Philippines Macro View

Country Trip Notes – Every Reason to Be Hawkish

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- **Macro themes** — In last week's meetings (Apr 3-4) with senior government officials and other resource contacts, we extracted the following macro themes: 1) Upside cyclical risks likely to persist with the commitment to fiscal expansion amid a firm inflation uptrend and strong liquidity condition. These underpin monetary tightening bias and prospective actions. 2) Recent market concerns: overheating and weak current account positions exaggerate sustainability risks (growth stalling) although excess liquidity cannot be ignored since financial stability risk could always follow. 3) Forces/Catalysts leading to structural disinflation in 2015 underpin a narrower inflation target range consistent with output gap. 4) Institutionalizing governance reforms in budget disbursements or Customs collections begin with greater institutional commitment to transparency, e.g., 'open data systems' and adopting the latest financial technology for tracking/reporting activities, etc.

- **Biding the time for rate adjustments** — Upbeat themes while prioritizing excess liquidity triggered macro prudential adjustments led by bank reserve hike. This paves the way for policy rate tightening in our view in 3Q14. GDP gains in 1Q14 coupled with an elevated CPI trajectory strengthen timing potential for rate hikes. With rate tightening likely saved for later, PHP likely susceptible to USD pressures.

- **Upside risks to inflation despite staying well within the BSP's annual inflation target range** — According to a senior BSP official, upside inflation risk should not be underestimated because of upbeat demand, supply constraints and strong liquidity. PHP's pass-through to inflation has waned from 0.11% previously to 0.05% in BSP's estimate to imply less urgency in containing weak PHP. According to an IMF official, lackluster oil/commodity prices support CPI prospects within BSP's target range.

- **Understated imports that 'overstate' current account surplus?** — While officials do not deny trade data discrepancies due to valuation issues or smuggling could understate imports, these are not significant enough to distort trade data and cast doubt on current account surplus. Recent BOP methodology (BMP6) removal of 'consignment' imports into the services component as suggested by the IMF but still included in the current account. IMF official noted 'unrecorded remittance flows' of roughly 5% of GDP that may be more significant in determining the current account.

- **Sustainability of growth issues** —Rising share of investments to GDP due to investments in BPO, real estate, manufacturing, accommodation services, re-fleeting of key air transport providers to public infrastructure suggest new capacities that improve productivity, elevate output and curb secular inflation risk. Tight power reserves in the Luzon grid during our summer months (Apr-May) rather than an 'overheating' condition would be keenly watched. Committed power supply is still on schedule that eases risk of 2015 power outages.

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We had discussions (Apr 3-4) with senior government officials (Bangko Sentral ng Pilipinas, Department of Finance/National Treasury, Department of Budget and Management, Department of Energy and PPP Center/NEDA) on policy issues/trends shaping the macro environment and prevailing policy bias. We also solicited views of senior economists of the IMF and World Bank in Manila. Highlights of our recent investor trip are as follows:

1. **On monetary tightening bias and inflation risk.**

Not to underestimate upside inflation risk. According to a senior monetary official, despite inflation trajectory remaining well within BSP's annual inflation target range (3%-5%), one should not underestimate upside inflation risk when upbeat macro momentum, supply constraints and strong liquidity remain in place.

Excess liquidity risk that can preview financial stability concerns. Bank reserve hike of 1% recently to 19% was directed at excess liquidity risk. We gather that more than upside inflation risk, excess liquidity can easily deteriorate into financial stability concerns. While the real property sector has heated up, the rise in real estate prices has not been excessive or rapid while the higher rental ratio relative to trend is still justified by demographics, housing demand backlog, OFW investments, etc. In the luxury space of the property sector, reduced 'licenses to sell' have been observed as an industry reaction to froth within this segment. BPO catalyst is evident in strong demand for commercial office space. There is an 'organic growth story' behind strong real property prospects.

