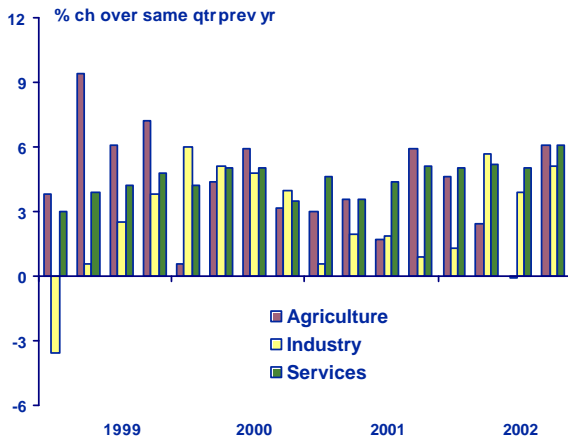


Country Brief : Philippines

There have been growing concerns in financial markets about the Philippines, particularly regarding the management of the budget. A related issue is the security situation, which boosts military spending and discourages investment. It is possible, although not very likely, that a vicious circle could develop in which a widening budget deficit, falling currency, rising inflation and rising borrowing costs feed on each other.

Strong growth across the board in the fourth quarter of 2002



Growth for 2002 came in better than expected at 4.6%, thanks to a particularly strong performance in the final quarter. Agriculture enjoyed a strong rebound after a weak third quarter.

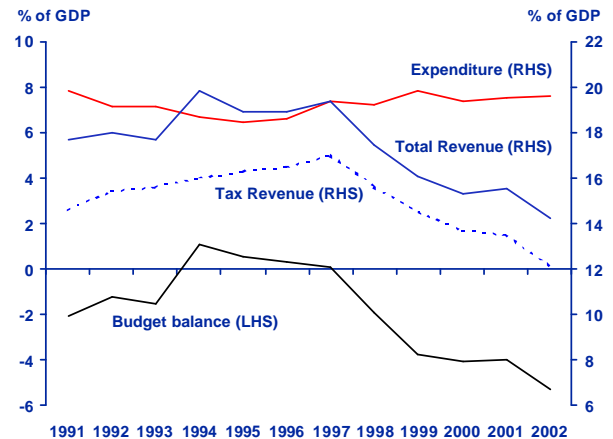
Will strong growth be sustainable?

There are doubts that economic momentum can be maintained given the need to reduce the budget deficit, as well as relatively high real interest rates, and poor investor sentiment. Nevertheless, the strong finish to 2002 will make growth through 2003 look good, thanks to base-effect arithmetic. Indeed, it would take a fairly severe reversal early in the year to prevent the official growth forecast of 4.2% to 5.2% being achieved.

Markets have penalised fiscal deterioration

Authorities in the Philippines have consistently failed to meet budget targets in recent years. For 2002, the deficit was originally projected at P130 bn. The target was raised several times, and the outcome was P213 bn or 5.4% of GDP. Markets have penalised the Philippines for these overshoots. There is little doubt that the peso is weaker and interest rates higher than they would have been if targets had been met. The prime lending rate is currently about 9% - very high in relation to inflation of 2.6% over the 12 months to December 2002.

Poor revenue collection the main cause of the widening deficit



As the above graph shows, government expenditure has been fairly stable in recent years at just under 20% of GDP. Revenue however, and particularly the largest component, namely tax, has not kept pace with GDP growth. Tax revenue declined last year to a low 12% of GDP, down from 17% in 1997. The problems are well known and include poor compliance on the part of taxpayers, inadequate auditing, inefficiency in the collection system, and availability of excessive deductions. Addressing these issues is one of the most important tasks facing the administration.

A worst case scenario

If there is no progress in reducing the deficit, there will be little scope for reducing borrowing costs and the peso will remain under pressure. In the short term there is significant potential for a rebound in inflation, and the authorities will need to guard against the development of a vicious circle, with rising inflation, a widening budget deficit, falling currency and rising borrowing costs feeding on each other. The Philippines has become more vulnerable since September 11 because of possible links between the various rebel groups operating in the south and international terrorism. Foreign investor interest, already low because of the difficulties of working through the bureaucracy, has been further discouraged. On balance, however, a downward spiral is not likely to happen. The authorities are able to control the budget (although it may take the prompting of adverse market reaction to do so), and the Central Bank has the

independence and willingness to tighten the monetary situation to avert a crisis, painful as that may be.

The path back to fiscal discipline will be difficult

For 2003, the deficit target has been raised from P120 bn to P202bn, but the medium term objective of a balanced budget in 2006 has been confirmed. If the government is able to tighten controls on spending and boost revenue collection, and in this way get on track to meet its balanced budget objective, then this will in time reduce capital outflows, stabilise the peso and achieve lower borrowing costs. However, it would mean that there will be no scope for fiscal policy to be used to support the economy in the foreseeable future, and this could prove painful and politically unpopular, particularly with the large agricultural sector subject to frequent adverse weather conditions.

Current account in surplus, but for how long?

The current account has been in surplus (which is not the traditional situation for the Philippines) since 1998, reflecting a vicious compression of imports as domestic demand collapsed after the 1997 Asian crisis, as well as good export growth in most years since then. The surplus peaked in 2000, and shrunk in 2001. The situation is complicated by recently-announced upward revisions to imports and correspondingly lower current account surpluses in 2000 and 2001. If data for 2002 are subject to revisions of a similar magnitude, then recent trends would imply that the current account is likely to move back into deficit in 2003. This would add to international concerns about Philippines risk and exacerbate upward pressure on borrowing costs.

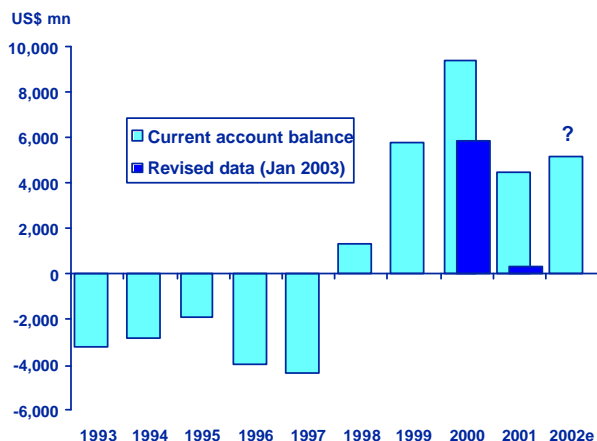
Leadership uncertainty

President Arroyo has announced that she will not run in next year's presidential election. In the short term this could be a positive, as she will be able to devote herself to managing the country, rather than positioning herself for re-election, although, as always, she will need to fight for support on every issue. However, as the election (due in May 2004) approaches, there will be uncertainty regarding who will be the next president, and what baggage he or she will carry regarding deals and promises that may have been made in order to build electoral support. However, this will be nothing new in a country where political parties tend to be built around individuals and alliances are flexible. Indeed, Arroyo herself became president thanks to a disparate grouping of interests under the banner of "People Power", which was bound together solely by a desire to force then-President Estrada from office.

Difficult security situation

There are very long-standing separatist movements in the south of the country, as well as freelance bands of kidnappers. President Arroyo has worked towards peace negotiations while at the same time maintaining military action against groups that refuse to participate. She has gained support from the USA for this approach, although this has tended to complicate domestic politics.

Recent revisions complicate analysis of current account



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