

## **Philippines Weekly Update January 30, 2005**

### **Travel & Security Status**

There is no credible information that transnational or domestic terrorist groups are planning attacks in Metro Manila.

### **Travel Advisories**

There were no other travel advisories or advisory amendments issued this week by nations that have a diplomatic presence in the Philippines. Previous common-sense advisories that urge travelers and residents to avoid attending or traveling near large political demonstrations or rallies are still applicable.

We agree with the current travel advisories of several Western governments that urge citizens to avoid travel to Mindanao, Basilan, Tawi-Tawi, and Jolo. These areas are chronically restive, lawless, and unstable, and they present a threat to Philippine and Western travelers alike.

### **RP-US Military Exercises**

The Philippines Senate has called for a review of joint US-Philippine military training, a key part of a mutual defense treaty between the Philippines and the United States since 1998. Senator Miriam Defensor Santiago, chairman of the Senate committee on foreign relations, complained that the US government has only been reimbursing the Philippines for about PhP71 million (US\$1.28 million) a year for the joint war games since 2000, compared with the PhP96 million (US\$1.7 million) a year that the Philippines actually spends on them. US Ambassador Francis Ricciardone declined to comment on Defensor Santiago's accounting methods, but said that both sides were always free to review the pact.

He added that there would be "fewer" US military personnel participating in joint military training this year because its troops are busy in Iraq, Afghanistan, and countries affected by the December 26 tsunami. There are currently about 70 US military personnel training troops in intelligence gathering in the southern Philippines at the request of the Arroyo administration. In military development

assistance alone, the US Government has pledged US\$161 million for fiscal year 2005. US aid to the Philippines is at the highest point since 1992.

### **Musical Chairs**

President Arroyo announced on Wednesday sweeping changes to her economic team, an effort to avert another downgrade from the credit ratings agencies and to bolster her claims to be tackling the country's increasingly unwieldy finances.

The shuffle, however, offers little reassurance for investors and economic analysts. Arroyo replaced this week the last member of the "dream team" of economic advisors with which she began her presidency four years ago. Energy secretary Vince Perez, former finance secretary Jose Isidro Camacho, and former trade secretary Manuel A. Roxas joined the Arroyo cabinet in 2001 full of enthusiasm upon her rise to the presidency. The three were all poached from the private sector, all Wall Street alumni and all had the trust and support of the business community. All three had messy jobs while in government: fiscal housecleaning, privatizing outdated and unprofitable power assets, and injecting some life into the business environment. All three remained respected throughout their terms in cabinet, and none of them made much headway.

These three men were some of the country's top financial talent, and if they couldn't set Arroyo's finances in order, then their replacements aren't likely to get very far. Former trade secretary Cesar Purisima was appointed finance secretary, replacing Juanita Amatong who had been promoted to the job from within the Finance Department in 2003. Both Purisima and Amatong had been given the top finance post in the absence of a viable private-sector candidate. Purisima is former chief executive officer of a local auditing firm, so he is not unequipped for the new job. But he, like Amatong, has been handed a poisoned chalice. No one from the private sector has been willing to take on the finance portfolio after the sudden resignation of Camacho, who had warned that a fiscal crisis was coming if Arroyo continued to borrow overseas.

Perez was replaced with Raphael Perpetuo Lotilla, president of the Power Sector Assets and Liabilities Management Corporation (Psalm), a spin-off company created to privatize the government's power generation assets. Lotilla is a lawyer and was an assistant director of the National Economic and Development Authority (NEDA), during which time he pushed for the government's position in the crafting of the Electric Power Industry Reform Act of 2001. Lotilla is unlikely to succeed in the energy post where Perez failed. Selling assets from the National Power Corporation to an overseas buyer – no one in the Philippines could afford them – has been one of the government's most critical steps in putting its finances in order. Lotilla, like Perez, is likely to find it difficult to sell a company stocked with political appointees and saddled with debt.

Two former chief executives of multinationals and avid Arroyo supporters also joined the cabinet. Juan Santos, former CEO of Nestlé Philippines, was named the new trade secretary, while Alberto Lina, former head of Federal Express' Philippine licensee Airfreight 2100 Inc., was named customs commissioner replacing George Jereos. Lina has perhaps the most difficult job: the Bureau of Customs is one of the most corrupt branches of the Philippine government.

Changing the team without changing the system that breeds corruption and mismanagement, however, is unlikely to make much headway. A full-blown fiscal crisis is still very much a possibility in the coming years.

