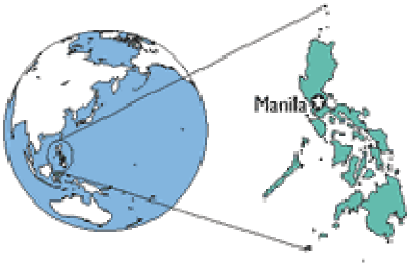
COUNTRY REVIEW

Philippines



7 September 2010

ANALYST: Dr. Manfred Stamer

EULER HERMES COUNTRY RISK GRADE: B

Country Risk Grades are on a scale of AA, A, BB, B, C, D where AA is the lowest and D the highest risk.

Strengths

- Generally good international relations
- Economy has shown robust GDP growth since 2002 and resilience to the global economic crisis
- Current account surpluses since 2003 as a result of continuously strong remittances from Filipinos working abroad
- Solid foreign exchange reserves

Weaknesses

- Recurrent political turmoil and ongoing security issues threaten political stability
- Government ineffectiveness and sluggish structural reform
- Vulnerability to external shocks because of a high dependency on exports of electronics and tourism
- Comparatively high level of public debt
- Under-developed banking sector
- Weaknesses in the business environment include burdensome regulations, endemic corruption and an opaque judicial system

Country Risk Assessment

Ratings	Philippines Latest	Philippines Previous	Median Grade B	Peers Thailand	Peers India	Peers Croatia
Systemic Political Risk:	**P3+**	**P3+**	**P2-**	**P3+**	**P2-**	**P2-**
Systemic Economic Risk:	**E4**	**E4**	**E4**	**E3**	**E4**	**E4**
ME rating:	ME4	ME4	ME4	ME3	ME4	ME4
Structure	*5.0*	*5.0*	*5.0*	*5.0*	*4.0*	*3.3*
Policy	*5.2*	*4.8*	*4.2*	*3.2*	*5.2*	*2.9*
Solvency	*2.8*	*2.8*	*2.3*	*1.3*	*1.9*	*4.8*
External Liquidity	*1.3*	*2.3*	*3.7*	*2.8*	*3.6*	*5.2*
SBE rating:	SBE4	SBE4	SBE3	SBE3	SBE4	SBE3
COUNTRY GRADE:	**B**	**B**		**B**	**B**	**B**

Nomenclature:
Political Risk Ratings are on a scale of P1 (lowest risk), P2+, P2-, P3+, P3-, P4 (highest risk).
Economic Risk Ratings are on a scale of E1 (lowest risk), E2, E3, E4, E5, E6 (highest risk).
ME (Macro-Economic) ratings are on a scale of ME1 (lowest risk), ME2, ME3, ME4, ME5, ME6 (highest risk).
The constituent parts of the ME rating are on a scale of 1.0 (best) to 6.0 (worst).
SBE (Structural Business Environment) ratings are on a scale of SBE1 (best), SBE2, SBE3, SBE4, SBE5, SBE6 (worst).
Country Grades are on a scale of AA, A, BB, B, C, D where AA is the lowest and D the highest country risk.

Source: Euler Hermes Economic Studies

ECONOMIC STRUCTURE

Country Profile	
Capital city:	Manila
Population:	92.227 mn (2009)
GDP:	USD 160846 mn (2009)
Currency:	Philippine peso (PHP)
Form of state:	Republic
Head of government:	President Benigno "Noynoy" AQUINO (since June 2010)
Next elections:	Congress: 2013 / President: 2016

Major Industries (% of GDP at market prices, 2009)	
Services	55.0%
Trade	14.5%
Industry	30.2%
Construction	5.1%
Agriculture, fishery, and forestry	14.8%

Global Assumptions	2010	2011
Real GDP grth (% yr/yr)	3.3	2.9
Inflation (%, av) *	1.2	1.4
Dated brent (USD/b)	75	70

* Major economies

Main Exports (% of total, 2009)	
Electronic products	57.8%
Agriculture-based products	5.5%
Textiles & clothing	4.4%
Mineral products	3.8%
Petroleum products	0.8%

Main Imports (% of total, 2009)	
Electronic inputs	30.5%
Chemicals	9.0%
Electronic & electrical equipment	8.8%
Crude petroleum	7.1%
Food	6.4%

Lead Export Markets (% of total exports, 2009)	
EU	20.7%
USA	17.7%
Japan	16.1%
ASEAN	15.2%
China PR	7.6%

Lead Import Markets (% of total imports, 2009)	
ASEAN	25.4%
Japan	12.4%
USA	11.9%
China PR	8.8%
EU	7.6%

