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Country briefings

China, Indonesia and the Philippines

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Inside:

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People's Republic of China

Nominal GDP: US$1,823 bn (market exchange rate)
US$8,091 (purchasing power parity)

Ranking: 5th largest MER basis; 2nd largest PPP basis

Population: 1,306 mn (July 2005)

Age structure: 0-14 yrs 21.4%
15-64 years 71.0%
65+ years 7.6%

Median age: 32.26 years

Life expectancy at birth: 72.3 years

Languages: Chinese (Mandarin)
Yue (Cantonese)
Wu (Shanghainese)
Minbei (Fuzhou)
Minority languages / dialects

Literacy: 90.9%

Land size: 9.5 mn sq kilometres

Capital: Beijing

Administrative divisions: 23 provinces; 5 autonomous regions;
4 municipalities

Main cities (mn people): Shanghai
Beijing
Chongqing
Tianjin
Wuhan
Guangzhou
Harbin
Shenyang
Chengdu
Nanjing

Independence: 221 BC (unification under Qin Dynasty)
1 January 1912 (Manchu Dynasty replaced by Republic)
1 October 1949 (People's Republic established)

Chief of State: President HU Jintao (since 15 March 2003)

Head of Government: Premier WEN Jiabao (since 16 March 2003)

Elections: President and Vice President elected by the National People's Congress for five-year terms (next election March 2008); premier nominated by the President and confirmed by NPC

Legislative branch: Unicameral National People's Congress (2,985 seats)

Elections: By municipal, regional and provincial people's congresses to five-year terms; next election due in late 2007

The structure of China's economy

The Chinese economy has been industrialising at a rapid pace since the process of opening and reform began in the late 1970s. Over the past three decades, the contribution of agriculture to GDP has steadily declined, taken over by industrial production and, more recently, services. Initially the process of industrialisation was driven by large state-owned enterprises (SOEs), which received favorable tax treatment and advantageous financing from state-owned and government directed banks. The private sector was allowed to expand during the 1990s, with some estimates indicating that it now produces roughly half of all output. However, this likely underestimates the role still played by the state. SOEs continue to dominate in a number of key sectors, including utilities and banking, and vestiges of the old model of economic planning fostered by directed lending remain in place. The model has been successful insofar as it has rapidly transformed the economy, which is now the second largest in the world (PPP basis) and contributes nearly 15% of global output. At the same time, the continued reliance on administrative mechanisms to balance demand and supply has created distortions that will need to be worked out over time.

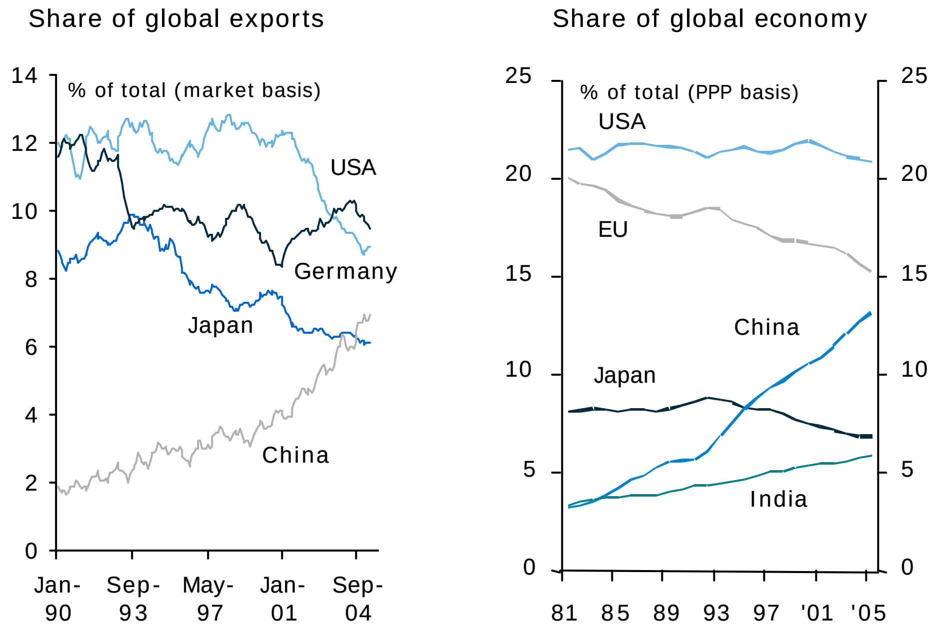
Composition of GDP – output (% of total)

