BBVA

Country Report

Economic Research Department

First semester 2008

Contents

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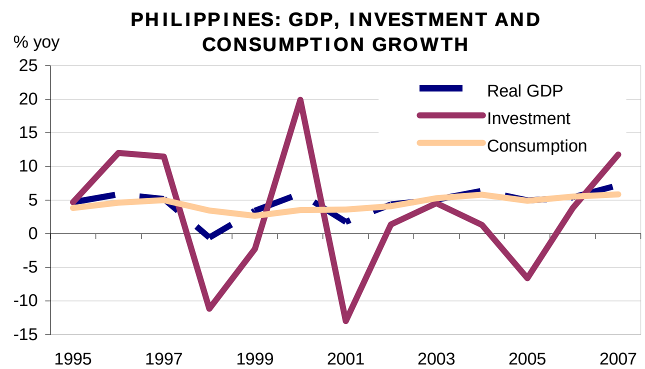
Economy

July 2008

ECONOMIC STRUCTURE

The Philippine's economy has been growing above its historical trend of 4-5% accompanied by a rebound in private investment in the last three years.

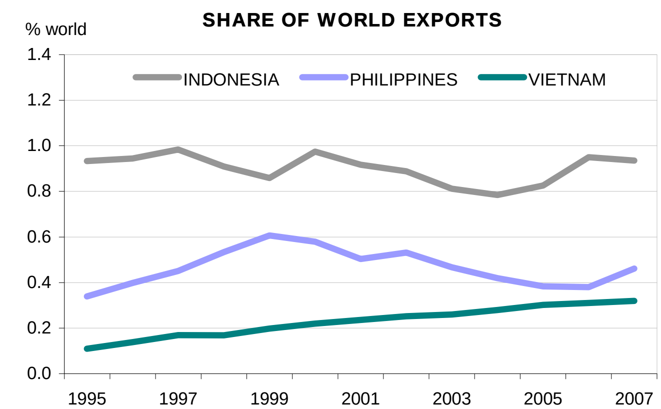


Source: ERD BBVA

According to IMF estimates, the output gap was positive in the early 1990s, but turned largely negative over 1992-1996, reflecting the serious shortfall in power capacity. After a short recovery, the output gap declined following the Asian crisis in 1997 and remained largely negative throughout the first half of 2000s driven by several weather–related shocks, as well as by weak domestic demand due to political instability.

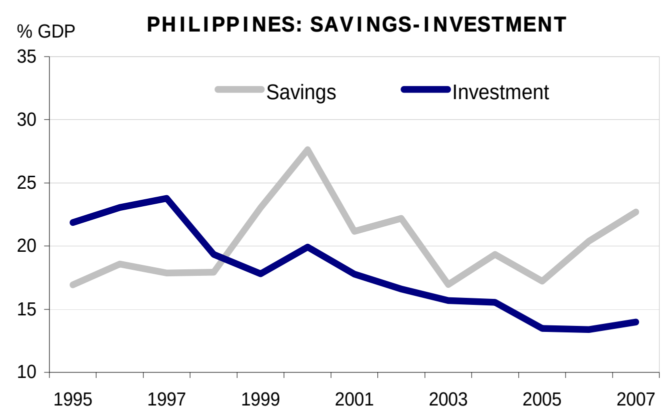
The Philippines has a somewhat unusual industrial structure for a low-income emerging economy. In particular, services constitute a large and increasing share of GDP accounting for over 44% and, a relatively low share of manufacturing of 21% of GDP accounting for less than 30% of GDP for the industry sector as a whole. In terms of employment, the services sector employs 50.2% of the total employment population, while the agriculture and industry sectors account for 35% and 14.8%, respectively.

On the external side, a trend of concern is that the Philippines has been losing market share of global exports since 2002, lagging behind the performance of other regional peers such as Indonesia and Vietnam. Philippines' exports are rebounding just recently, albeit still far from its peak levels.



Source: IMF DOTS, ERD BBVA

Overall investment is still low in terms of GDP, contributing to an increasing private saving-investment surplus in absence of more investment supporting policies, notably a shift of government expenditure away from current spending and toward infrastructure. Moreover, the outward migration of skilled labor keeps expanding with over eight million of persons deployed, near 10% of the total population in 2007.

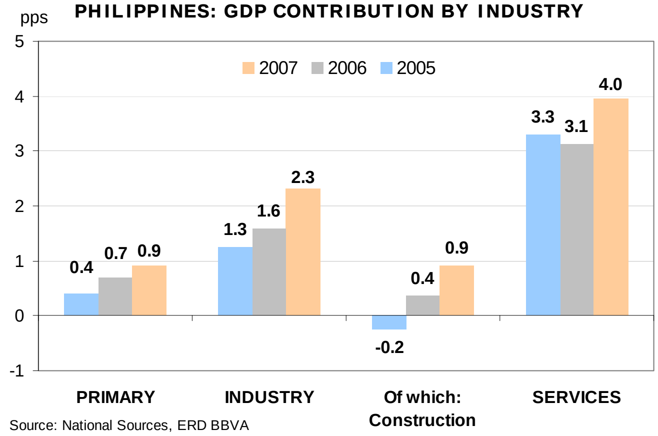


Source: ERD BBVA

RECENT DEVELOPMENTS

Despite domestic political tensions and increased market volatility in 2007, the Philippine economy performed unusually well with a GDP growth of 7.3% vs. 5.4% in 2006, and its highest growth in decades. Growth was led by the services sector, which accounted for 4 percentage points or 55% of GDP growth, followed by industry (32%) and, the primary sector (agriculture, fishery and forestry) which contributed with 0.9 percentage points or 13% to GDP growth. The construction sector experienced a significant turnaround in 2007 growing by 19% year-on-year and contributing 12.6% to GDP growth, after years of deceleration or negative contribution since 2001.