No loosening of credit standards—a key condition for financial stability risk. Despite strong loan growth to the property sector, there is no 'loosening' of lending standards according to the bank loan officers' survey. Recently there's been net 'tightening' in the real property space. However strong lending to production sectors, particularly those with 'forward linkages', have been observed and not just to real property/mortgage sector or for consumption.

Rate tools may be 'too blunt' an instrument to address credit gains to the property sector. Using interest rate tools to cool down a hot property sector may be 'too blunt' an approach since it could harshly impact the other more productive non-property sectors that would still need credit support and low interest rate setting. Hence the use of well-targeted macro prudential measures would be preferred in addressing any financial imbalance.

Upside inflation risk would drive 'gradual and circumspect' adjustments of policy rates. Meanwhile exchange rate pass-through has diminished from 0.11% to 0.05% in BSP's estimate. Pass-through effects cannot be downplayed since 15%-30% of total private goods are imported according to input-output tables/analysis. PHP pass-through would still have an impact on inflation expectations.

2. **On overheating risk.**

Despite growth ahead of potential, investment-driven growth (or higher investments contribution to GDP) could sustain an output gap neutral to inflation risk. Actual GDP growth exceeding potential output growth of 6.5% (IMF estimate) over the past 2-3 years but a persistent positive output gap doesn't necessarily result in an 'overheating' economy (perhaps higher inflation risk). Higher investments (share of real investments ex-inv to GDP rose to 21% in 2013 from

17%-18% in 2009-10) contribute to rising potential output. We interpret this as an output gap while positive at this stage that may be regarded as still 'neutral' to inflation. According to the senior monetary official, because of higher investment contribution, the capital-output ratio may be sharply rising likely to result in higher productivity. The official claimed there's 'less' underemployment rate such that the combination with higher capital productivity bodes well for higher potential output growth.

Narrowing inflation target range in line with output gap. The senior BSP official claimed that price-setters need not pass on their costs rapidly because of increased competition that includes availability of imports and BSP's credibility to keep inflation low under inflation targeting. This suggests a 'narrowing' inflation target range would be in line with the output gap. Demand-based inflation that's sticky downwards would not be a strong threat but more the cost-push variety including food price pressures. With imports of rice this year (800,000 metric tons), augur for stabilizing food prices. Duration of pass-through of food price shocks would be 4-5 months. Longer duration for oil price shocks of 6-9 months.

Largely a 'quality of growth' issue rather than overheating. Recent growth phenomenon that exceeded potential may reflect 'quality of growth' issue rather than 'overheating' according to the IMF official. With strong credit growth to the real property/construction sectors, the source of GDP growth seems concentrated on a few sectors.

3. **Other macro sustainability risk/issues**

Beyond short-term gains/risks, the IMF official claimed the real macro issue is sustainability risk. For the robust growth condition of 7% or more to be extended, particularly after Pres. Aquino's term, may require structural reforms. While there was no mention of what these key reform areas would be, consolidation of fiscal incentives and liberalization of the 'negative' foreign investments list would definitely count. There's a need to get 2-3 structural reforms accomplished soon to ease 'investment bottlenecks' that impede higher growth. These reforms would increase productivity that bode well for faster long-term gains. While the local economy is basically driven by services, it's still essential to have a few strong manufacturing industries contributing to growth and job generation. Moreover investments' share to GDP need not soar to 30% or more to be able to attain and sustain GDP growth exceeding 7% or more.

Cyclical risk may also be represented by 'one-sided dimensional growth' heavily dependent on BPO and real estate developments. Credit to the property market and BPO service sectors more elevated than the rest of the economy. Need to broaden growth through more contribution from the other sectors, but this may require more deregulation and economic liberalization as well. Conglomerate-related risk was also raised in the discussion considering their balance sheet expansion and hefty exposure of the banking system to these few local conglomerates.

