

Philippines Macro View

Post-Election Agenda: Key Takeaways from Policy Meetings

- **Key takeaways** — Highlights of our recent discussions with key senior officials suggest strong commitment to fiscal and macro reforms but we probably won't see big, headline grabbing reforms during the last three years of the Aquino administration. With Aquino thumbing down amendments to the nationalist provisions of the 1987 Constitution, we think the key reform initiatives requiring legislative support to watch out for would be: 1) consolidation of fiscal incentives; 2) Customs modernization and a tariff scheme that can enable Customs to address smuggling; 3) amendments of the BSP charter that would require recapitalization of Php500bn and potential loss-sharing agreement with government; 4) amendments to the Build-Operate-Transfer law that contribute to institutionalizing PPP; and 5) review of mining tax regime (different from the revenue-sharing agreement).
- **Seeking more policy flexibility** — Among the policymaking agencies pursuing internal reforms, BSP leads with SDA refinements that would facilitate the move to having an interest rate corridor (IRC) in place. IRC details (including a timetable) remain sketchy, but no doubt SDA would be converted to the deposit rate of planned IRC. This policy paradigm would sustain inflation targeting while address excess liquidity risk and thus accords BSP flexibility to calibrate policy tools consistent with inflation and liquidity objectives that may or may not be correlated.
- **Other than commitment to onshore borrowings this year, the Treasury ruled out borrowings on behalf of PSALM with preference to issue long bonds in 2H13** — Plans to supply inflation-linked bonds later in the year would be weighed against the likelihood of issuing another batch of retail Treasury bonds. The Treasury plans to review its parameters of the bond sinking fund upon closer scrutiny of the law that may not require 'compulsory' Treasury contributions to the fund every time it issues peso long bonds. This would go a long way to curb medium-term debt supply risk.
- **Finance on track with its 'single Treasury account' while 2014 national budget would be the 'release' document** — In 2014, the approved national budget would be the main 'release' document for project and program disbursements (amid other budgetary reforms in place) to remove layers of bureaucracy delaying fund releases and thus fast-track spending. The Treasury's single account would enable efficient monitoring and tracking of funds used/unused by agencies/departments, which would lead to a better gauge of the cash-flow position and future borrowings.
- **Market implications** — These reforms that strengthen institutions, policymaking capability and investment setting comprise the critical mass of reforms in support of the ratings momentum over the next three years. If in place, these reforms should accelerate fiscal consolidation, lower debt supply risk, and enhance investment-driven growth – which translates into a stronger medium-term outlook for PHP and local currency assets.

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Post-Election Agenda: Key Takeaways from Policy Meetings

BSP: Interest rate corridor (IRC) to lead to more efficient inflation targeting while addressing financial stability risk

- **On SDA 'refinements' and impact:** Removal of tax exemptions and inability to float cash management bills handicapped the new Central Bank's (or BSP) liquidity management capabilities. These conditions led to BSP setting up the special deposit accounts (SDA) really geared for the banks with excess liquidity and may want to park money with BSP beyond the overnight/weekly facilities. While SDA with longer tenors was priced at a 'premium' to the overnight RRP, BSP never meant it to be an 'investment product' or to serve as 'collateral' for bank lending.
- **Why did SDA balloon close to Php2tn?** A senior monetary official attributed this to the slow pace in capital market development amid strong liquidity. In an environment in which there was limited incentives to develop new products/services, banks and their trust companies invested money in SDA. Parking money in SDA didn't require much cost while being easy to market to retail/institutional clients. Over time, the SDA balance expanded to roughly 50% of total liquidity in the estimate of the senior monetary official. While liquidity management objectives were met with SDA, it was at a tremendous cost to BSP. Among the key objectives behind the SDA refinement is to drive out funds under investment management to support production and investment activities.
- **Moves to refine SDA were meant to be gradual, with BSP avoiding the 'cold turkey' approach.** Non-residents were banned from participating in SDA alongside stiff constraints for banks NDF holdings. SDA rate cuts, now 150bp lower than the overnight (RRP) policy rate, would ease BSP's costs of stabilization while also distinguishing SDA from the overnight rate as the monetary authority shifts to an interest rate corridor (IRC). BSP's recent circular on further SDA refinement aimed at distinguishing between IMA (investment managed accounts) and UITF placements in SDA. IMA funds were requested to exit the SDA by Nov. Since BSP is not a 'bank for the general public' (that could 'compete' with the private banks given BSP banking licenses to operate) and thus should not be accepting retail money under IMA.
- **Adopting an Interest Rate Corridor (IRC):** Despite SDA restructuring, SDA won't be abolished. With hefty gap between the SDA yield and RRP rate, the BSP official claimed that the SDA yield would be the 'deposit' rate in the planned IRC. Why adopt the IRC policy approach? Considering an expanding liquidity environment turning out to be a blend of onshore and offshore sources following an external accounts and a real economy that's more open to globalization, the monetary authority wants to complement its 'inflation targeting' program with due attention to the appropriateness of monetary aggregates. We interpret this as potential for excess liquidity risk from conversion of resilient remittances, strong credit growth to portfolio investments, FDI, etc. can lead to inflationary risk as well as financial stability risk. According to the BSP official, having IRC would make inflation targeting more 'efficient'. Additional challenge to the monetary authority would be to effectively communicate to the public that appropriate money supply level and growth consistent with maintaining/managing BSP's inflation targets.
- **Adopting IRC would accord BSP the flexibility to calibrate policy tools consistent with inflation and liquidity objectives, as rate adjustments within the corridor may or may not be independent of the other.** We think this