PHILIPPINES: GDP CONTRIBUTION BY INDUSTRY

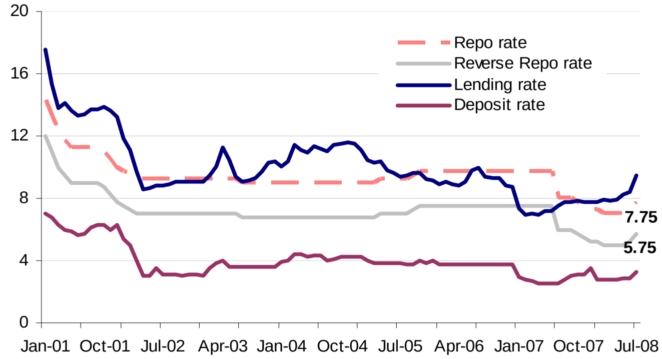


Source: National Sources, ERD BBVA

On the demand side, economic growth was led by domestic spending. Private consumption was robust on the back of strong remittances growth, albeit the favorable impact of remittances was undermined by the exchange rate appreciation of 12.5% in nominal effective terms. The trade deficit continued increasing to 5.1% of GDP, but the current account surplus remained strong at 4.4% of GDP on high levels of transfers from overseas workers which registered a 13.2% year-on-year growth in 2007.

On the monetary front, the Bangko Sentral Ng Pilipinas (BSP) adopted inflation targeting in 2002 with the exchange rate determined by the market and BSP's intervention limited to smooth volatility and build up reserves. Given the improvement in the balance of payments position, with stronger portfolio and current inflows, the central bank cut the lending rate (repo rate) four times between October 2007 and January 2008 but has since turned more hawkish, hiking rates twice -25 basis points in June and 50 basis points in July- to reach 7.75% in the repo rate and 5.75% in the reverse repo rate by end of July 2008.

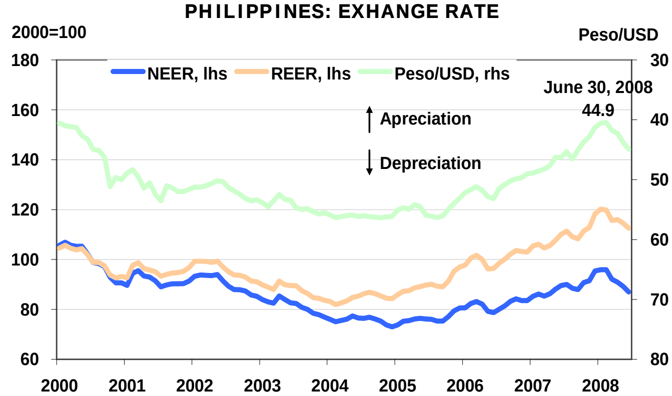
PHILIPPINES: SELECTED INTEREST RATES



Source: Thomson Datastream, ERD BBVA

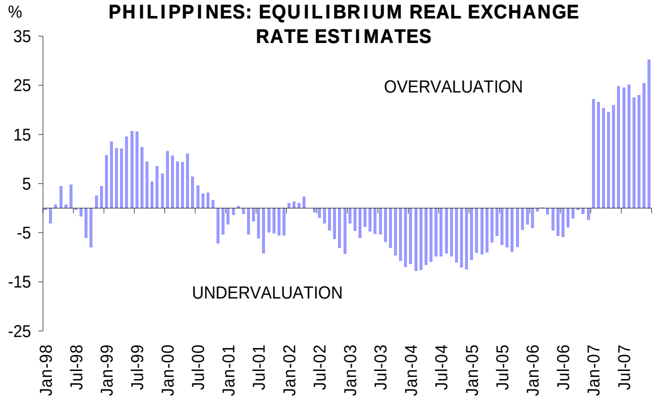
The exchange rate against the US dollar appreciated to nearly 16% in 2007, further from 7.6% the previous year, and by 14% in real effective terms in addition to 8% in 2006. However, in the first six months in 2008 the peso has weakened 3% against the US dollar, due to net portfolio outflows and increasing concerns on the impact of higher inflation on economic growth.

PHILIPPINES: EXHANGE RATE



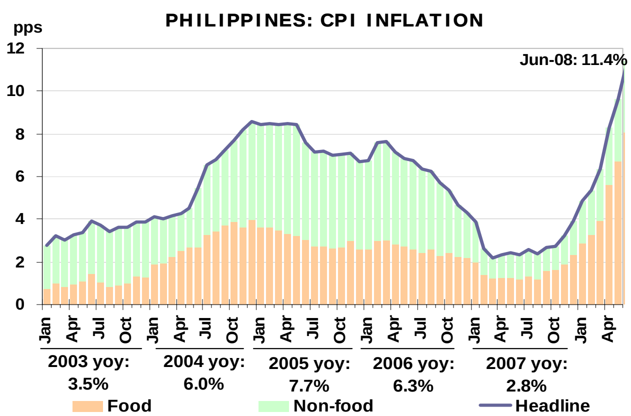
Source: ERD BBVA

Notwithstanding the relatively large margins of error surrounding estimates of the equilibrium level of the exchange rate, a tentative assessment is that the current level of peso was broadly overvalued in 2007. The latest trade-weighted estimates through end- 2007 range from an undervaluation of 3% in 2006 to a significant overvaluation in 2007. The narrowing of the undervaluation appears to be due to the strengthening of the peso, which in real effective terms appreciated by 14% year-on-year in 2007.