Negative real rate condition is more worrisome than excessive liquidity risk according to the Fund official. We interpret this risk concern as a condition that may facilitate heightened risk perception that can create financial imbalances. Persistent negative real rates may also reflect duration of monetary accommodation and to some extent, BSP's inability to issue cash management bills resulting in heavy reliance on SDA for liquidity management. Compression of SDA balances is not a deliberate 'loosening' of monetary policy although it was during the 'sweet spot' period of strong growth and low inflation.

4. **Financial costs not a major consideration for BSP to do 'combination tightening'**

BSP's financial costs incurred in pursuit of inflation and monetary objectives should not be considered a primary constraint in shifting its policy bias. Having 'negative capital' doesn't constrain a Central Bank from being effective in monetary and inflation management.

5. **On the 'new' annual inflation target of 2%-4% in 2015**

Prospects for structural disinflation. In 2015, the inflation target range is 2%-4% as structural changes are likely to lead to 'disinflationary forces'. Globalization that spawns competition leading to compelling conditions to keep costs down, policy credibility earned by BSP and government to keep inflation low, investment drivers that improve potential output and increased market competitiveness are among the factors cited that would lead to structural disinflation. Despite likelihood of these disinflationary catalysts in place, inflation expectations remain 'backward looking'. Real interest rates remain 'very negative' that bodes well for growth but not necessarily a factor behind the strong liquidity condition.

6. **On import valuation and current account risk.**

Consignment imports that reflect 'transfer pricing' could have a larger impact on import valuation rather than smuggling. According to senior officials of BSP and IMF, 'transhipment' issues and valuation differences (timing of arrival, CIF vs. FOB, exchange rates, etc.) accounted for much of the trade data discrepancy between Philippines and foreign sources. Consignment goods dominate Philippine imports that capture the complex issue of 'transfer pricing' and thus contribute to material product value differences between source (of foreign goods) and the domestic market. In the new BOP methodology (BPM6), consignment imports have been 'taken out' of the goods side and relegated to the non-merchandise trade section of the current account. Smuggled imports (oil and rice) undervalue imports, but their impact cannot be 'significant' if these grey market imports cannot obtain 'funding' onshore. Nonetheless rampant smuggling activities have to be funded by USD bank deposits overseas.

Shifts in net foreign reserve assets—a better gauge of surplus/deficit incurred by residents' transactions with rest of the world. The Fund official noted statistical and other qualitative errors in the trade data would get reflected in the net unclassified items of the BOP that reconciles the constructed current account and capital accounts with the change (delta) in net reserve assets of BSP and the banks. NUI while sizeable as it runs to the billions of USD annually isn't regarded as excessive as a share to total trade and other measures. Moreover NUI can be net positive (or error measurements 'undervalued' current account items)—not necessarily net negative (or error measurements buoyed up current account) all the time. What the official highlighted is the strong quality of the BSP and banking reserves data (foreign assets and foreign liabilities) that offers a strong basis for determining current account and capital account gaps. This was seconded by the BSP official that current account risk should be assessed in view of gross foreign assets held by BSP and the banks and changes in external debt. Other than hefty reserves stock (>11 months worth of imports of goods and services), we continue to record a declining external debt stock and debt servicing. Unlike other EM, the country's external debt maturity is heavy on the long-term tenor that reduces country exposure to roll over/tenor risk.

Unrecorded remittances or those flows channeled through the informal system still make up a huge chunk of underreported flows in the current account. According to the Fund official, citing Global Analytics estimates indicated that remittances may be understated by ~**5% of GDP**. Even BPO receipts do not yet take into account payments of global financial and non-financial companies for their offshoring/outsourcing activities in the Philippines.

7. **Resilient to external financial shocks, i.e., Fed tapering risk**

Low non-resident exposure to public sector debt. Exposure of non-residents to sovereign debt is 59% with the hefty residual percentage reflecting strong 'home bias'. Peso denominated government debt exposure of non-residents is 11%-12% including Global Peso Notes (ex-GPN at 8%-9%). Retail-based funding structure (more peso liquidity with onshore banks CASA) reduces reliance on external wholesale funding for growth. Hence the country would be more resilient to external financial shocks.

