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ECONOMICS: ASIAN PERSPECTIVES

PHILIPPINES: POLITICAL UNCERTAINTY AND A NEW MONETARY-POLICY REGIME

+ Vincent Tsui, Economist—Global Economic Research, vincent.tsui@abglobal.com
+ Anthony Chan, Asian Sovereign Strategist—Global Economic Research, anthony.chan@abglobal.com

The Philippine bond market, which has been supported by solid sovereign fundamentals, is facing two major sources of uncertainty: the newly elected president's economic policy and the introduction of a new monetary-policy regime. On the whole, we remain confident about the country's sovereign profile in the coming quarters.

Uncertainty Threatens Market Stability

The Philippines' US dollar(USD)– and local currency–denominated sovereign bonds have handsomely rewarded investors over the past few years. They benefited from credit-rating upgrades, which reflected prudent policy settings and improvements in the country's external position. Spreads have been stable and much tighter than those of similarly rated peers. Local-currency bonds have also been supported by abundant liquidity in the banking system, resulting from foreign exchange intervention aimed at mitigating the continuous fund inflow from external income.

However, this cozy setup is under threat as two major risks have arisen. The first stems from the presidential election, in which the outspoken Rodrigo Duterte emerged as the frontrunner in the run-up to the poll and was ultimately elected. Because he was not well known in the market and was not from the establishment, uncertainty about policy continuity has raised concerns. The second was a change in the central bank's monetary-policy regime.

Structural Strength in External Position

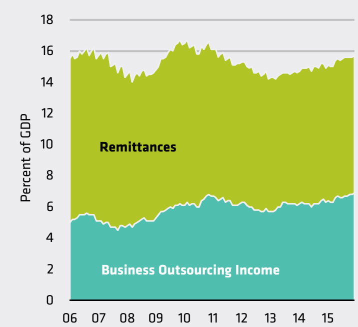
Outgoing president Benigno Aquino was well received by the market during his six years in office, owing not only to his anti corruption drive and governance reform, but also to a prudent fiscal policy that kept the economy on a sustainable growth track. Therefore, policy continuity has been a key risk for the Philippines' sovereign profile, particularly with the flamboyant Duterte soon to take office.

Despite such concerns, we remain confident about the Philippines' sovereign profile over the coming quarters, given the structural nature of the strength in the country's fundamentals.

First, the Philippines' external position is likely to remain robust. Remittances from Filipino workers overseas and income from business process outsourcing (BPO) services have been stable and sizable over the years, amounting to about 16% of GDP even during the 2008 global financial crisis (*Display 1*). This alone is more than sufficient to finance imports, and it will continue to help sustain the country's current account surplus (*Display 2*).

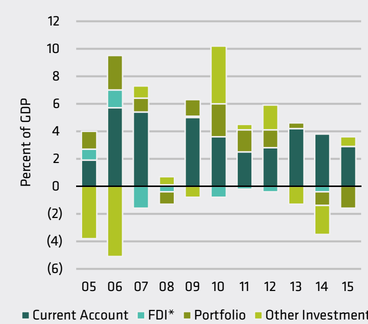
The Philippine economy has not relied much on external funding, as is evident in the limited amount of fund flows in its capital account over the past several years.

Display 1
External Income Remains Stable, Sizable



As of May 18, 2016
Source: CEIC Data and AB

Display 2
C/A Surplus Reduces Need for External Funding



As of May 18, 2016
*Foreign direct investment
Source: CEIC Data and AB

Moreover, foreign reserves exceed the total amount of bonds and equities held by foreign investors, keeping the country relatively immune from the whims of global investor sentiment.

Second, even though some in the market worry that Duterte may take a more aggressive, pro-growth fiscal stance, we see limited risk that the economy will overheat. The investment-to-GDP ratio has been low for a long time despite solid economic growth and accommodative monetary policy. In fact, we think investment has been insufficient, resulting in high utility costs—electricity bills are among the highest in Asia and have hampered the development of the manufacturing sector.

Third, the country has a small government. Even though the previous administrations have been perceived as having a populist bias, the fiscal deficit has been kept at reasonable levels. The deficit has exceeded 4% of GDP only three times over the past three decades, and even in those instances it remained below 5%. While this fiscal conservatism exacerbated the underdevelopment in infrastructure, it has helped the Philippines avoid the swings in external positions that have hurt many other emerging economies. Moreover, since the Philippines' political landscape has been highly fragmented and Duterte's party has limited clout in Congress, there should be sufficient legislative scrutiny.

Political Stability Not Guaranteed

Even though we remain comfortable about the Philippines' sovereign profile, we remain vigilant about the political risks. Crony capitalism remains prevalent in the country. And since Duterte is not from the establishment camp, the market remains skeptical about how well he can forge a relationship with the social elite. An abrupt policy change that undermines vested interests could result in political instability.

Investors should bear in mind that the political tranquility over the past six years isn't the norm in the country's recent history. A state of emergency was declared in 2006 after failed military coup attempts, and during the demonstrations in 2007. Even though it's difficult to quantify how much political risk premium should be priced into sovereign spreads at this stage, investors should keep an eye on the tail risks.

New Monetary-Policy Regime

Another key focus for investors is the shift in the monetary-policy regime to an "interest-rate corridor" system. That matters not only to local-currency bond (RPGB) performance, but also the peso (PHP). The currency has tended to move in close tandem with "carry returns" (e.g., the excess return of a long PHP, short USD position)—except in 2012–2013, when the correlation was distorted by strong foreign portfolio inflows (*Display 3*).