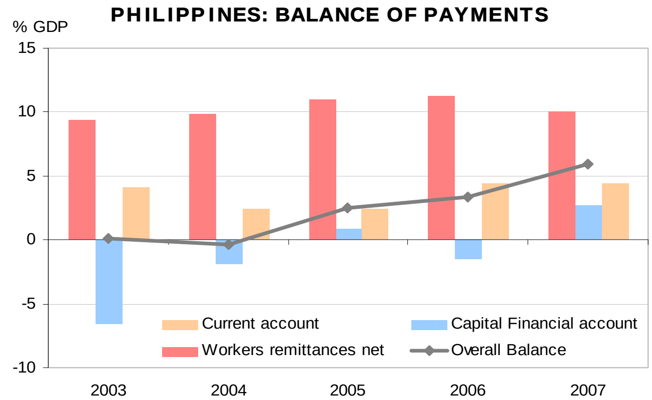
Source: ERD BBVA

Inflation from rising commodity prices is the biggest near-term risk, including rice and oil and gas product prices, which account for 9.4% and 2.9%, respectively of the CPI basket. Inflation averaged 2.8% in 2007, the lowest in 21 years aided by an appreciating peso. In the first six months of 2008, headline inflation averaged 7.6% from 2.6% in the same period last year. Similarly, core inflation increased to an average of 5.1% in the period from 2.8% in full 2007. As the inflation appears to become more broad-based, the central bank has signaled a turn towards monetary policy tightening starting from June 2008. However, it will remain cautious not to tighten in excess as it still expects for the upward price pressures to subside and for growth in domestic demand to soften by year-end.



Source: IMF, CEIC, ERD BBVA

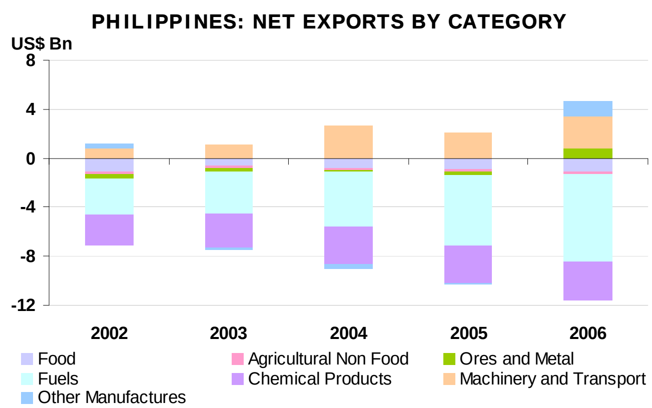
On the balance of payments side, the Philippines have experienced a surge in net foreign exchange inflows since 2005. These inflows are predominantly driven by the current account, particularly very strong inflows of transfers and remittances.



Source: Thomson Datastream, ERD BBVA

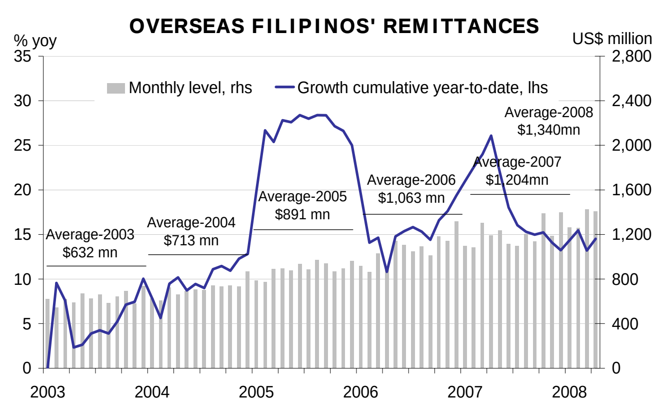
By components on the current account side:

- Trade of goods balance runs an increasing deficit due to the deterioration of its terms of trade as the Philippines is a net importer of highly priced fuels and commodities and exports low-value added electronic goods and manufactures.



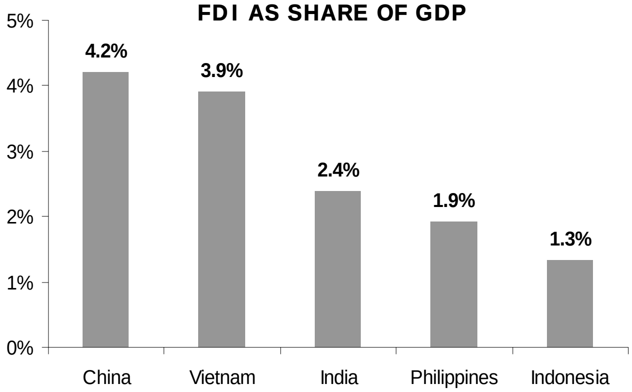
Source: UNCTAD, ERD BBVA

- Workers remittances accounted for more than 10% of GDP, significantly high when compared to just 1% in Indonesia. It is probable that remittances will not keep growing at the high rate of the last three years and hence, the need to increase non-debt capital flows for the financing of the balance of payments.