8. **National Treasury's key funding initiatives**

Low national government (NG) debt ratio purged of bond sinking fund (BSF). NG debt fell to 42.8% of GDP in 2013 from slightly less than 50%, if we net out BSF. Meanwhile the FX component of NG debt stood at 32.5% of GDP last year consistently down from 42.8% in 2008. Peso and FX debt maturities are 9.6yrs and 10.9yrs respectively as of 2013.

Treasury will continue to undertake debt swap exercises. Whether it's redenominating foreign liabilities to peso liabilities or it's swapping short duration peso to long duration peso liabilities, these activities are aimed at shifting 'high coupon' debt to 'low coupon' debt. The National Treasurer doesn't see 'bulk' maturities in the near-term similar to last January's peso benchmark bond maturity >Php100bn. Payment of peso bond maturities assured by BSF. In 2Q13, Treasury's auction program would be concentrated in the short duration to 5yr segment of the curve consistent with market appetite.

Treasury's single account (TSA) system. Consistent with global practice, TSA would enable daily bank collections to be remitted daily to Treasury's account with BSP that would allow 1) Treasury's liquidity management to be supportive of BSP's liquidity management goals while 2) having updated daily information on its cash deposits that make for efficient and cost-effective funding of budgetary disbursements.

No funding requirement for the state-owned Power Sector Assets and Liabilities Management (PSALM) in the near-term. Collections from the National Grid Corporation of the Philippines (managing the national transmission assets), PSALM's reforms and privatization proceeds of NPC power plants support internally generated cash flows.

9. **Budget disbursement priorities and reforms**

In the senior Budget official's presentation, reconstruction assistance budget (Yolanda) consisted of: a) 'Immediate' budget of Php34.5bn; b) Php90.6bn in 2014; and c) Php235.8bn in 2015-17 period for a total budget of Php360.9bn. Near-term, disbursement of the reconstruction budget could provide a firm basis for larger fiscal contribution to growth.

Total infrastructure outlays in the 2014 budget is projected to rise by 40% to Php404bn. Fiscal issue is how to minimize fiscal 'slippage' (or disbursements below

target). According to the senior Budget official, factors likely to minimize fiscal slippage of the infra budget are: 1) centralized project implementation with the infra agencies having more project experience while freeing up the other departments to carry out their real mandates; 2) pre-project implementation activities can be started as early as the month after the FY budget proposal has been submitted to Congress; and 3) budgetary reforms to cut 'red tape' delays led by having the approved Government Appropriations Act (GAA) of the new fiscal year as the key releasing document for funds needed by implementing agencies on day 1. The 2014 budget program contains funding for feasibility studies of these projects. There's also the initiative to include local government units (LGU) in project implementation depending on LGU capacities (WB project initiative).

Status of major budget programs under the 2014 budget: 1) Conditional cash transfer program of Php62.56bn that will cover 4.3mn indigent households. 2) Government provided Php6.7bn as its counterpart for identified PPP projects. This amount covers 'cost of right-of-way and other related infrastructure activities which the government may have to provide in connection with PPP arrangements'. 3) Standby funds in the amount of Php20bn were allocated for Risk Management Program to cover commitments/obligations made by the government in PPP projects awarded/auctioned off. 4) Php84.5bn of the Department of Health's budget supports the Universal Health Care program that would cover health services required by 10.2mn poor families. 5) Php309.4bn budget for Education that includes support for construction of needed classrooms under K-12 education reform program.