	1980	1990	2000		2004	
			Old	*New*	*Old*	*New*
Agriculture	30.1	27.1	16.4	14.8	15.2	13.1
Industry	44.2	36.9	43.6	40.3	45.9	40.8
Construction	4.3	4.6	6.6	5.6	7.0	5.4
Services sector	21.4	31.3	33.4	39.3	31.9	40.7

Source: China Statistical Yearbook

To some extent, China has followed the growth model pioneered by Japan. The model is both investment- and export-led, and can lead to volatility in demand as well as risks of an investment overhang. There is no doubt that the export drive has been successful, with China's annual exports rising from US$62 bn in 1990 to US$760 bn in 2005. China holds roughly 8% of manufactured export market share, up from 0.8% in 1980 and close to the US (10.8%) and Germany (11.4%). Expenditure side GDP data underscore the role that net exports have played in China's history, with net exports comprising 5% of GDP in 1990.

China's share of global GDP and exports



Source: Datastream , IMF

In January 2006 the authorities released a significant revision to their GDP series that increased the estimated size of the domestic economy by US$200 bn, or nearly 17%. The revision, which incorporated the result of the economic census taken every 10 years, was due to a significant increase in the estimated size of the services sector and therefore of the domestic economy. It supports the notion that the domestic consumption is more robust and a greater growth driver than had been previously indicated in official data. The table above shows the composition of GDP on the production side, with the old and new series for 2000 and 2004 exhibited side by side. Nonetheless, investment still comprises a high percentage of the economy.

The table below provides an estimate for expenditure side GDP, but represents the old series as data for the revised series has not yet become available. As such, we would anticipate that the contribution from household consumption would increase, probably at the expense of gross fixed capital formation.

Composition of GDP – expenditure (% of total)*				
	1980	1990	2000	2004
Household consumption	53.4	49.7	43.1	42.0
Government consumption	12.2	12.3	12.4	11.6
Gross fixed capital formation	30.1	25.8	36.4	43.5
Net exports	-3.2	5.5	2.8	2.5

**Excludes inventories*
Source: UN Statistics Division; China Statistical Yearbook

Politics

The Chinese Communist Party has been at the helm of the government since the founding of the People's Republic in 1949. The governing system remains one-party rule, with the national leadership emerging through bureaucratic selection rather than popular election. The current leadership is what is known as the fourth generation, and formally came to power in 2003 after acceding to leadership positions in the previous year. Despite one-party rule, the geographic spread of China means that provincial and municipal officials often enjoy a high degree of autonomy.

Since coming to power, President Hu and Premier Wen have been able to rapidly consolidate their power base within the bureaucracy. This has included an increased focus on reducing corruption in the ranks, with more high profile cases being brought to court. The mishandling of the SARS epidemic in 2003 was an instructive experience, and the leadership has been more forthright with other similar situations such as the toxic spill in the Songhua River late last year and the spread of the H5N1 strain of bird flu.

