected to emerge as the leading destination for Business Process Outsourcing Services.

Expectations regarding rapid progress in privatization did not materialize, on account of slower than anticipated privatization in the power sector. Privatization of generating assets has been slow because of investor demand for guaranteed power purchase contracts.

The telecom sector could witness an increase in competition and consumer choice. The National Telecommunications Commission (NTC) recently issued rules and regulations for 3G licensing in the Philippines. The NTC plans to issue about five new 3G licenses within the next 3-4 months. This could increase competition over the medium term and dent the current market duopoly. Consumers would gain from the increased competition by way of lower prices and more service choice.

Impending Resolution of the PIATCO dispute could clear the way for new infrastructure investments. Press reports indicate that the Frankfurt Airport Authority is planning to sell its stake in PIATCO to a local corporate. If structured well and completed quickly this could help to resolve a long standing dispute that has marred new private investments in the infrastructure sector.