Key budget reform initiatives revolve around the Public Financial Management (PFM) reform roadmap 2011-16. Key macro objective is to 'clarify, simplify, improve and harmonize' the government's financial management processes and information systems. Among the key PFM reforms is the government's integrated financial management information system (GIFMIS—design has been finalized and contract targeted for awarding on June 2014) that contains Treasury's single account, real-time online monitoring and control of budgetary accounts, systemic recording & reporting of government liabilities, unified account code structure, and predictable allotment and cash release programming. Cashless purchase card would also be pursued as a reform measure in which purchase cards will be used by government agencies for low value payments of a restricted number and type of goods and services. This cashless purchase card program would lead to a 'cashless and checkless' payment system starting 2014 and the target for utilization by all national government agencies is 2015. Finally as discussed earlier, starting 2014, the approved GAA would be the main releasing document for project/program disbursements to cut bureaucratic layers of fund releases and thus, speed up disbursements.

2015 budget proposal would have a 15% jump in expenditures. Other than accelerate fiscal disbursements for key project/program initiatives during the last full fiscal year of the Aquino administration, the Budget official claimed that disbursements have to keep in step with fast rising revenues. Next week's budget increase of 15% would keep to within the programmed fiscal deficit to GDP ratio of 2%.

10. **Likelihood power failures during the height of Philippine summer (Apr-May)**

Power reserves are likely to be 'thin' in Apr-May including in Luzon according to the Energy official's assessment. Expected peak system demand in Apr-May 2014 assumed to grow by 4.6% (GDP growth forecast of 7% and elasticity demand

ratio of 0.6%) remains less (but not a significant buffer) than available capacity (< 9,000MW) in Apr-May. However if for some reason or due to unforeseen circumstances, peak demand growth for power shoots past 4.6% in Apr-May, then power shortages in Luzon would become real. During the rainy season, peak demand is expected to head back to the 8,000MW per month range. Over 2016-20, peak demand growth of 4.8% is assumed (with GDP growth forecast of 8% and elasticity ratio of 0.6%).

With 435MW of coal-fired power supply (Southwest Luzon Power Generation Corp by DMCI Power Corporation and South Luzon Thermal Energy Corp. by Trans Asia Oil and Energy Development Corporation) scheduled to be commissioned this year that will buoy up committed power reserves, 2015 power situation during the summer months would be less worrisome. Roughly 253 MW in wind power is scheduled for commissioning in 2014 (subject to FIT) alongside 20MW in biomass power and 200MW in natural gas. For 2014-16, the Luzon grid committed power projects would supply an additional 1,724.65MW.

In the Visayas region, power reserves are larger given the implied gap between available capacity (~1,600MW-1,700MW) and system demand (<1,500MW). For 2014-15, government expects peak demand growth rate of 7% given elasticity demand of 1% applied to GDP growth forecast of 7%. Over the 2016-20 time frame, government expects peak demand growth of 8% with GDP growth forecast of 8% and elasticity demand of 1%. For 2014-16, the Visayas region has roughly 580MW of committed power projects.

The Mindanao power outages are anticipated starting Mar 2014 in the government's projection of peak demand forecast exceed available capacity up to Sep 2014. Given downtime in hydro supply during the hottest months of the year, the power supply shortage is expected to be worst in Mar-Apr. Government expects peak demand growth forecast of 5.6% over the 2014-15 period with elasticity ratio of 0.8% and GDP assumption of 7%. Peak demand growth forecast rises to 12.8% (elasticity demand ratio rises to 1.6%) in 2016 and eases to 8% over the 2017-20 period (elasticity demand ratio drops to 1%). Over 2014-17, government reported a committed power supply of 1,078.5MW for the Mindanao grid.

11. PPP (Public-Private Partnership) program updates

According to the PPP Center/NEDA senior officials, most PPP projects are based on 'viability funding gap (VFG)'—the preferred financial methodology for valuing key infrastructure projects to be offered to the private sector. VFG would determine the amount of government equity to be offered in the public investment project that would make it attractive (or commercially viable) for private capital to participate. Maximum government equity in a project is 50% of project costs. Unlike in previous BoT projects in the past, government wants to shy away from providing a 'guaranteed return' or 'take or pay' arrangement. In the bidding parameters, private proponent has to inform government what amount is required to make the project 'viable'. Everyone bidding for the public investment project would provide an amount that would potentially utilized the VFG and the project bid that requires the minimum VFG would be poised to get the best bid for the project.