refers to either to 'symmetrical' rate adjustments--adjusting the deposit rate and RRP rate by the same basis points up or down (thus keep the gap between the deposit and RRP rate constant) that may signal simultaneous actions to address both liquidity and inflation risks, or asymmetrical rate moves (e.g. SDA rate being cut independent of the RRP rate) which are meant to tackle either liquidity or inflation risk.

- **The BSP official noted that RRP refinements would also be considered because of prevailing concentration risk in the banking system (few large banks vs a bigger number of small and medium-sized banks).** Moreover BSP would have to deal with the affected SDA liquidity (due to BSP's circular) that may eventually expand banks' RRP (since banks would 'naturally' absorb this liquidity as retail investors park their funds initially with the banks).
- **BSP estimated that Philippine GDP has the potential to expand by 6%-7% annually up from 4%-5% on the back of higher productivity (measured by total factor productivity estimates) and declining incremental capital output ratio (implies rising efficiency of capital).** Higher estimate of potential output strongly implies 1) the output gap would pose lower inflationary threat, and 2) the appropriate money supply target would be determined consistent with the economy's larger absorptive capacity given a higher potential output. With BSP's new estimates of potential output, the senior official believes that the annual inflation target can be lowered to 2%-4% by 2014-15 from the current 3%-5%.
- **Amendments to the BSP charter would still be required to ensure a monetary authority would be in a strong financial position with the flexibility to address the inflation challenges and financial market stability.** With the economy having grown by almost 10x since BSP was created in the mid-1990s, the official claimed that among the BSP amendments, the ideal capital requirements for the monetary authority would be Php500bn instead of Php50bn. Loss sharing arrangements with the fiscal entity would have to be entertained as well aside from recapitalization. Like any Central Bank, BSP has to have the capacity to issue debt securities as part of its open market operations. BSP is also angling to get back its tax exempt status since it is pursuing 'fiscal stability' objectives as well.
- Despite the strong Php in 1Q13, it is not overvalued. Waning of inflation implied a real effective exchange rate has been relatively unchanged as inflation differentials with other countries have been broadly stable. Cyclical export weakness due to the drag from tech exports can be attributed to reduction of inventories according to electronic firms. Although the improving book to bill ratio of the US semi-conductor industry signal return of favorable orders for tech exporters. The BSP official also noted that non-tech export industries are doing well driven by supply chain activities that cushion the tech export downside.
- Low likelihood of asset bubble risk in the real estate sector as the bulk of the residential property transactions in the low-cost to middle-income segments are in response to 'backlog of residential demand'. Buyers in the luxury to mid-luxury condominiums and other property were not entirely for speculative purposes but for 'leasing' with modest supply at 200K-250K units. Housing prices have not yet soared to thresholds similar to Singapore and Hong Kong. Pre-selling activities and not bank funding alone are behind real estate development.

