ALLIANCE FIXED INCOME℠ | INVESTMENT RESEARCH AND MANAGEMENT

ASIAN WEEKLY ECONOMIC INSIGHTS

September 3, 2004

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Philippines: Strategy Update

Local media reported today that the Energy Regulatory Commission has been fast-tracking the application of Napocor to raise the basic power rate to an average of PHP1.87/kwh. An official approval of the rate increase is likely to be announced over the weekend.

This is credit positive because the proposed rate hike will help alleviate the government's fiscal burden. Our estimation is that the expected power tariff increase will generate an extra PHP67bn in revenue, which will roughly cut half of the existing operation losses of Napocor.

It is also reported that members of the Lower House have agreed to cut their pork barrel funds (i.e. local community funds which accounted for some 20% of total national government spending in 2003) by about PHP5bn in the coming year. This is a good start as politicians are responding positively to President Arroyo's latest push for fiscal reform.

The next key tax measures which we believe will get support from the congress is the introduction of an indexation of sin tax. But the timely procedure of the passage of reform bills means that the actual approval may not occur until October or November.

To recap, we expect two to three tax measures - out of President Arroyo's eight-point tax reform program - will be implemented in the coming months. It is politically difficult for the society and politicians to take on all the proposed tax measures in a single year. Arroyo's proposed tax package would amount to about PHP80-100bn in a fiscal year. If we assume one-third of these measures are successfully implemented in the coming year, they would not be sufficient to structurally change the fiscal outlook in the near term, but should be able to help contain the budget shortfall below the PHP200bn mark in FY2005.

The relative values of ROP bonds look attractive, as they have lagged the overall emerging market's performance over the past month. The positive new flows on the fiscal front will underpin the short-term performance of ROP bonds. For ROP '25, we expect a spread tightening of 30-40bp, basically bringing the spread level back to the pre-election lows in late April. However, the headwind will continue to be new supply of sovereign bonds, and the government has said that it needs to raise some $750 million before the end of the year to on-lend to Napocor. Already, there is rumor of a re-opening of ROP '25. We believe that ROP '11 also looks attractive on a relative value basis.

On a longer-term basis, we remain cautious on the fiscal outlook. In our view, President Arroyo is no 'tough reformer' but is quite politically skillful by exaggerating the risk of a 'fiscal crisis' in a bid to push for a few tax measures in the first few months of her second term. We still think that the probability of a structural improvement in the national government's fiscal deficit will be 50/50. Our fundamental recommendation on the ROP sovereign remains 'marketweight'.

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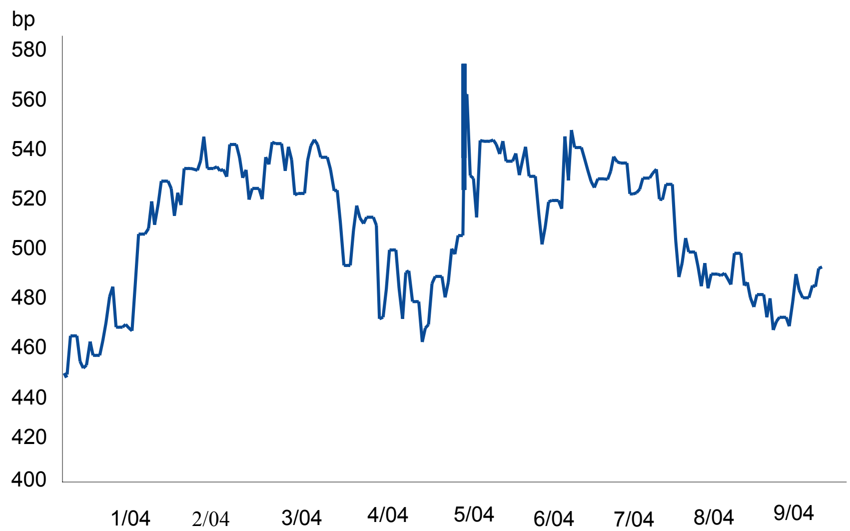
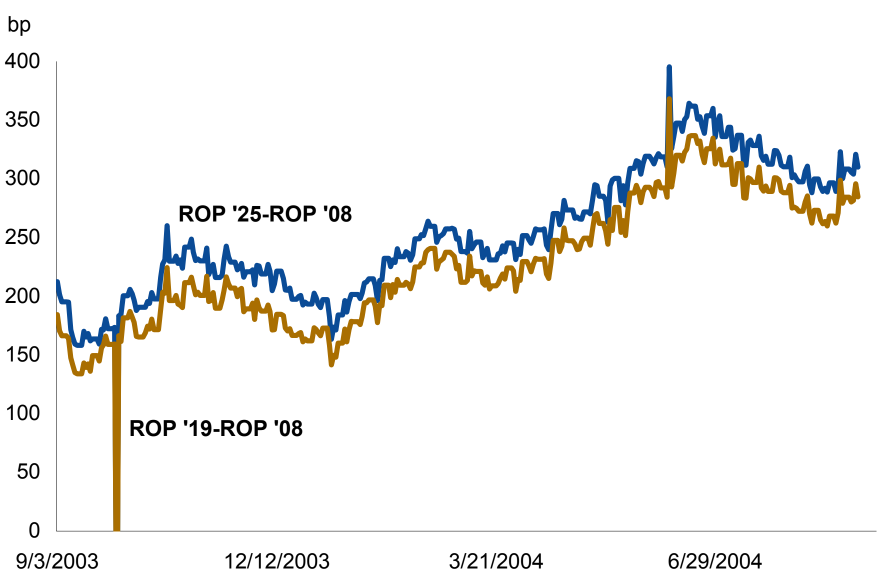
Display 1: ROP 2025
Basis Points Over UST



Source: Bloomberg and Alliance Fixed Income estimates *September 3, 2004*

Display 2: ROP Spread Differential
Basis Points



Source: Bloomberg and Alliance Fixed Income estimates, September 3, 2004