

ECONOMICS: ASIAN PERSPECTIVES—JANUARY 13, 2012

Three Factors Support the 2012 Outlook for Philippine Government Bonds

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We expect the Philippines’ budget deficit to widen modestly in the current fiscal year. Despite this, our outlook for the government’s debt securities is positive, based on the relative dovishness of the central bank, a track record of fiscal prudence and the economy’s resilience.

Budget Deficit Narrows—For Now

The improvement in the Philippines’ fiscal position during the past fiscal year (which ended in December) beat both the market’s expectation and our own (**Display 1**). The budget deficit narrowed to PHP96.3 billion or 1.0% of GDP in the first 11 months of 2011 compared with PHP269.8 billion or 3.0% of GDP over the same period of the previous year.

It would be premature to declare that the government has succeeded in its aim of bringing the fiscal deficit to within 2% of GDP by 2013, particularly given that the reduction in the budget shortfall to date has resulted primarily from underspending, with a 2.1% year-on-year decline in fiscal expenditures in the first 11 months of 2011. Infrastructure investments are about to be frontloaded following implementation of the government’s Disbursement Acceleration Plan (DAP) and this, together with a likely fall in tax income as a result of weaker growth momentum, means the deficit is set to widen modestly in the current fiscal year.

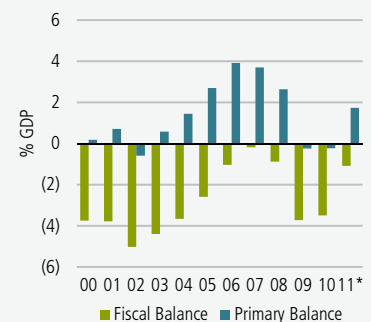
Even so, we have identified three favorable factors which, in our view, could cause the Philippines to outperform its regional peers on currency and US dollar denominated debt. These are: the relative dovishness of the central bank, helped by a favorable inflation trajectory; a track record of fiscal prudence during the past decade; and the economy’s resilience, which the market recognizes.

Central Bank Has a Dovish Bias

The dovish bias of the Bangko Sentral ng Pilipinas (BSP) should be supportive for the local-currency bond market. BSP—which was the slowest and most reluctant among Asian central banks to kick-start monetary tightening following the 2008 global recession (**Display 2**)—became one of the first in the region to shift to an accommodative policy stance in December when Governor Tetangco gave an explicit signal that monetary easing would take place in first quarter 2012. Bank Indonesia and the Bank of Thailand have already cut, although, in the case of the latter, the 25

Display 1
Budget Consolidation Is on Track

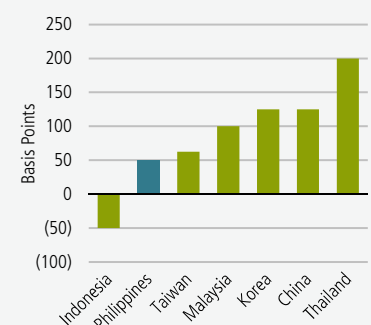
Overall Budget Balance and Primary Balance as % of GDP



As of January 12, 2012
*Annualized figures from first 11 months of 2011
Source: CEIC Data and AllianceBernstein forecasts

Display 2
Central Bank Is More Dovish than Regional Peers

Current Policy Rate vs. Trough of Previous Easing Cycle in 2009



As of January 12, 2012
Source: Bloomberg and AllianceBernstein forecasts

basis point reduction was prompted by flood disruption. Since making the cut, central bank officials have maintained a neutral tone.

The latest Philippine inflation trends provide support for a proactive change of stance. December Consumer Price Inflation (CPI), for example, receded markedly to 4.2% year on year from 4.8% year on year in November, and a high base caused by surging grain and fuel prices in first half 2011 is likely to drag headline inflation further down in the coming months

(Display 3). Indeed, our research suggests that, even if price levels were to stop declining on a month-to-month basis and were to grow instead at the previous six-month average of 0.2%, headline CPI would dip below 3% year on year from February 2012 onwards, breaching the lower end of BSP's inflation policy target range.

Bond Supply Risk Is Limited

We believe the risk of a government-bond supply shock is lower for the Philippines than for other ASEAN countries—an assessment that works in favor of the country's bond issuance, whether in local currency or US dollars.

In Malaysia, for example, we expect the government to increase social spending ahead of the general election likely to be called this year by Prime Minister Najib. Also, Thailand's Yingluck administration—which won power last year with a campaign that included populist expenditures—may be tempted to resort to more fiscal pump priming as a way of restoring some of the popularity the Prime Minister lost following what was regarded as her inadequate response to the flood disaster. By contrast, the six-year presidential term set by the Philippines' constitution limits the incentive for government to spend aggressively. The fiscal prudence this tends to support can be seen in the slow growth in total expenditure relative to fiscal revenue in seven out of the last 10 years, and the overall stability in spending during most of that time **(Display**

4). Data for the first 11 months of fiscal 2011 indicate the budget is set to return to a primary surplus.

Earlier this month, Budget Secretary Abad revealed that the Aquino administration intended no further fiscal stimulus following the introduction in November of the PHP72 billion (0.7% of GDP) DAP, and claimed that frontloading 80% of the infrastructure investments outlined in the FY2012 budget would be sufficient to secure economic growth for now.