Source: Bangko Sentral Ng Pilipinas, ERD BBVA

- Net foreign direct investment (FDI) flows, which had been very weak in previous years, turned strongly positive since 2005. In 2007, net FDI flows are distorted by a one-off sale of a large foreign-owned firm. While FDI flows have increased, levels are relatively low as the Philippines' economy is geared towards the service sector characterized by relatively low capital intensity.



Source: IMF, CEIC, ERD BBVA

- Portfolio flows showed a significant turnaround since 2005, attracted by a buoyant stock market and positive interest rate differentials with the US. However, since the beginning of 2008, net portfolio flows have been negative and spreads have risen, but not disproportionately as the impact of the global financial turmoil for the Philippines has been in line with that of the other regional emerging markets.

- By contrast, the net other investment account (essentially loans) has been mostly negative until 2007, mainly due to increasing short-term foreign borrowing of banks and loan repayments of the public and private non-financial sector. Net currency outflows continued in 2007, as domestic investors sought to increase the diversification of their holdings. The persistently strong exchange rate and the sustained balance of payments surplus prompted the authorities to relax controls on capital outflows last year. The authorities increased the allowable net foreign open position of banks to 20% of capital from 5% and doubled the limit on permissible outward investment by residents without prior approval to US$12 million in early 2007. This was followed by a second phase of liberalization measures earlier this year allowing foreign exchange swaps for non-hedging purposes and raising the limit on outward investment to US$30 million.

- Foreign exchange reserves reached US$33.7 billion by end-2007. With the exchange rate weakening slightly since the beginning of 2008 and, the net portfolio outflows due to concerns on the impact of oil and food price increases on the fiscal deficit, Philippines´ gross international reserves increased to US$36.6 billion as of May 2008, covering some 6 months of imports,

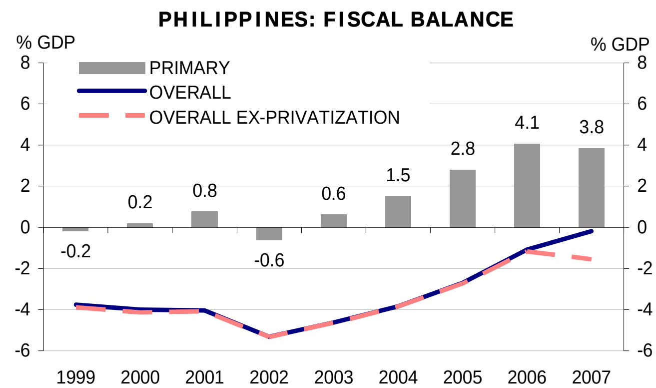
SUMMARY OF THE BALANCE OF PAYMENTS

US$ millions	2003	2004	2005	2006	2007*
A. Current account balance	288	1,628	1,984	5,347	6,351
Trade balance (f.o.b.)	-5,851	-5,684	-7,773	-6,732	-8,236
Services	-1,963	-1,777	-1,340	137	1,077
Investment Income	-284	-71	-294	-1,255	-467
Transfers	8,386	9,160	11,391	13,197	13,977
B. Capital account balance	726	-1,630	2,229	20	3,928
FDI	188	109	1,665	2,818	-514
Portfolio investments	562	-1,713	3,475	3,043	3,088
C. Overall balance	115	-280	2,410	3,769	8,576
D. Change in international reserves 1/	-698	835	-2,266	-4,472	-10,784

*Preliminary 1/ negative sign = increase
Source: Bangko Sentral Ng Pilipinas

PUBLIC AND EXTERNAL FINANCE

The National Government (NG) balance has experienced a significant turnaround from recurrent overall deficits. The NG fiscal deficit declined from 5.3% of GDP in 2002 to 0.2% in 2007.



Source: Bangko Sentral Ng Pilipinas, BBVA

The tax reform has improved the VAT's efficiency since 2006. Additionally, tight control over spending and improved performance of government owned and controlled companies (14 major GOCCs), have slashed the public sector deficit and improved the Philippines' debt sustainability. However, the better than expected performance of the fiscal accounts in 2007 was largely due to one-off privatization receipts (40% of the power generation capacity was privatized). Subtracting privatization revenues, the overall deficit increased to 1.55% of GDP in 2007 from 1.2% the previous year. The government plans to privatize up to 70% of the installed power sector in order to boost competition and reduce electricity rates so it counts with more privatization revenues in the fiscal budget. Initially, the fiscal program planned to maintain a balanced budget through 2008 but it has been revised down in June to a deficit of 1% of GDP, in view of slower expected growth and rising subsidy expenditure. The fiscal program in 2008 includes an increase of 28% in infrastructure expenditure and of 118% in subsidies with respect to the previous year, under the assumption of a reduction in interest payments and an increase in tax revenues.