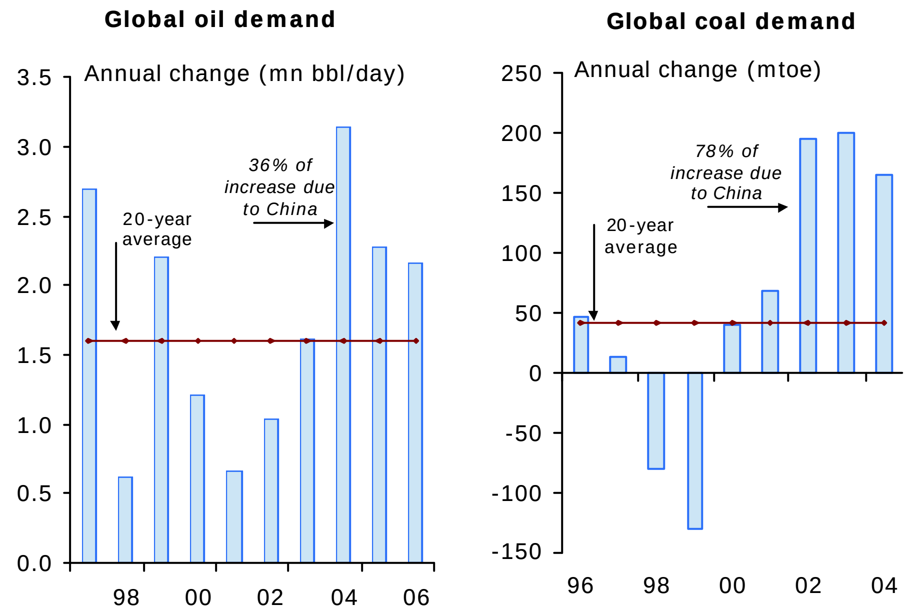
The next major political event in China occurs at the end of 2007, with elections for the National Party Congress late in the year, which will be followed by new selections for the State Council. President Hu will spend time over the next few years grooming his successor in advance of these changes.

On economic policy, Hu and Wen have refocused attention away from "growth at all costs" to "sustainable growth." The 11th Five-Year-Plan, published in October 2005, clearly states the need to diversify the economy in the direction of value-added goods as well as services, and to begin to address some of the environmental degradation that has resulted from such rapid growth. There is ongoing concern about social harmony in response to rising income disparity and increasingly public protests in relation to economic issues such as land use.

Economic relations with Australia

China's demand for oil and iron ore in particular have been beneficial for Australia's overall trade balance, and prompted a boom in the resources sector that has fuelled growth across the economy. We calculate that the increase in Gross Domestic Income since Australia's terms of trade started turning around five years ago has been worth, on average, A$2,100 per capita.

China is driving commodity price inflation



Source: BP Energy Handbook, 2005; Bloomberg

China is also a rising source of demand for Australia's commodity exports directly, and last year surpassed the United States as Australia's second-largest trading partner last year. The total value of all trade in goods and services now exceeds A$40 bn, with trade detailed in the tables below.

Summary of Australia's trade with China 2004/05, A$ bn	
Value of all trade in goods	37.4 bn
Value of all trade in services	3.5 bn
Overall balance on trade in goods	-5.3 bn
Overall balance on trade in services	1.2 bn
Overall balance on trade in goods and services	-4.1 bn

Demand for iron ore from Australia in particular has risen in the past several years as China's steel industry has expanded dramatically. In 2004, China surpassed Japan as the largest source of demand for Australia's iron ore exports. However, China does not even rank in the top 5 of Australia's coal markets as China produces its own low-grade coal for electricity generation and largely limits its imports from Australia to coking coal. Although China is a major buyer of Australian wool, wool has not kept pace with hard commodities.

Australia's top exports to China, 2004/05, value A$ bn	
Iron ore	3,818
Confidential items*	2,725
Wool	1,276
Coal	490
Other ores	483
Copper ores	349
Crude petroleum	307
Aluminium	232
Machinery & transport equipment	213
Non-ferrous waste	199

**Includes nickel and other mining related exports*
Source: ABS

Forecasts

Along with the government's announcement of an upward revision to the size of the economy in January was an increased estimate for the pace of economic growth, particularly over the past several years. Whereas growth since 2000 had averaged 8.8% under the old series, the new series puts growth at around 9.2%. Real GDP growth reached 9.9% last year according to the new series, and we forecast growth will remain above 9% this year and subsequently decline to the 8-9% range. Economic policymakers have indicated that they believe the natural growth rate for the economy is around this 8-9% level due to the still considerable labour surplus.

Despite the high levels of growth over the past few years, inflation has remained tame. Indeed, a strong trend of disinflation was recorded last year with headline CPI falling from nearly 4% in February 2005 to under 1% in September 2005 before returning to nearly 2% in recent months. The threat of high inflation in China is low given the slack labour markets, although there are shortages in specific sectors and geographic locations. Inflation expectations have also remained muted thanks to ongoing controls on prices of energy-related products and services, such as retail fuel prices and electricity. In this environment, we believe inflation will remain well contained in the coming years as such controls will only be lifted gradually.