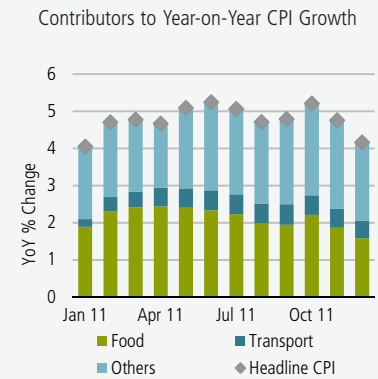
The Department of Finance has also taken steps recently to reduce funding risk, issuing long-dated debt to lengthen the maturity profile of government liabilities and converting foreign-debt liabilities into local currency. All these factors, together with a budget shortfall that of the country's regional peers, should mitigate the upside risk for Philippine sovereign spreads in the event of external shocks.

Resilience Wins Market Support

The Philippines economy—which maintained positive growth throughout the 2008 global recession—is more resilient to external shocks than others in the region, as a result of its relatively small export sector (less than 35% of GDP) and the support for domestic consumption provided by a stable inflow of remittance income from workers overseas (10% of GDP). While growth momentum eased noticeably in 2011 after a reduction in government spending and a plunge in exports, underlying household consumption remained solid, growing at more than 5% year on year **(Display 5).** We expect another impetus to growth to come from the PHP154 billion (1.6% of GDP) of Public Private Partnership (PPP) infrastructure projects scheduled in 2012.

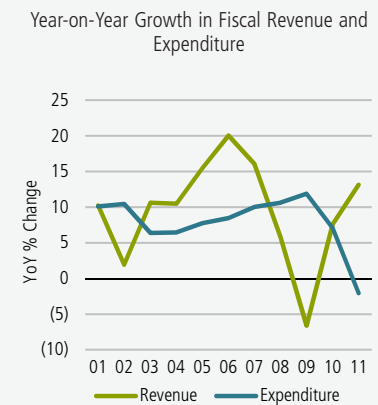
The PPP scheme had been due to get under way last year but was delayed because the government agency had underestimated the complexity involved in designing technical specifications and monitoring mechanisms. Some caution is needed, in our view, when assessing the scheme's likely impact: there is

Display 3
CPI Set to Recede as Food Prices Fall



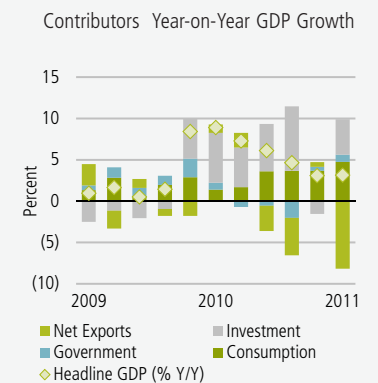
As of January 12, 2012
Source: CEIC Data and AllianceBernstein forecasts

Display 4
Fiscal Prudence Keeps Spending Stable



As of January 12, 2012
Source: CEIC Data and AllianceBernstein forecasts

Display 5
Consumption Resilient, Even as GDP Slows



As of January 12, 2012
Source: CEIC Data and AllianceBernstein forecasts

some risk, for example, that not all the projects will be put out to tender as planned, and suspicions linger in the market that the country's adoption of the PPP model is premature. Despite this, cash-rich domestic conglomerates have already indicated genuine interest in some key projects and we believe that, on a net basis, such undertakings should mitigate the impact of weak trade performance and underpin growth in future quarters.

The economy's resilience has drawn support from international investors. The Philippine equity market was the best performer in Asia in 2011 and the peso has been the second-best performing currency behind the Chinese yuan since global risk aversion took hold in August (**Display 6**). Meanwhile, Philippine sovereign spreads have remained stable and traded below Indonesia's. While S&P raised the country's credit outlook to positive in December, the current BB rating is still lower than the BB+ rating assigned by Fitch. A move to investment grade (BBB-, which is two notches higher on the S&P scale) is still some distance away in the absence of evidence of structural improvement in the country's growth prospects. Nevertheless, a catch-up action by S&P should be positive for market sentiment, in our view.

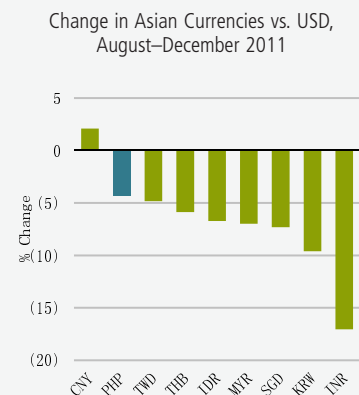
The bottom line is that the Philippines' benign growth outlook should limit the risk of fiscal pump priming and continue to buoy foreign investors' appetite for Philippine assets.

The Risk Factors

Looking ahead, the key risks to the Philippines rates market are: a surge in oil prices driven by geopolitical tensions in the Middle East; improved global growth prospects that would delay the pace of monetary easing; second-round effects of the euro-area sovereign-debt crisis, which could prompt the government into further fiscal pump priming (and hence risk a government-bond supply shock); and the risk of domestic political tensions that could affect foreign-investor sentiment. Such tensions could arise, for example, from recent government efforts to curb tax evasion and from court cases against former president Arroyo.

Nonetheless, from a structural perspective, budget consolidation is solidly on track with revenue collection in the first 11 months of 2011 suggesting that the tax yield has already rebounded to 14% of GDP, helped by the expiry of exemptions introduced during the 2008 global recession. This will put the government

Display 6
Peso a Top Performer Since August Global Equity Rout



As of January 12, 2012
Source: Bloomberg and AllianceBernstein forecasts

debt-to-GDP ratio on a declining trend. At the same time, the continued reduction in interest payments as a share of total expenditures (helped by lower refinancing costs) provides fiscal flexibility and will be a positive for the government's primary balance (see "Philippines' Fiscal Strategy Aims at the Right Targets, But Needs to be Executed Well," Asian Perspectives, September 16, 2011). ■

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