Basic indicators

Selected economic indicators	2007	2008	2009	2010f	2011f
Nominal GDP (USD mn)	144,038	167,491	160,846	183,987	203,423
Population (mn)	88.71	90.46	92.23	94.01	95.83
GDP per capita (USD)	1,624	1,852	1,744	1,957	2,123
Real GDP growth (% yr/yr)	7.1	3.8	0.9	6.0	4.0
Inflation (%, eop)	3.9	8.0	4.3	4.0	4.0
Fiscal balance (national government; % of GDP)	-1.6	-1.3	-3.9	-4.5	-4.2
Current account balance (% of GDP)	4.9	2.2	5.3	3.3	2.5
External debt/GDP (%)	45.9	38.7	39.3	38.0	36.9
External debt/Exports of goods & services (%)	111.6	111.8	132.9	118.7	114.2
Debt-service ratio (%)	10.3	9.8	10.4	10.3	11.6
Foreign exchange reserves (USD mn)	30,071	33,047	37,504	40,000	42,500
Import cover (months)	5.5	5.7	8.2	6.9	6.5
Exchange rate assumption, PHP:USD (av)	46.2	44.3	47.7	46.0	45.0
Exchange rate assumption, PHP:EUR (av)	63.0	65.2	66.3	59.3	54.0
f: central forecast					

Sources: National figures, IMF, ADB, World Bank, ECB, Euler Hermes Economic Studies

Political Stability

Systemic political stability and government effectiveness remain weak as a result of a largely dysfunctional form of government, recurrent political turmoil, frequent coup rumours, powerful vested interests, endemic corruption and ongoing security issues. An opaque judicial system, relating to which there are questions over the degree of independence, also weakens political stability.

During the presidency of Gloria Macapagal Arroyo (January 2001 to June 2010), continuous political bickering rendered policymaking relatively inefficient. In addition, domestic security issues have repeatedly drawn attention away from economic policy. The Philippines frequently experiences terrorist actions as the Communist NPA in the north and the criminal Abu Sayyaf rebels in the southern islands of Mindanao have remained active. Internationally-monitored peace talks between the government and the separatist Muslim MILF rebel groups over the expansion of an autonomous region in the south of the Philippines have been intermittent for many years, but a lasting peace deal remains elusive. Overall, the security situation in Mindanao remains poor and commercial transactions in that region should be avoided.

Benigno "Noynoy" Aquino became President on 30 June 2010, after winning the election in May with 42% of the vote as a result of his strong anti-corruption stance and reputation for honesty, which he inherited from his mother, former president Corazon Aquino who led the 1986 "people power" protests that ousted dictator Marcos. International investors responded positively to Aquino's election victory. However, it remains to be seen whether he is able and willing to clamp down meaningfully on corruption and, at the same time, tackle the main economic policy challenge, which is to bring public finances back into balance while also raising expenditure in areas such as infrastructure, education and healthcare. Aquino's 12 years in Congress (the legislature) before taking over the presidency had been rather underwhelming for some analysts.

The Philippines' international relations are reasonably good. In particular, ties with the US are strong as a result of historic and economic factors, while relations with China are improving steadily.

Economic Stability

The World Bank classifies the Philippines as a lower middle income country, as is indicated by a GNI per capita of USD1,790 in 2009. With annual average growth of GDP per capita in the last ten years of just 2.4%, widespread poverty has remained a problem. The agricultural sector still contributes 15% to GDP, industry 30% and services 55%. The economy is relatively export-intensive and is particularly dependent on the electronics industry, which accounted for almost 60% of exports in 2009, and tourism, leaving it vulnerable to external and political shocks.

The economy has shown notable resilience to the global economic crisis and avoided recession. Real GDP growth was 0.9% in 2009 overall and accelerated to a remarkable 7.9% yr/yr in H1 2010. On the supply side, industry was the main growth driver, expanding by around 16% yr/yr, reflecting rapid construction growth and strong external demand, in particular for electronic and electrical products. Services expanded by about 6.5%, while agricultural output contracted by 3% as a result of drought. On the demand side, H1 growth was relatively broad-based: private consumption grew by around 5% yr/yr, government consumption 12% (boosted by pre-election spending in Q1), investment 16% and exports 25%, while imports increased by around 23%. We expect domestic demand to remain robust while external demand is likely to ease in H2 and 2011 because of slowing global growth. Consequently, the economy is set to lose some momentum and calendar year growth is forecast at 6%+ in 2010 and 4% in 2011.