Finally, we believe that China's external balances will remain in a strong surplus, particularly in the current account. The trade surplus reached US$102 bn last year, and we forecast a similar if not slightly higher level this year. Foreign direct investment of about US$60 bn should also be repeated. Outflows from the current account are minimal, as there is very little foreign currency debt. Portfolio flows under the capital account are strictly regulated.

Key economic indicators

	2004	2005e	2006f	2007f	2008f
Real GDP growth (%)	10.1	9.9	9.3	9.0	8.8
Nominal GDP (US$ bn)	1,931	2,175	2,437	2,680	2,912
CPI (%, year average)	3.9	1.8	2.0	3.2	2.9
Fiscal balance (% GDP)	-2.1	-1.7	-2.0	-1.8	-2.1
Current account (% GDP)	4.0	6.7	4.4	4.0	3.7
Foreign exchange reserves (US$ bn)	609	818	925	850	820
USD/CNY, eop	8.28	8.07	7.78	7.55	7.50
AUD/CNY, eop	6.46	5.91	5.45	5.29	5.15
One year base lending rate (%)	5.58	5.58	5.80	5.60	5.50

Source: Economics@ANZ

Issues in the economy

- The ongoing liberalisation of the exchange rate and the capital account remain a major policy focus. We continue to expect the authorities to move only slowly, deliberately allowing the local market to develop while slowly opening the capital account. The focus in the coming months will be to loosen regulation on capital outflows in order to ease the pressure on international reserves, which accumulated at an average rate of about US$17.4 bn per month last year. Nonetheless, expectations of the ongoing revaluation of the CNY are likely to continue to attract capital inflows. As has been the case over the past few years, such inflows complicate the conduct of monetary policy by depressing interest rates and forcing the government to continue to rely on administrative measures to temper liquidity-driven investment growth.
- Many observers have raised concerns about the possibility of overcapacity in the economy, particularly given the high contribution of

investment to GDP. The GDP revision indicated that investment is unlikely to be as large as was previously estimated, which is important. Nonetheless, the authorities are actively working to diversify the economy, and shift investment away from heavy manufacturing and promote domestic consumption. Trade friction resulting from China's rapid export growth is also contributing to this policy direction. Going forward, we expect to see more emphasis on consumers. We also anticipate rising Chinese investment overseas, particularly in energy assets (eg Australia) and in the manufacturing sector (eg SE Asia).

- The domestic banking and financial markets are developing rapidly, particularly with the opening of the banking sector under WTO. The local stock market performance has been weak in recent years due to an oversupply of IPOs from SOEs, but corporate bond market issuance reached CNY 65.4 bn last year (US$8.1 bn) last year, the highest issuance recorded since 1992. Development of the local financial market is an important factor in helping to increase domestic consumption and reduce the role of externally-driven demand, since a greater pool of domestic assets will help reduce the need for precautionary savings.
- With the 17th national convention of the Chinese Communist Party scheduled for 2007, this year will start to feel like an election year. We anticipate more official statements regarding social cohesion and peace, and a growing focus on trying to reverse the rise in income disparity, particularly between urban and rural regions.

Indonesia

Nominal GDP: US$270 bn (market exchange rate)
US$864 bn (purchasing power parity)

Ranking: 23rd largest MER basis; 15th largest PPP basis

Population: 242 mn (July 2005)

Age structure: 0-14 yrs 29.1%
15-64 years 65.7%
65+ years 5.2%

Median age: 26.5 years

Life expectancy at birth: 69.6 years

Languages: Bahasa Indonesia
English
Dutch
Local dialects (eg. Javanese)

Literacy: 87.9%

Land size: 1.8 mn sq kilometres

Capital: Jakarta

Administrative divisions: 30 provinces; 2 special regions;
1 special capital city district

Independence: 17 August 1945

Chief of State and Head of Government: President Susilo Bambang YUDHOYONO (since 20 October 2004)

Vice President: Muhammad Yusuf KALLA (since 20 October 2004)

Elections: President and Vice President elected by direct vote for five-year terms (next election September 2009);

National Legislature: The Peoples Consultative Assembly (MPR) consists of the 550-member House of Peoples Representatives (DPR) plus 128 regional representatives (DPD)