### **General Corruption**

Retired Lieutenant General Jacinto Ligot, accused of illegally acquiring at least PhP60 million (US\$1.08 million) through his job as former military comptroller, finally appeared at a Congress inquiry on Wednesday after snubbing their first four subpoenas. Ligot, comptroller from 1999 to 2001, invoked his right not to incriminate himself, like General Carlos Garcia, who also happens to be facing charges he accumulated vast assets while he held the same post. Investigations against both men implicate their wives and children.

The Congress committee, particularly the opposition, has so far tried but failed to get Ligot to admit owning several expensive properties that they say he acquired while in office. The committee's motives run much deeper, however. By bringing down Ligot on corruption charges, they hope to implicate his boss and mentor former military chief of staff Angelo Reyes in what they say is a "web of corruption" in the military. And the manhunt would not stop at Reyes, who was instrumental in putting Arroyo in power. They hope to cast doubt on Arroyo's personnel choices and – more importantly – her administration's seriousness in curbing systemic corruption.

### **2005 Government Budget**

The budget department has announced that government spending this year would reach PhP960.9 billion (US\$17.4 billion), up 9% from last year, to fund a costly streamlining program and to service Napocor debts. The government would have to shell out about 40% of the total budget to service total public sector debt.

The budget is being promoted as a 10-point anti-poverty program, but it contains little that directly addresses this issue. There was no mention of increasing social security or improving public health services. The government allocates PhP140.9 billion (US\$2.55 billion) to education, the largest share of the budget, but the education department has only programmed PhP5.63 billion (US\$102 million) for

capital outlays; the rest goes to teachers' salaries. The public school system has long been in disarray while private schools have become unaffordable, further widening the gap between the elite and the masses.

While PhP84.26 billion (US\$1.52 billion) is allocated for developing former US military bases Clark and Subic as international logistics centers, the government had to decline several soft loans for infrastructure development because it can't afford to chip in enough of its own money. The Japan Bank for International Cooperation (JBIC) canceled at least six projects worth 30.8 billion yen (US\$299 million) and scaled down eleven other projects. The biggest cancellation was the public works department's 12.8 billion-yen (US\$124 million) loan to finance a project that would have improved roads that connect northern Luzon with Mindanao – key to transportation of farm products and other goods from the areas that produce to the ones that consume.

It's a loss that the country can ill afford. Public infrastructure – a key issue for foreign investors – varies widely throughout the country, with many national highways only two lanes wide. Many towns have sprung up over the past few decades along the national highways and residents use them as their main form of transport. Driving long distances in the Philippines means remaining alert for children dashing across the highway for an ice cream, or getting stuck behind an ox-drawn cart as a farmer takes his rice to a mill half a kilometer away. Worse still are the corners that are cut in road construction as a result of corruption: the end result is potholes and large pavement cracks that increase the number of traffic accidents and bruise fruits and vegetables on the way to market.

By prioritizing projects like Clark and Subic rather than national roads, Arroyo may be able to keep some foreign investment in the country. Both sites already have excellent infrastructure that has attracted a number of foreign companies who prefer to be outside Manila. But by neglecting key farm-to-market roads, the administration risks reinforcing an already deep gulf between the haves and the have-nots.

### **Taxes: Arroyo Uses Carrots As Well As Sticks**

As part of an ongoing and frantic attempt to increase government revenues, Arroyo signed into law on Monday a bill that gives financial rewards to tax and customs employees if they exceed collection targets. And better tax collection is badly needed. The government loses more than PhP120 billion (US\$2.17 billion) a year in uncollected taxes and PhP60 billion (US\$1.08 billion) thanks to smuggling. Arroyo hopes that some of the bleeding will stop if she gives tax and customs officials – reported to be among the most corrupt in the civil service – a cut of the increased revenue. If the bill had been in place last year, for example, customs and tax officials could have shared something like PhP1.5 billion

(US\$27 million), an amount that would have doubled or even tripled everyone's salaries.

Will it work? It is hard to say. Salaries for government employees are already so low that doubling or tripling them may not make much difference, especially for employees who are already used to pocketing the taxes they collect. The government is trying to entice employees to get on board by setting its targets low during the first year, ensuring that officials exceed them and guaranteeing that there are rewards to parcel out.

### **Value-Added Tax**

In the face of tremendous populist opposition, Congress approved on Thursday a bill that will raise value-added tax (VAT) to 12% from 10%. Twenty-two opposition lawmakers and six party-list group members walked out during the deliberations, complaining that the increase in government revenues would come straight out of the pocketbooks of the country's poorest. The bill has been passed to the Senate, where it will test Arroyo's political will yet again: opponents of VAT are legion in the Senate, some of whose members are up for election in two years. They are unlikely to support a bill this unpopular with their voters.