VFG demonstrated investor acceptance in recent PPP project awards. In the 6 PPP projects awarded by government, the school infrastructure project phase 1 (Php16.3bn) and phase II (Php3.9nbn) would have to be fully paid by government over the project life span. However under the VFG methodology, the government 'earned' Php11bn from the private proponent that bagged the NAIA Expressway

(Phase II) project worth Php15.5bn. Same for the automatic fare collection system (Php1.72bn project cost) in which government 'earned' Php1bn after recently bidding it out. In short, the VFG appears to be an appropriate PPP methodology that's market-based while not committing future tax payments to a guaranteed set of returns.

PPP project likely to be awarded soon to a private proponent is the Php17.5bn Mactan-Cebu International Airport Passenger Terminal building. Other PPP projects scheduled for bidding within the year are: CALA Expressway (Php35.4bn), Light Railway Transit (LRT) Line 1 Cavite Extension and O&M (Php64.9bn), and Integrated Transport System – Southwest Terminal (Php2.5bn).

Key reform that can facilitate PPP project activities past 2016 would be the amendment to the BoT law. This amendment proposes exemption of the private proponent from paying local government property taxes/permits for as long as the national government is the 'contracting party'. The national government will then coordinate with the LGU in settling taxes/permits related to the project activities. Issue of who will shoulder payment of the LGU property taxes delayed the LRT 1 (Cavite line extension) project bidding. Other issues relate to the need for amending the right-of-way (ROW) acquisition to allow for a more streamlined process. PPP officials also want clarification on the 'unsolicited' proposal option since PPP projects are all solicited thus far.

12. **Other macro-related issues**

The reconstruction program addressing requirements of typhoon Yolanda's victims would test the system's bureaucracy down at the LGU level (eg requirement of getting a host of signatures/approvals of key LGU officials to facilitate disbursements for a project activity according to the law). For rehab projects/programs supported by multilateral credit agencies, potential risk of rising backlog is imminent given bureaucratic compliance under the law, which is compelling government to look for alternative ways to getting money/aid to the victims. One approach is through the use of existing 'bilateral/multilateral programs' that can help create legal space to speed up dissemination of cash transfers and aid as well as fast-track project implementation at the community level.

Moreover the LGU in some of the affected areas lacked the technical capacity to undertake technical appraisals/plans/design of local community projects/programs often required by multilateral/bilateral lending and assistance programs. Some multilaterals also require the greater transparency in the tracking/monitoring of project activities once money is disbursed (eg Geo tagging system). Beyond disbursements, key government agencies may have the minimum tracking systems that use open data systems to report project activities but not at the LGU level.

Between red tape/bureaucracy/foreign ownership limits and lack of infrastructure, which investment bottleneck constitutes a larger threat to investments? The WB lead economist believes high transaction costs arising from the tight, investor-unfriendly bureaucratic rules would be a larger drag to investments for some sectors than infrastructure gaps. Case in point cited would be the need to reform the 'cabottage law' that has hiked the cost of doing business (inter-island shipping costs) but not necessarily tightened port capacity. It's possible that reforming the 'rules' would lead to more investments in the sector and over time, put more stress on existing infrastructure, if these gaps are not addressed. However the point is that existing regulatory framework in industries/sectors that resulted in higher costs of doing business have to be addressed with the same

passion/zeal currently displayed in addressing the obvious infrastructure gaps. While there's a 'new wave of support' in the House of Representatives to address the 'nationalist provisions in the 1987 constitution particularly for infrastructure, utilities and services, lacking Pres. Aquino's prioritization would probably be needed to see it through the end of Aquino's term. Whether these constitutional amendments would be attractive in courting investments post-2016 presidential elections remains an uncertainty at this stage.

Appendix A-1

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