Government Finance Summary

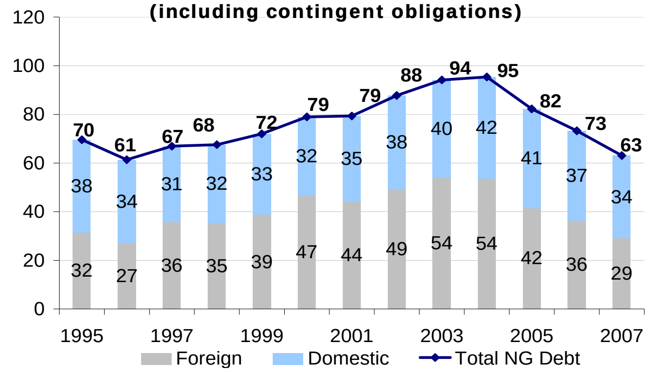
% of GDP	2003	2004	2005	2006	2007
A. Revenues	14.8	14.5	15.0	16.2	17.1
I. Tax Revenues	12.8	12.4	13.0	14.3	14.0
II. Non-tax Revenues	2.0	2.1	2.0	2.0	3.1
o/w Privatization	0.0	0.0	0.0	0.1	1.4
B. Expenditures	19.5	18.3	17.7	17.3	17.3
I. Allotment to LGUs	3.4	3.0	2.9	2.9	2.9
II. Interest Payments	5.2	5.4	5.5	5.1	4.0
III.Subsidy	0.3	0.3	0.2	0.2	0.4
C. Primary Balance	**0.6**	**1.5**	**2.8**	**4.1**	**3.8**
D. Surplus/(-)Deficit	**-4.6**	**-3.8**	**-2.7**	**-1.1**	**-0.2**
E. Financing	6.6	5.0	4.3	1.8	1.5
I. External (Net)	3.3	1.7	1.7	2.0	0.8
External (Gross)	5.6	4.1	4.0	4.7	1.8
Less: Amortization	2.2	2.4	2.3	2.7	0.9
II. Domestic (Net)	3.3	3.3	2.6	-0.2	0.6
Domestic (Gross)	6.7	7.9	7.3	6.1	4.9
Less: Amortization	3.4	4.6	4.7	6.3	4.3

Source: Department of Finance, BBVA

Going forward, it is probable that populist announcements, especially as the May 2010 election gets closer, hampers the achievement of the fiscal targets, negatively affecting market confidence in the longer term.

The national government debt structure has also improved with outstanding debt (including contingent obligations) declining from a peak of 95% of GDP in 2004 to 63% in 2007. The authorities are switching towards domestic issuance, with domestic debt share increasing to 54% of total debt in 2007. The domestic debt consisted 30% of short-term issues and T-bills with the balance accounted for by medium and long-term loans and government bond issues.

PHILIPPINES: NATIONAL GOV'T DEBT TO GDP (including contingent obligations)



Source: Bureau of Treasury, ERD BBVA

In general, the sustainability of the Philippines' public debt depends largely on the strength of future reforms on the fiscal side and further improvement of the debt structure. The authorities took advantage of the relatively favorable conditions in 2007 to improve the debt structure with total prepayments of $3 billion in private and public debt, reducing the debt service ratio from nearly 16% of exports and current income to less than 10%. The Philippines' external debt has steadily declined —from a peak of 73% of GDP in 2001 to just 38% in 2007-, helped by the appreciated peso and a stronger economic growth.

INDICATORS OF EXTERNAL VULNERABILITY

	2001	2005	2006	2007
Current Account/GDP (%)	63.3	2.0	4.5	4.4
Exports/GDP (%)	58.3	-9.2	-5.6	-5.0
Worker remittances/GDP (%)	10.8	12.4	11.9	10.0
Foreign Debt Interest/GDP (%)	4.1	4.3	4.6	2.6
Debt Service Ratio (%)	15.7	13.5	12.0	9.8
Capital Flows/GDP (%) 1/	1.3	2.3	0.02	2.7
Foreign Debt/Merchandise Exports(%)	20.9	18.9	17.4	14.8
Foreign Debt/GDP (%)	72.9	54.8	45.4	38.1
Reserves/Foreign Debt (%)	30.2	34.1	43.0	61.4
Reserves/Imports (months)	4.4	4.1	4.6	6.2
Foreign Debt (US$ mn)	51,900	54,186	53,367	54,938
International Reserves (US$ mn)	15,692	18,494	22,967	33,751

1/ FDI and other capital distorted in 2006 by one-off sale of a large foreign-owned firm
Source: Bangko Sentral Ng Pilipinas, ERD BBVA

The private sector accounts for 31% of total external debt in 2007, down from 36% in 2001. The private non-financial sector and the banking system account each for half of the non-public external debt, with the share of private commercial banks rising in recent years to 8% of total foreign debt in 2007. For the government's foreign debt, all outstanding at end-2007 was long-term, nearly 60% were foreign denominated securities and, 40% were multilateral institutions or bilateral creditors. Over 80% at fixed rate, 68% was denominated in US dollars followed by 22% in Japanese yen and merely 5% in Euro.

NG EXTERNAL DEBT OF THE REPUBLIC OF THE PHILIPPPINES 1
As of 29 February 2008
IN THOUSAND US DOLLARS

LOAN ACCOUNT	Outstanding as of 29/02/08 (In US $)*	% TO TOTAL
GRAND TOTAL	37,636,966.36	100.00%
INTEREST FREE	1,217,933.97	3.24%
FIXED RATE	31,283,182.19	83.12%
US LIBOR	514,408.42	1.37%
VARIABLE RATES	4,621,441.78	12.28%
IBRD CQB	604,481.74	13.08%
IBRD VARIABLE	698,972.16	15.12%
ADB FLT	2,544,835.71	55.07%
CHF LIBOR	67,941.37	1.47%
EIBOR	11,746.24	0.25%
JAPAN LTPR	693,464.56	15.01%

1/ Excludes GOCCs/GFIs loans guaranteed by NG
2/ Amounts in Original currencies converted into US dollar using BSP reference rate prevailing on 29/02/2008
Source: National Sources, ERD BBVA

Yet, the Philippines' external debt remains significantly high and vulnerable to shocks, especially to the exchange rate and, to a lesser extent, to economic growth.