Elections: Parliamentary elections due in 2009

The structure of Indonesia's economy

The structure of the Indonesian economy has shifted away from the agriculture, forestry & fishing sector which, in 1980, accounted for a quarter of GDP and today represents around 15% of GDP. Indonesia has a rich mineral resource base and the mining & quarrying sector accounted for around 9% of GDP in 2004. Crude petroleum & products and LNG are Indonesia's major exports. The manufacturing sector has gained in importance, with its share of GDP growing from 12% in 1980 to 26% in 2004. Manufacturing has mainly been concentrated in labour-intensive industries such as textiles & garments, which is a major export item, as well as resource-based industries (eg. pulp & paper, cement, iron & steel). On an expenditure basis, household consumption has been the mainstay of the economy, currently accounting for close to 70% of GDP. Fixed investment, which was close to 30% of GDP in the early 1990s plunged to less than 25% in the aftermath of the Asian crisis. The low rates of investment in recent years have impeded a return to the strong rates of economic growth experienced prior to the crisis.

The crisis years were also characterized by an escalation foreign debt levels and deterioration in the fiscal balance. The current administration has, however, since made serious inroads into improving the external debt and fiscal profiles. Foreign currency debt to GDP, which reached exceeded 140% of GDP in 1998, dropped to close to 50% in 2005 and the fiscal deficit is forecast to be maintained at under 1% of GDP over the next few years.

Composition of GDP – output (% of total)				
	1980	1990	2000	2004
Agriculture, forestry & fishing	25.3	19.4	16.0	15.1
Mining, Manufacturing & Utilities	29.9	33.5	40.0	38.6
Construction & Services	44.8	47.1	44.0	46.3

Source: UN Statistics Division

Composition of GDP – expenditure (% of total)				
	1980	1990	2000	2004
Household consumption	55.3	56.8	68.1	68.0
Government consumption	9.8	8.8	6.3	7.4
Gross fixed capital formation	23.1	28.3	24.1	23.5
Exports of goods & services	35.9	25.3	31.6	31.1
Imports of goods & services	28.4	23.7	26.0	29.0

Source: UN Statistics Division

Politics

President Yudhoyono (SBY), leader of the newly formed Democratic Party, won a convincing victory in the country's first direct presidential elections in 2004. The relatively smooth election process, with parliamentary elections in April, presidential polls in July and the run-off on 20 September underscored significant democratic progress in Indonesia. President SBY's party, however, only secured 10% of the seats in parliament and relies on Golkar, which is led by VP Jusuf Kallaand has the largest single-party representation, to achieve a majority in parliament.

President SBY has four more years at the helm before his term ends in 2009. The investment mood in Indonesia has become more optimistic with a December 2005 cabinet reshuffle that installed the well-regarded economic team of Coordinating Minister of Economic Affairs Boediono, Finance Minister Sri Mulyani Indrawati, and incumbent Trade Minister, Mari Pangestu. The immediate focus has been to address structural issues such as fuel and electricity price controls, and to resolve regulatory issues that impeded investment in infrastructure.

While President SBY's popularity has slipped following the implementation of difficult reform, in particular the dismantling of fuel subsidies, he still retains broad support compared with previous Presidents. This provides scope for further reform to be carried out, albeit gradually, without the occurrence of substantive protests that would be disruptive to economic activity.

External relations have improved markedly under the leadership of President SBY. Relations with China have improved considerably with both Presidents making bilateral visits in 2005. Indonesia continues to maintain strong ties with Japan and relations with the US have gradually improved with military links being restored late last year. Serious efforts to address corruption and capture high-level terrorism suspects have contributed toward rising international goodwill toward Indonesia.

Relations with Australia

Bilateral relations between Indonesia and Australia continue to improve. In April 2005, President SBY and PM Howard signed a Joint Declaration for a Comprehensive Partnership, underscoring efforts to further strengthen bilateral commercial ties. This was followed, in September 2005, with the signing of the Trade and Invesment Framework by trade minsters from both countries.