Monetary policy is based on inflation targeting. The authorities' inflation target bands have been set at 3.5-5.5% for 2010 and 3-5% for 2011. After falling to just 0.1% yr/yr in August 2009, inflation increased to 4.4% in April 2010; since then it has eased to 4% in August. Like most emerging market currencies, the Philippine peso (PHP) is vulnerable to shocks and tends to weaken if global investors flee to safer assets. In 2008, the PHP lost around 15% against the USD as a result of worries about the elevated inflation rate and the global financial crisis. However, the PHP/USD exchange rate turned out to be broadly stable in 2009 as the Philippine economy showed remarkable resilience towards the global economic downturn. From late April to late May 2010, PHP/USD softened again sharply, although briefly, by 6.5% as a result of global concerns about the sovereign debt crisis in the EU. As these concerns have eased, the PHP has rebounded and is currently around 3.5% up against the USD year-to-date. The Bangko Sentral ng Pilipinas (BSP; the central bank) cut its key policy interest rates by a total of 200bps each between December 2008 and July 2009, in order to support the then weakening economy while inflation eased. Since then, the overnight borrowing rate has been kept at 4% and the overnight lending rate at 6%. As inflation is on track to meet the authorities' 2010 target band and the PHP appears to be broadly stable overall, the BSP is unlikely to be in a hurry to lift interest rates substantially in the near term.

Public finances remain a cause for concern. The previous government had made considerable progress on fiscal consolidation, reducing the fiscal deficit to 1.3% of GDP in 2008 from a peak of 5.5% in 2002. In 2009, fiscal stimulus to mitigate the impact of the economic slowdown, as well as shrinking revenues, again pushed up the fiscal deficit, to 3.9% of GDP. Moreover, pre-election spending has lifted the H1 2010 fiscal deficit 28% above the year-earlier level and 35% above target. Moreover, since President Aquino puts less emphasis on balancing the budget than his predecessor, instead advocating more spending on social services, his government has already raised the deficit targets for the next few years, aiming for 3.9% this year and a gradual reduction to 2% of GDP by 2013. This assumes relatively unrealistic GDP growth of 7-8% in 2011. Therefore, we forecast the fiscal deficit to reach 4-5% of GDP in both 2010 and 2011. Data on public debt vary because of different definitions but the public debt to GDP ratio is one of the highest in Asia, by any measure. The IMF estimated non-financial public sector debt at 63.7% of GDP at end-2009. Overall, the fiscal position is not disastrous and financing problems are unlikely in 2010-2011. However, if the government is unable to improve spending as well as tax revenue, financing costs may rise in the medium term and the debt burden could increase again.

The current account surplus widened to 5.3% of GDP in 2009 from 2.2% in 2008, as the trade deficit narrowed—merchandise exports contracted less than imports—the solid surplus in the services account (mainly tourism) increased slightly and, most importantly, the inflows of remittances remained strong. We expect the current account surplus will narrow moderately, to 3.3% of GDP in 2010. Foreign exchange reserves have continued to increase since 2008 and stood at around USD40bn in mid-2010, sufficient to cover more than six months of imports or, in other terms, more than twice of all external debt payments falling due in 2010.

Total external debt stood at a manageable level of 39% of GDP or 133% of export earnings at end-2009. Debt-service in 2010 and 2011 will amount to 10-12% of export earnings.

Structural Business Environment

The Structural Business Environment is below average in our assessment overall, with some serious impediments to strong, sustainable growth. The Philippines ranks 140th in our evaluation of 210 economies overall. Formal and non-formal barriers to trade are high and foreign investment is deterred by numerous restrictions, perceptions of widespread corruption, regulatory inconsistency and recurring political instability. Moreover, payments, capital transactions and transfers are also limited by several restrictions, controls and quantitative limits. The banking sector is relatively under-developed, bank supervision is weak as a result of a lack of legal protection and financial intermediation is low, as indicated by comparatively weak private sector credit growth in the last few years. On a positive note, the share of non-performing loans in total loans has declined from 17% in 2001 to 4.5% in mid-2009, demonstrating a continuing improvement, although the ratio is still higher than in some neighbouring economies.