The government, which accounts for nearly 70% of the external debt, could adjust its borrowing mix with greater financing from peso denominated bonds to reduce exposure to exchange rate risks. Switching from debt denominated in a foreign currency to peso-denominated equity financing could reduce economy-wide balance sheet vulnerabilities arising for currency mismatches, such as a sudden rise in demand for foreign exchange causing runs on reserves in periods of financial stress.

RISKS AND CHALLENGES AHEAD

Fiscal discipline, adequate management of external debt and improvement of the investment climate remain some of the key challenges for the Philippines' economy to achieve higher levels of growth. Among the risks and challenges ahead:

- Fiscal sustainability

The remarkable turnaround of the fiscal accounts in the last couple of years has relied on external factors -such as the peso appreciation and lower interest rates that reduced the interest payments-, the windfall from the 2006 VAT reform, privatization receipts and years of expenditure compression. However, the prospects for the fiscal sector are deemed to be less bright than in the recent past and as a result, the authorities have postponed the target of deficit zero to 2010. On the external side, the fiscal position is vulnerable to a rise in global commodity prices and hence, the increase in subsidy expenditure in one hand and, in the other hand, to changes in investors´ sentiment and the associated re-pricing of risk that lead to higher interest payments on its debt. On the domestic front, an economic slowdown would not only reduce tax revenues, as corporate profits and consumption spending decline, but also increase transfers to the most vulnerable social sectors and to compensate predictably higher losses in government owned and controlled corporations. Additionally, privatization receipts are expected to decline as most of the big-ticket items have been privatized and the remaining assets are more difficult to sell to private investors due to weak corporate performance and regulatory hurdles.

Going forward, a sustained revenue base and solid fiscal position is necessary to increase the Philippines' infrastructure and social sector spending, enhance rural development and agricultural productivity and further reduce its debt burden.

- Philippines´ vulnerability to the external sector

Another risk is the economy's exposure to the external sector, which remains vulnerable considering that:

- Total external debt remains high at 38% of GDP and is sensitive to changes in the exchange rate and sovereign risk premium. Hence, greater issuance in pesos would reduce vulnerabilities and improve standings with ratings agencies.

- Negative impact of deteriorating terms of trade as it imports more than 40% of its energy needs but exports mostly low value-added electronics and other manufactures as well as agro-based products. In this case, a more diversified export structure, especially in terms of higher value added production, would help to improve the Philippines' trade deficit position.

- Investment environment weak and supply-side constraints

In terms of the economy's competitiveness, energy supply and infrastructure constraints have been some of the major hindrances to more foreign direct investment. Overall electricity rates remain relatively high due to system losses, reliance of hydroelectric plants on irregular weather conditions and continued supply and transmission constraints. Yet, public infrastructure investment could be boosted in the near term by election spending. Investment in growth industries and areas where the Philippines has a sustainable competitive advantage could provide another platform for growth. These include services such as the business process outsourcing (BPO), mining, tourism, infrastructure and real estate. Additionally, working-age population will keep on growing at a fast pace and could contribute to sustain output. However, unless some labor market rigidities are lifted, the demographic advantage would not be enough to compensate the current infrastructure bottlenecks.

In sum, a weak institutional framework and low investment returns would continue in the medium-term in the absence of necessary structural reforms.

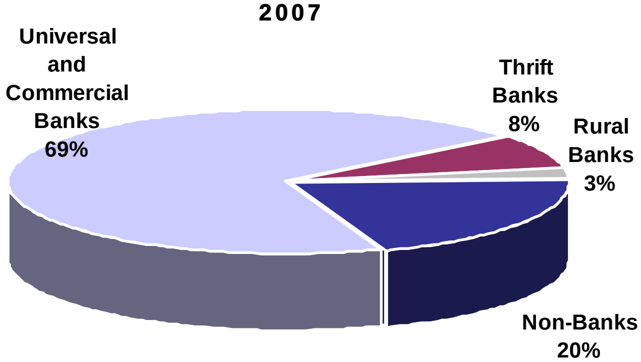
Banking

July 2008

FINANCIAL SYSTEM STRUCTURE

Banks dominate the Philippine financial system accounting for 80% of total assets[1]. The Philippine banking system is composed of universal and commercial banks, thrift banks, rural and cooperative banks. In terms of size, the banking system was equivalent to 77% of GDP in 2007.

FINANCIAL INSTITUTIONS´ ASSETS* 2007



* Excluding Bangko Sentral Ng Pilipinas

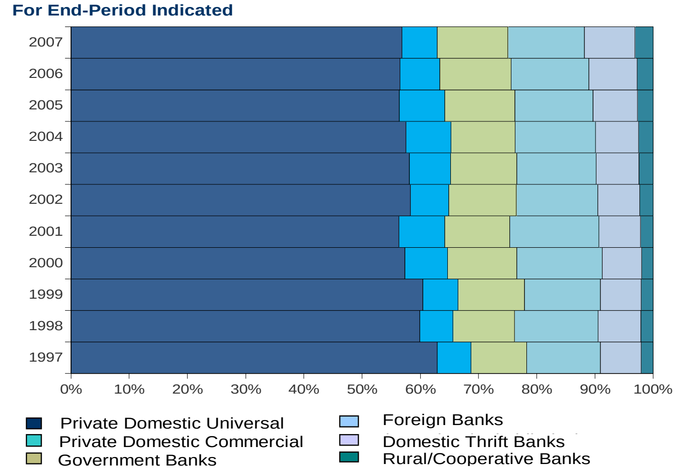
Source: BSP, BBVA

Universal and commercial banks[2] represent the largest single group accounting for 69% of system's assets and nearly 89% of banks' assets in 2007. They offer the widest variety of banking services among financial institutions. In addition to the function of an ordinary commercial bank, universal banks (permitted since the 1980s) are also authorized to engage in underwriting and other functions of investment houses, to own or affiliate with insurance companies, brokerages and, other non-bank financial institutions.