Total trade between Australia and Indonesia was recorded at A$6.7 bn in FY2004/05 (year ending June 2005), compared with A$6.4 bn in FY2000/01. Indonesia ranked as the 10^{th} largest export market for Australia and 14^{th} most important source of imports. Australia generally records a deficit with Indonesia but registered a small surplus of A$92 mn in FY2004/05. In terms of services trade, total trade between Australia and Indonesia amounted to A$1.7 bn in FY2004/05 acounting for 2.4% of total services trade with Indonesia ranked as the 10^{th} most important partner.

According to the Australian Bureau of Statistics, Australia's stock of investment in Indonesia was A$2.3 bn as at December 2004, making Indonesia the 16th largest investment market.

Australia's Merchandise Trade with Indonesia

FY2004/05	A$ bn	% share of total	Rank	5-year trend growth
Exports to Indonesia	3.41	2.7	10	4.4
Imports from Indonesia	3.32	2.2	14	4.5
Total Trade	6.73	2.4	13	
Trade Balance	0.09			

Source: DFAT, Composition of Trade Australia

Australia's Merchandise Trade with Indonesia

Main Australian Exports*	A$ mn (% of total)	Main Australian Imports*	A$ mn
Crude Petroleum	474 (13.9%)	Crude Petroleum	1,309 (39.5%)
Cotton	255 (7.5%)	Non-monetary gold	202 (6.1%)
Live animals	215 (6.3%)	Paper & Paperboard	120 (3.6%)
Aluminium	203 (5.9%)	Refined Petroleum	104 (3.1%)
Copper	147 (4.3%)	Wood	103 (3.1%)

*: *includes confidential items which accounted for 26% of exports and 5.4% of imports*
Source: DFAT, Composition of Trade Australia

Forecasts

In the period since the Asian crisis, Indonesia has been growing at a rate of 4¼% pa. (1999-05), driven largely by private consumption and more recently by investment. Growth slowed in the second half of 2005 due largely to the impact of accelerating inflation and interest rates on consumption and investment. The substantial reduction in fuel subsidies and the decline of the Indonesian rupiah prompted a jump in annual inflation, which averaged 17.8% in Q4 2005 compared with 7.8% in Q1 2005 while the central bank's key policy rate climbed to 12.75% in December 2005 from 7.4% at the start of the year. However, full-year growth was recorded at a relatively healthy 5.6%, up from 5.1% in 2004.

The economy is likely to expand at a slower pace of around 4¾% in 2006 against a higher interest rate and inflation environment but is expected to bounce back to grow by more than 6% in 2007. The government's decision to cut fuel subsidies in March and October 2005, while contributing to an acceleration in the inflation rate, has boosted the government's economic credentials. The expectation of electricity tariff hikes and further fuel subsidy reductions during the year will keep prices elevated.

Ratings agencies have made successive upgrades on Indonesia's debt ratings since 2002 in recognition of a relatively stable political and economic backdrop, commitment towards fiscal consolidation and a marked improvement in its external debt profile. Moody's Investors Service announced, in February 2006, that it has put Indonesia's foreign and domestic currency ratings on review for a possible upgrade. An upgrade to B1 is anticipated during Q2 2006.

Key economic indicators

	2004	2005e	2006f	2007f
Real GDP growth (%)	5.1	5.6	4.8	6.1
Nominal GDP (US$ bn)	257.6	300	345	390
CPI (%, year average)	6.1	10.4	10.2	7.5
Fiscal balance (% GDP)	-1.6	-0.7	-0.8	-0.3
Current account (% GDP)	1.2	0.5	1.2	1.6
Foreign exchange reserves (US$ bn)	34.9	32.9	35	40
USD/IDR, eop	9,270	9,830	8,750	8,580
AUD/IDR, eop	7,233	7,203	6,125	6,006
Policy rate (% pa)	7.4	12.75	10.25	7.25

Source: Economics@ANZ

Issues in the economy

- The government has made efforts to pursue reform and streamline business operations. However, the bureaucracy remains the main obstacle to the pace of change. Concerns over corporate governance, judicial reform, entrenched vested interests and security will continue to emerge as risks to investment.
- Growing competition, especially from China, will pose a serious challenge for Indonesia's manufacturing sector. Nevertheless, Indonesia stands to benefit from strong mineral demand and the potential for investment in this sector is significant provided that the regulatory envrionment improves.
- More frequent threats of terrorism will also remain an impediment to large-scale investment. Nevertheless, the government's quick response to the Bali 2 attack reflects better crisis management by the current administration.