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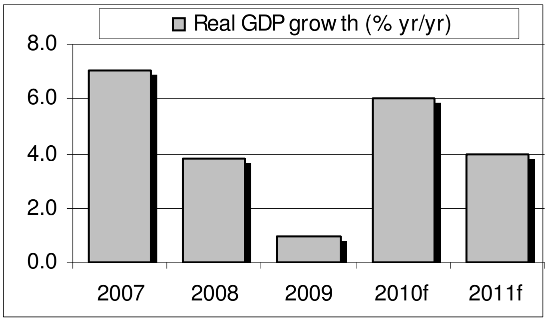
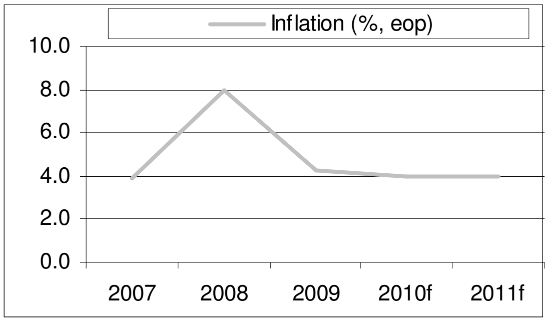
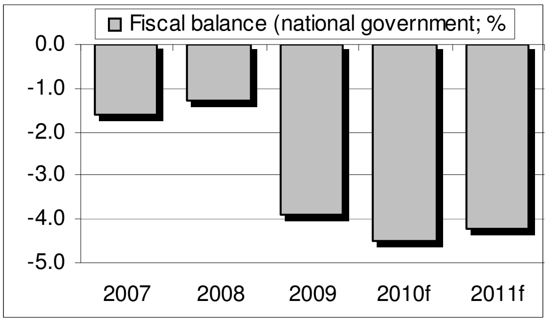
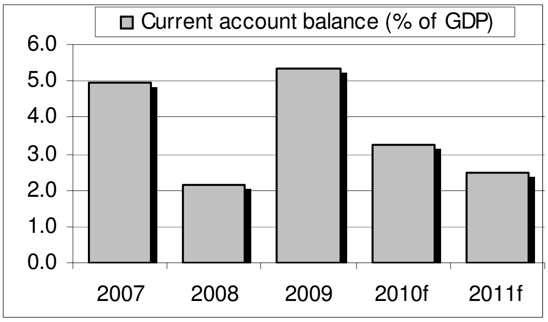
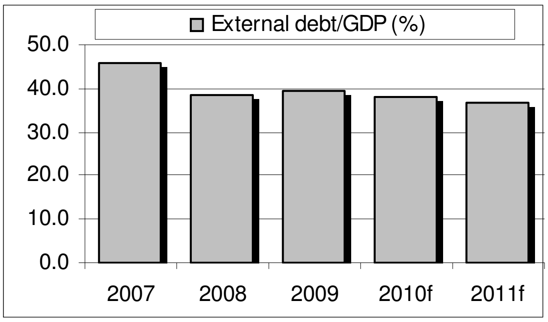
Charts

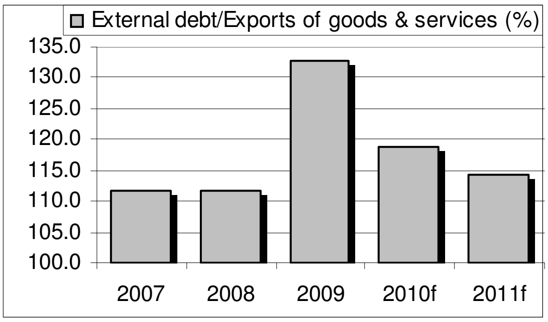

Real GDP grow th (% yr/yr)
8.0
6.0
4.0
2.0
0.0
2007
2008
2009
2010f
2011f

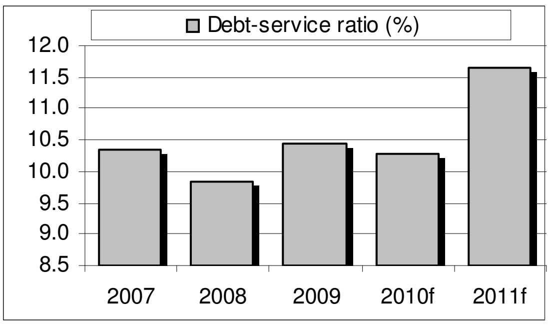

Inf lation (%, eop)
10.0
8.0
6.0
4.0
2.0
0.0
2007
2008
2009
2010f
2011f

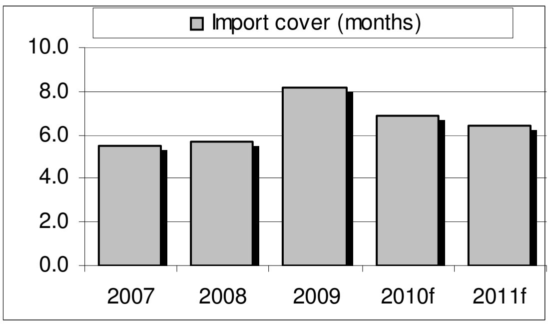

Fiscal balance (national government; %
0.0
-1.0
-2.0
-3.0
-4.0
-5.0
2007
2008
2009
2010f
2011f


Current account balance (% of GDP)
6.0
5.0
4.0
3.0
2.0
1.0
0.0
2007
2008
2009
2010f
2011f


External debt/GDP (%)
50.0
40.0
30.0
20.0
10.0
0.0
2007
2008
2009
2010f
2011f


External debt/Exports of goods & services (%)
135.0
130.0
125.0
120.0
115.0
110.0
105.0
100.0
2007
2008
2009
2010f
2011f


Debt-service ratio (%)
12.0
11.5
11.0
10.5
10.0
9.5
9.0
8.5
2007
2008
2009
2010f
2011f


Import cover (months)
10.0
8.0
6.0
4.0
2.0
0.0
2007
2008
2009
2010f
2011f