The thrift banking system is composed of savings and mortgage banks, private development banks, stock savings and loan associations and microfinance thrift banks. The group has increased its share to 9.5% of total banks´ assets from 7.2% in 2000. Thrift banks are engaged in accumulating savings of depositors and investing them. They also provide short-term working capital and medium- and long-term financing to especially small- and medium- enterprises and individuals.

Rural and cooperative banks are the more popular type of banks in the rural communities and, account for only 3% of the banking system. Their role is to promote and expand the rural economy in an orderly and effective manner by providing the people in the rural communities with basic financial services. Rural banks and cooperative banks are differentiated from each other by ownership. While rural banks are privately owned and managed, cooperative banks are organized/owned by cooperatives or federation of cooperatives.

Philippine Banking System: Distribution of Assets
For End-Period Indicated



Source: BSP, BBVA

The banking regulator (BSP) retains the supervision and regulation on non-bank financial institutions (NBFIs). This group consists of institutions engaged in the borrowing of funds from 20 or more lenders for the borrower's own account through issuances, endorsement or assignment with recourse or acceptance of deposit substitutes for purposes of re-lending or purchasing receivables and other obligations.

[1] Excluding Bangko Sentral ng Pilipinas
[2] Including government and foreign banks.

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BANKING SECTOR STRUCTURE

The Philippines´ banking sector is apparently very fragmented, with 847 banks and 6,897 offices (Schedule 1). However, the sector structure is fairly concentrated in five universal banks controlling some 50% of the banking assets and deposits. The four largest privately-owned – Metrobank, BDO-EPCI, BPI y PNB- dominate the most important local banking market of Manila and leverage from alliances with firms in the same business conglomerate. The government-owned banks – Development Bank of the Philippines, Landbank and United Coconut Planters Bank- have historically focused on policy lending and have at times assisted the BSP in providing soft liquidity for smaller banks in the past.

TOP FIVE UNIVERSAL AND COMMERCIAL BANKS 1/ (Amounts in Billion Pesos)

Assets			Loans		
Rank	Name of Bank	Amount	Rank	Name of Bank	Amount
1	Metrobank	571.5	1	Metrobank	281.3
2	BDO-EPCI Inc.	566	2	BDO-EPCI Inc.	265
3	BPI	460.5	3	BPI	193.6
4	Landbank	371.1	4	Landbank	155.1
5	DBP	244.2	5	DBP	131.1
	Total	**2213.3**		**Total**	**1026.1**
	% Share	**49.3**		**% Share**	**46.6**

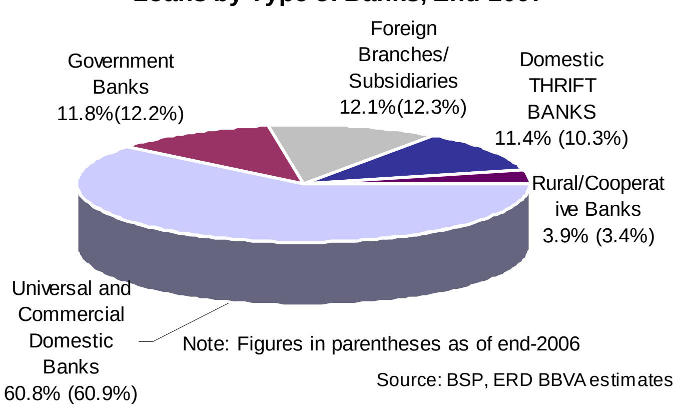
Deposit Liabilities			Capital Accounts		
Rank	Name of Bank	Amount	Rank	Name of Bank	Amount
1	Metrobank	456.7	1	BPI	64.3
2	BDO-EPCI Inc.	417.2	2	Metrobank	62.3
3	BPI	370.5	3	BDO-EPCI Inc.	56.1
4	Landbank	279.5	4	DBP	37.3
5	PNB	176.3	5	Landbank	34.7
	Total	**1700.2**		**Total**	**254.7**
	% Share	**53.4**		**% Share**	**48.7**

1/ Based on Published Statement of Condition as of 30 September 2007

Source: BSP, ERD BBVA

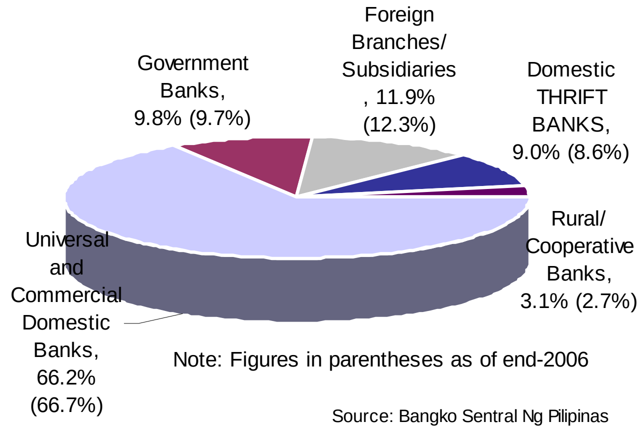
In terms of market share, private domestic banks control about 60% of banks' loans and 66% of deposits, followed by foreign and government banks. In 2007, thrift banks gained overall market share from private domestic banks and foreign banks.