The Philippines

Nominal GDP: US$95.4 bn (market exchange rate)
US$409.4 bn (purchasing power parity)

Ranking: 45th largest MER basis; 24th largest PPP basis

Population: 88 mn (July 2005)

Age structure: 0-14 yrs 35.4%
15-64 years 60.6%
65+ years 4%

Median age: 22.3 years

Life expectancy at birth: 69.9 years

Languages: Filipino (based on Tagalog)
English
8 major dialects

Literacy: 92.6%

Land size: 0.3 mn sq kilometres

Capital: Manila

Administrative divisions: 79 provinces; 117 chartered cities

Independence: 12 June 1898 (from Spain)

Chief of State and Head of Government: President Gloria MACAPAGAL-ARROYO (since 20 January 2001);

Elections: President elected by popular vote for six-year terms; election last held 10 May 2004 (next to be held in May 2010)

National Legislature: The Congress of the Philippines consists of the Senate (24 members) and the House of Representatives (212 directly elected members and 24 members selected by party list). Senators are elected for six-year terms and representatives for three-year terms

Elections: Senate - last held 10 May 2004 (next to be held in May 2007); House of Representatives - elections last held 10 May 2004 (next to be held in May 2007)

The structure of the Philippines' economy

In recent years the contribution to GDP of the manufacturing sector has been around 23-24%, that of the agriculture, forestry & fishing around 19% and the services sector of close to 50%. The agriculture sector is vulnerable to drought and storms. In particular, the sector was badly affected by the 1998 *El Nino*. The manufacturing sector is largely concentrated on electronics (eg. computers and semiconductors) and consumer durables. The Philippines' large English-speaking workforce has also attracted multinationals to move services-related operations (eg. call centres) to the country. On an expenditure basis, household consumption's share of GDP has risen steadily and accounts for three-quarters of GDP. Remittance inflows from Filipinos working abroad have been a major contributor to the resilience of the domestic economy. Remittances were over US$8 bn in 2004 and are expected to stay strong.

The Philippines' macroeconomic stability, however, has been weakened by high fiscal deficits over a number of years – largely due to a very narrow tax base and low revenues – and large foreign currency debt burden. This has led to successive sovereign credit ratings downgrades. However, there has been encouraging progress on fiscal reform and the fiscal deficit is expected to come in at under 2% of GDP in 2007 from over 5% of GDP in 2002. This, in turn, should help to improve the debt profile of the Philippines over the coming years, reducing inflation pressures and improving macroeconomic stability.

Composition of GDP – output (% of total)

	1980	1990	2000	2004
Agriculture, forestry & fishing	23.1	21.9	19.4	19.3
Mining, Manufacturing & Utilities	29.9	28.4	27.7	27.7
Construction & Services	47.0	49.7	52.9	53.0

Source: UN Statistics Division

Composition of GDP – expenditure (% of total)

	1980	1990	2000	2004
Household consumption	62.9	71.2	74.6	75.8
Government consumption	10.5	10.1	10.5	9.6
Gross fixed capital formation	24.9	23.1	24.9	21.8
Exports of goods & services	23.1	27.5	41.7	39.5
Imports of goods & services	26.2	33.3	45.0	46.1

Source: UN Statistics Division

Politics

President Arroyo's second term of office has been eventful. She has withstood calls for her resignation in 2005, which were triggered by allegations that she had rigged her May 2004 election victory. A subsequent opposition bid to impeach the president was defeated, effectively diminishing the prospect of her removal from office. In late February 2006, President Arroyo declared a State of Emergency following threats of a coup. Several arrests of soldiers and civilians have since been made. While there have been growing calls for President Arroyo to step down, she still enjoys majority support from both Congress and the military and the lack of a serious presidential contender has helped to consolidate her position.

Political noise will remain high in the coming months as Congress debates a constitutional amendment that would start the process by which the Philippines would move to a parliamentary system of government. Nonetheless, this is still likely to remain just noise. Assuming that Arroyo remains in office at least for the next few years – her term expires in 2010 – the unpredictable political environment is unlikely to significantly undermine economic or financial markets.