Bangko Sentral ng Pilipinas (BSP) has announced that the interest-rate corridor system will take effect on June 3. It has also cut its policy rate (the reverse repo rate, now renamed the "overnight borrowing rate") by 100 basis points (b.p.) to 3% and the repo rate (now renamed the "overnight lending rate") by 250 b.p. to 3.5%, while keeping the special deposit account (SDA) rate at 2.5%. As a result, the upper and lower bands of the corridor will be symmetrical at 50 b.p. each.

BSP also revealed that the reserve requirement would be reduced after the formal implementation of the interest-rate corridor. The central bank says the policy shift, on the whole, should be neutral to monetary conditions. We think that would be hard to quantify, and on a net basis domestic monetary conditions will remain accommodative, providing a supportive environment for RPGBs. There are two reasons why we think so.

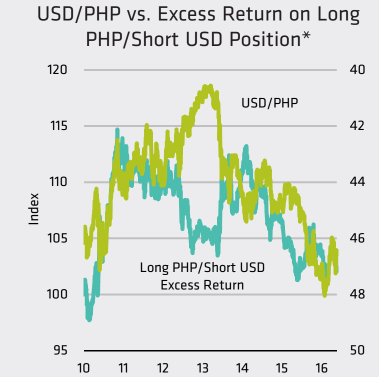
First, the middle rate (the overnight borrowing rate) was lower than the market expected. This rate will be used as a reference for the upcoming auctions for term deposits by the central bank for liquidity management. So, a lower-than-expected rate would have a similar effect to a surprise monetary easing—as is reflected in the RPGB market's rally after the BSP announcement.

Second, we remain skeptical about whether BSP will be able to operate the new facility at a sufficient scale to fully absorb the massive liquidity in the system and guide market interest rates close to the policy target.

Massive Domestic Liquidity to Stay

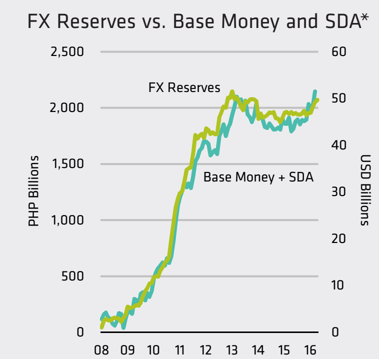
The massive liquidity in the domestic financial system originates from unsterilized foreign exchange intervention, which is aimed at stemming peso appreciation.

Display 3
Peso Has Been Driven by Carry Returns



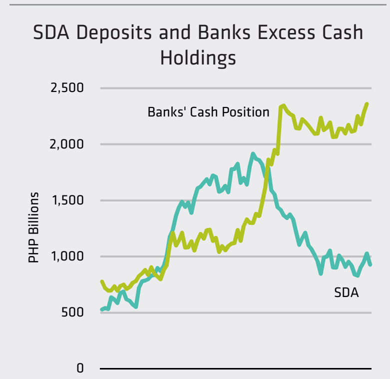
As of May 18, 2016
*Indexed: January 2010 = 100
Source: CEIC Data and AB

Display 4
FX Intervention Boosts Monetary Aggregate



As of May 18, 2016
*Special deposit account
Source: CEIC Data and AB

Display 5
SDA Restrictions Boosted Banks' Excess Cash



As of May 18, 2016
Source: CEIC Data and AB

When BSP buys US dollars and sells pesos in the market, the central bank cannot absorb the excess peso liquidity by issuing its own securities owing to statutory limitations. Therefore, continuous foreign exchange intervention has resulted in massive liquidity in the private sector (*Display 4, previous page*).

In the past, the majority of the liquidity was trapped in BSP's interest-paying special deposit account (SDA). However, owing to interest-rate differentials between BSP's assets (USD) and liabilities (PHP), the central bank has been incurring losses that have eroded its balance sheet.

In theory, a central bank can keep bleeding red ink and even operate with a negative equity. But a persistent and expanding negative equity may undermine policy credibility over time. In 2013, BSP restricted various institutions from accessing the SDA, a move that pushed liquidity toward banks (*Display 5, previous page*). The massive liquidity in the banking system pushed market interest rates below the central bank's target, making the policy rate only a symbolic measure.

We believe that concerns about sterilization costs will continue to restrain the scale of BSP's liquidity mop-up operations through the new term-deposit auction facility. The interest rate the facility pays is even higher than that of the SDA.

Investment Implications

The Philippines' sovereign spreads have been very rich against similarly rated countries in recent years. Even though we expect the country's sovereign profile to remain intact, at least in the coming quarters, we see limited upside. On the downside, political risks remain uncertain. Eventually, the risk premium could be added to the market's pricing. Meanwhile, rating agencies are keeping a close eye on the continuity of governance reform and prudent policy settings.

In terms of the new interest-rate corridor regime, even though the volume of BSP's auction is yet to be announced, we expect the ample liquidity in the banking system to stay, keeping RPGBs well supported. Market interest rates should also continue to stay at low levels.

For the peso, while the Philippines' solid external account should keep the currency relatively resilient in a risk-off market, unattractive carry returns could undermine the currency's performance against its regional peers in a risk-on environment. ■