None of the opponents, however, has a practical alternative as to how the government could raise revenues. VAT is one of the government's major revenue sources, second only to income tax. The current VAT scheme fails to meet expectations because it exempts 26 "politically sensitive" sectors such as farm products and inputs, cotton, copra, coal, gas, and petroleum products. Medical, dental, legal, and veterinary services are also VAT-exempt, as are school tuition fees. In addition to the overall increase in the VAT, some of these items would now be taxable.

The finance department expects the VAT reforms to generate up to PhP55 billion (US\$996 million) in additional revenue: PhP25 billion (US\$452 million) from the reduction of the VAT-exempt list and PhP30 billion (US\$543 million) from a two-percentage point increase in the VAT rate, although independent economists put that number much lower. In any case, projected collections from higher VAT are larger than from any other tax measure that has been proposed thus far.

Few observers are optimistic it will pass as proposed and a fatally watered down version of the bill that will be more palatable for the voting masses is a much more likely alternative.

## **Economic Fundamentals**

### **Philippine Peso**

The peso traded at 55.03 against the dollar at midday Friday, stronger than last week's close of 55.549.

The peso gained strength as proceeds from the Philippines' first of a series of dollar denominated debt issues poured in the country. The Philippines issued a US\$1.5 billion new bond offer Wednesday, pricing the 25-year bond at a yield of 9.7%, with investors searching for higher interest in a low-yield environment were attracted to the price. Investors ordered more than five times the number of bonds on offer, which is expected to spur strong secondary demand.

The bond sale came a week after Standard & Poor's (S&P) downgraded the country's foreign-currency rating by one notch to BB-minus, citing a lack of urgency by the government in tackling potentially painful fiscal reforms. The market was relieved: investors and traders had feared a two-notch cut.

The deal was the largest single sovereign deal by the Philippines, which is struggling to cover a budget gap exacerbated by weak revenue collection and corruption. It was part of the country's plan to raise US\$4 billion overseas this year to help plug its budget shortfall.

The *Asian Wall Street Journal* argues persuasively as well that with a national population of 84 million people and a per capita income of US\$1,000, or a third of nearby Malaysia or Thailand, that smart consumer companies in the Philippines have learned over the years how to market goods and services to the poor.

Foreign investor hot money earmarked for emerging market blue chip earners has been flowing in recent weeks into Philippine equities like cell phone giant Globe Telecom, SM Prime Holdings, and fast-food leader Jollibee. The demand for pesos by hot money investors has helped strengthen the peso to 14-month highs. Investors are chasing these "poor consumer oriented" stocks because they are lubricated by the products they offer and which are paid for rain or shine by the US\$8–10 billion in annual remittances by overseas Filipino workers (OFWs).

The stronger peso is not reflective of any fiscal success by the Arroyo administration nor is it some bizarre contrarian phenomenon to the recent S&P sovereign bond downgrade. Fund managers are simply betting on the realities of OFW remittances and where most of the money is spent once it enters the Philippines market place.

## **Quotes of the Week**

“(Energy secretary Vince Perez) must have been under very severe pressure from power wielders, power brokers, not necessarily excluding politicians in connection with the privatization process (of Napocor). This must have been circulating in his mind for some time...my suspicion as a former bureaucrat, particularly a former Cabinet member, is that he has found the kitchen too hot. If you can't stand the heat, you get out of the kitchen.”

- **Senator Miriam Defensor-Santiago** on Perez' resignation

"The cases of Ligot and Garcia show that there is a group of Ali Baba and the 40 Thieves in the AFP. The question is, who is Ali Baba?"

- **Congressman Rolex Suplico** on the inquiry into corruption in the Armed Forces of the Philippines

"The standing joke in this country is that it is good to know the law, but it is better to know the judge. If the problem is not corruption, it is the slow pace of justice. From minor cases to the big ones such as the plunder case against deposed President Joseph Estrada, the wheels of justice in the Philippines turn at a glacial pace.”

- **The Philippine Star's January 27 editorial**

"Who is the real MILF? We thought it was Hashim Salamat's intellectual property. But now, there seems to be people who are into kidnapping and bombing who are still calling themselves MILF. So who owns the MILF brand? I don't know."

- **American Ambassador Francis Ricciardone** on the upcoming talks between the government and the Muslim rebel Moro Islamic Liberation Front (MILF)

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