Relations with Australia

Australia's total trade with the Philippines has declined in recent years. The Philippines ranked as the 25th largest export market for Australia and 33rd most important source of imports. Australia's trade surplus with the Philippines has been weakened in recent years and was recorded at A$169 mn in FY2004/05 (year ending June 2005) compared with A$988 mn in FY2000/01. In terms of services trade, total trade between Australia and the Philippines amounted to A$412 mn in FY2004/05 acounting for 0.6% of total services trade with the Philippines ranked as the 25th most important partner.

According to the Australian Bureau of Statistics, Australia's stock of investment in the Philippines was A$0.9 bn as at December 2004.

Australia's Merchandise Trade with the Philippines

FY2004/05	A$ bn	% share of total	Rank	5-year trend growth
Exports to the Philippines	0.87	0.7	25	-9.7
Imports from the Philippines	0.70	0.5	33	10.9
Total Trade	1.57	0.6	29	
Trade Balance	0.17			

Source: DFAT,Composition of Trade Australia

Australia's Trade with the Philippines

Main Australian Exports*	A$ mn (% of total)	Main Australian Imports*	A$ mn (% of total)
Milk & Cream	144.9(16.7%)	Crude Petroleum	116.0 (16.6%)
Medicaments	99.2 (11.4%)	Computers	107.9 (15.4%)
Copper	47.2 (5.4%)	Telecom. Eqpt.	55.2 (7.9%)
Coal	38.6 (4.4%)	Integrated circuits	40.0 (5.7%)
Copper ores	32.2 (3.7%)	Radio receivers	34.6 (4.9%)

**: includes confidential items which accounted for 8.9% of exports and 4.7% of imports*
Source: DFAT,Composition of Trade Australia

Forecasts

Real GDP growth for 2005 was 5.1%, lifted by a robust fourth quarter outcome of 6.1% YOY. 2006 is expected to see a slightly slower, albeit healthy, pace of economic expansion, supported by investment and strong remittance inflows, which will help underpin private consumption.

The fiscal deficit for 2005 was down 22% from 2004 and was 18.6% lower than the target, bringing it to 2.9% of GDP. The Supreme Court lifted the freeze on the implementation of the Expanded Value Added Tax (EVAT) in October 2005, paving the way for the government to continue with fiscal reform. This is a significant step towards reducing borrowing needs and the debt service burden. A further narrowing of the fiscal shortfall is expected for 2006 to around 2.1% of GDP. President Arroyo aims to bring the budget to balance by 2008, two years ahead of plan.

Inflation is expected to edge up, reflecting in part the impact of the expansion of the VAT to incorporate a wider range of products and services and an increase in the VAT rate to 12% from 10% from 1 February. High oil prices will also continue to add upward price pressures. Inflation is forecast to average 8% in 2006 from 7.7% in 2005 – well above of the target of 4-5%.

The central bank has been vigilant in its watch over inflation risks, having raised policy interest rates three times in 2005. The overnight borrowing rate is currently at 7.5%.

Key economic indicators

	2004	2005e	2006f	2007f
Real GDP growth (%)	6.0	5.1	4.8	4.3
Nominal GDP (US$ bn)	86.1	98	110	122
CPI (%, year average)	5.9	7.7	8	6
Fiscal balance (% GDP)	-3.9	-2.9	-2.1	-1.5
Current account (% GDP)	2.6	2.0	2.0	1.8
Foreign exchange reserves (US$ bn)	13.1	16	17.5	18.5
USD/PHP, eop	56.2	53.1	50.7	50.0
AUD/PHP, eop	43.9	38.9	35.5	35.0
Policy Rate (% pa)	6.75	7.5	7.75	7.25

Source: Economics@ANZ

Issues in the economy

- Growing competition for trade and investment will continue to pose a serious challenge to growth in the manufacturing and services sectors. The electronics sector may lose ground to China and call centres and back-office services to India.
- Exports are heavily dependent on electronics goods and are thus vulnerable to global weakness in this sector.
- While the Philippines economy and investment environment has coped well with leadership challenges and policy uncertainty, the unpredictable political environment is likely to cloud prospects for a ratings upgrade and impede large-scale investment flows.

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