National Treasury: Still committed to source onshore funding to avail of low interest setting while contributing to easing Php appreciation

- **The National Treasurer confirmed sustained commitment to source funding onshore while planning on a last-quarter supply of onshore dollar bonds (last year Treasury floated US\$500mn of onshore sovereign bonds).** With its hefty cash deposits to start FY13, Treasury's debt supply was directed at ensuring liquidity in its peso benchmark bonds with recent focus in 2Q13 directed at the belly of the curve. But for the rest of the year, the Treasury plans to issue new debt supply in the long end of the curve. The Treasury is also coordinating with BSP in its issuance and its no secret that BSP prefers the Treasury to tap the local capital markets. The Treasury also wants to time its onshore dollar bond supply in the last quarter of the year when OFW remittance flows surge and thus mitigate market expectations of a strong Php towards end-year or compel the BSP to accumulate FX reserves to ease Php appreciation.
- **Towards end of the year, Treasury was mulling inflation-linked bonds (ILB) issuance and perhaps another retail Treasury bond (RTB) supply exercise.** While the ILB issuance would be a first, compressed real interest rates and low inflation expectations usher conditions for the maiden ILB. This would have to be weighed against another RTB supply that's been a funding success for Treasury (with strong local bank participation) over the past years. RTB supply that has attracted retail liquidity can be positioned as an alternative to SDA although term premia preference between the two is different, although compensated for by RTB yields. Moreover RTB can be hyped up as an 'inclusive' debt instrument since it's meant for the small savers market. [Note: Between RTB and ILB, we sense another repeat performance for the RTB issuance with maiden ILB supply on a limited scale.]
- **Treasury's build up of its cash deposits (Php404bn as of end-Mar 2013 vs Php576bn as of end-2012) is 'opportunistic' cash accumulation given flattened local bond yields post-credit rating upgrades.** End-Mar cash balances of Php404bn represents 0.7x std deviations above the average deposit balances. With Treasury's single account later in the year, government would be in a better position to determine its appropriate cash position and its borrowing requirements. [Note: Earlier, given the hefty cash deposits of Treasury, we suspected this provided evidence of Treasury's liquidity management role by issuing more local debt than needed to help BSP in curbing domestic liquidity growth and ease SDA payments pressure. The trade-off is that the government debt to GDP ratio may not decline as fast.]
- **No re-lending or borrowing on behalf of PSALM this year.** The senior Treasury official assured us that PSALM doesn't need to go to the market this year after the Energy Regulatory Commission's approval of its petition for 'universal charges' that would mean higher electricity tariff rates passed on to consumers. A key implication is that PSALM would not pose additional debt supply risk to government bonds.
- **According to the senior Treasury officer, a review of the law doesn't require 'compulsory' contributions to the bond sinking fund, particularly for peso-denominated bonds.** Elevating the government debt stat and ratio to GDP (and to a certain extent, government's cash deposits) is the Treasury's bond sinking fund—a result of the law 'compelling' government to provide early on for amortization of the long peso bonds. The way to do this is to start 'refinancing' these future obligations by more borrowings at the present. These contributions

every time government floats a long tenor to expand its debt maturities (good for ratings but its like government investing in its own debt securities), only result in adding to existing debt stock. If its contributions to the bond sinking fund are not compulsory, government plans to attain certain thresholds that would stabilize the size of the fund e.g. contribute only to funding 2yr-3yrs of maturing bond obligations). Without the bond sinking fund, the net government debt to GDP can fall to 30%-40% instead of the current gross debt ratio of 51%.

- **Other Treasury initiatives** refer to pursuit of the agreement with the accredited government bank dealers for a 'single price' convention of the bonds to bring together tax exempt and non-tax exempt entities into trading local government bonds. Score cards for the performance of the GSEADs is being entertained to distinguish the banks that can be ranked as primary dealers with the rest as secondary market dealers. Treasury will also push for amendment to its tenor borrowing limit of 25yrs and extend this to 50yrs or more. Flexible tenor limit can help usher conditions for long-term local funding of PPP-related and other infrastructure projects.
- **Non-resident holdings of peso government debt stood at 8% of total peso bonds despite the withholding tax.** The senior Treasury official suggested that with tight ROP supply, some foreign funds/entities shifted to peso bonds or GPN.

Finance Department: Mining tax reforms, consolidation of fiscal incentives and other tax administration reforms that aim at a longer planning horizon

- **Government will embark on long-term planning for fiscal sustainability while improving financial systems to get a better gauge of government's daily cash flows.** Education and infrastructure would be key priority areas with two additional school years to start reforms in the educational system. This would require more school infrastructure as well as more qualified teachers. Tier 2 and tier 3 areas of growth (areas outside Metro Manila) would be prioritized in budget spending and allocation. Government has adopted measures/steps to increase its capacity to spend. Prior to new fiscal year and Congressional passage of the new government budget, government agencies can jumpstart programs and projects by undertaking initial approvals, cash programming and other pre-bidding activities required. Treasury will move to a single account to enable government a better handle of 'cash flows', including existing cash positions and payments, on a daily basis, that would lead to more predictable and efficient borrowing (targeting end of the year). Steps are being undertaken to 'harmonize' financial reporting from the different agencies.
- **While the mining law will not be amended, the existing revenue-sharing scheme between the government and mining firms will be finalized soon.** This bodes well for full implementation of the mining guidelines settled last year. Under the new Congress, government may push for a review of the mining tax regime that enacted under the 1995 mining law. The review is meant for effective implementation of the law considering new players e.g. small mining entities. Perhaps the tax rate e.g. excise vs VAT, may differ per mining product, although the standard rates may apply for all.
- **Key fiscal reform under the new Congress would be the consolidation of fiscal incentives.** Finance, Trade and Industry and Board of Investments are having ongoing discussions to finalize a consensus bill to be submitted to Congress for approval.

- **After passage of the excise tax reforms late last year, the additional planned reforms are inclined towards further improvement of tax administration and enforcement of existing laws.** Government listed an electronic letters of authority monitoring system and having procurement, payment and distribution monitoring systems, listing programs/projects that would leverage technology to improve tax collection efficiency that would be at the core of reforms for the Bureau of Internal Revenue. The Finance official cited the use of third-party information including from local government units in averting tax evasion and identifying new tax payers. Instead of tax credit certificates (TCC), government plans to provide VAT refunds to exporters/importers and qualified investors, and eventually dry up TCC supply, and thus deter 'trading' of these certificates and corruption. For Customs, reforms range from electronic tracking of cargo to codification of customs memorandum orders, which have been prioritized as key reforms. Government will support the Customs Modernization and Tariff Bill in Congress to stay in sync with the Kyoto Convention requirements in an era of low tariff setting. This bill also intends to amend provisions of the Customs tariff code that have not been changed since it was approved by Congress. The Finance official claimed that this bill and ensuing amendments to the existing tariff code would aid Customs in addressing institutional inefficiencies and corruption, as well as preventing smuggling.

Budget and Management: Reform initiatives

- **Budget outperformance (actual exceeding of program targets) in 1Q13 were noted for infrastructure and capital outlays, led by roads and bridge projects of the Public Works & Highways and irrigation projects carried out by the Department of Agriculture.** Infrastructure and other capital outlays expanded by 50.1%YoY in 1Q13. Having the account management teams in place facilitated faster disbursements of infrastructure projects. Maintenance and other operating expenditures expanded by 25.2%YoY, largely due to faster disbursements of the conditional cash-transfer program. Subsidy expenditures fell by 24.8%YoY during the quarter due to limited procurement of palay for the National Food Authority and the policy of 'no work program, no subsidy' to other state-owned enterprises.
- Measures comprising tighter alignment with priorities starting with zero-based budgeting (ZBB) & evaluation of major programs in 2010 would evolve to the budget prioritization framework in 2013. According to the Budget official, Php10.5bn savings were incurred with the ZBB, while the prioritization framework this year seeks to align budget priorities with the Aquino cabinet's priorities.
- **Steps and measures fostering speedier budget execution have been responsible for faster non-interest expenditures (primary fiscal expenditures).** In 2010, government instituted disaggregation of lump sum funds among agencies to deter 'lazy spending', encourage increased transparency among department/agencies on what it can absorb or implement while remaining committed to completing its budgetary allocations. In 2011, government adopted procurement innovations the early phase of the government's electronic procurement system that is now widely accepted among different agencies. Last year, account management teams were formed to address bottlenecks in key projects and programs. This resulted in Php5bn-Php6bn in 'savings' for the Public Works and Highways department. This year, government will institutionalize the 1-yr program of 'validity of appropriations' that would deter 'carry over' of budget execution and lead to predictability of budget application. Next year, government plans to have the approved national budget as the main 'release' document for project and program disbursements following all the

budgetary initiatives since Aquino took over. Having the approved government budget as 'release' document removes layers of bureaucracy in disbursing funds that can fast-track spending subject to other reforms initiated like the 1-yr validity program and disaggregation of lump sum funds among agencies.

PPP Center: Institutionalizing the PPP activities would depend on more project rollouts and awarding alongside amendments to the Build-Operate-Transfer law

According to a senior PPP Center official, amendments to the BOT law would address 'grey areas' that hampered the pace of PPP activities. Some of the amendments would require 'harmonization' of internal mandates among key government agencies. The draft of the BOT amendments is available and ready to be submitted to Congress.

Appendix A-1

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