Philippines: Market Share of Outstanding Loans by Type of Banks, End-2007



Source: BSP, ERD BBVA estimates

Philippines: Market Share of Deposits by Type of Banks, End-2007



Source: Bangko Sentral Ng Pilipinas

THE ROLE OF FOREIGN BANKS

Since the liberalization of the Philippines' banking system in 1994, foreign investors are initially allowed to acquire up to 40% of the capital in domestic banks but a maximum of 60% is allowed subject to the regulator's approval. Additionally, there is a statutory[3] maximum limit of 30% of the system-wide assets that can be owned by foreign banks.

FOREIGN BANKS ACQUISITIONS IN THE PHILIPPINE BANKS

DATE	ACQUIROR	DOMESTIC TARGET	VALUE (US$ mn)	STAKE
Sep-07	UBS	Philippine National Bank	40	5.0%
Jun-07	China Banking Corp	Manila Banking Corp	36	87.5%
Feb-07	Spinnaker Capital Ltd	Rizal Commercial Banking Corp	93	17.1%
Oct-05	General Electric Co	Keppel Bank Philippines Inc	26	96.5%
Apr-01	Cambridge Pacific Fund Lt	Banco de Oro Universal Bank	50	17.0%
Jul-00	Investor Group	Philippine National Bank	224	30.4%
Dec-99	DBS Bank	Bank of Philippine Islands	294	12.3%
Jul-99	United Overseas Bank	Westmont Bank of Philippines	78	60.0%
Apr-99	Investor Group	Philippine Commercial Intl Bk	846	72.0%

Source: Investment banks' reports

As of end-2007, there are 15 foreign banks' branches allowed for universal banking, 70 subsidiaries of foreign banks and 16 branches in commercial banking, and 87 thrift banks controlled by foreign banks. All in all, they account for 13.2% of banking system's assets, slightly ahead of government banks and around 12% of loans and deposits in 2007. Yet, foreign bank presence remains well below the limit of 30% of bank system assets established by the regulator.

Foreign banks (branches, subsidiaries) hold the distinction of being the most cost-efficient in the industry at 59.6% (up from 56.7% in 2006), well ahead of domestic universal

[3] Section 3 of R.A.No.7721 (an Act liberalizing the entry and scope of operations of foreign banks in the Philippines).

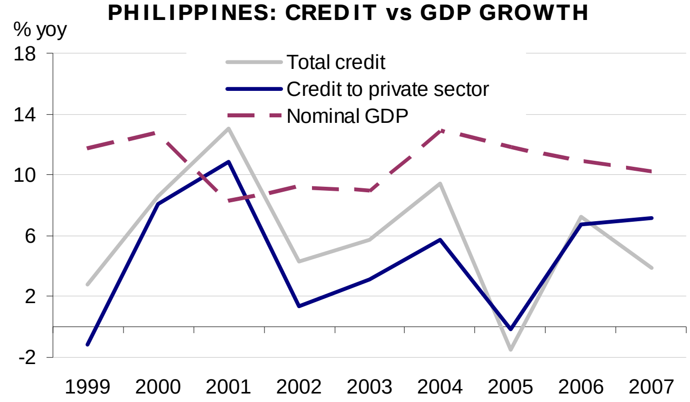
banks at 67.2%. Besides holding a major market share of 61.4% of the industry's credit card receivables –foreign banks´ niche market-, they are also gaining market share in foreign currency deposit unit loans (FCDU) at 30.9% from 26.2% in 2006 but their share in automobile loans shrank to 8.6% from 10.5% in 2006. In residential real estate loans, foreign banks hold the lowest share among banks (0.8%), due to constitutional restrictions on foreign ownership of land.

BANK DEVELOPMENTS

Relatively low cost deposits remain the main source for bank funding (71.4% of assets). Notably, banks maintained a relatively high liquid assets-to-deposit ratio at 51.8%. In 2007, all system subgroups reported a moderate asset expansion led by rural and cooperative banks, except for private domestic commercial banks which posted a 7.2% decline in assets. Bank's net interest margin remained relatively steady at 4.6%, albeit cost-to-income ratio (net of bad debts and provisions for probable losses) rose to 68.3% from 66.5% in 2006 due to higher capital expenditure, particularly on branching and IT-related investments to comply with Basel II requirements. Banks sustained their core earnings in 2007, with net income after tax (NIAT) growing by 9.5% but significantly slower than in 2005 and 2006 with growth rates close to 30% year-on-year. The deceleration followed a decline in non-interest income, namely a contraction in trading revenues, and a rise in total operating expenses by 8% over a year ago. Interest based-income was the major contributor to operating income at 63%. Yet, interest income growth has been sluggish, despite a recovery in bank lending, due to declining interest rates. Profit from assets sold and recoveries on charged-off assets propped up banks' extraordinary credits (i.e., earnings) and contributed to one fifth of their net income.

Bank lending has been sluggish, albeit starting to pick up in 2007 at 7.2% annualized growth, following the central bank's rate cut of 250 basis points in four steps between July 2007 and January 2008. One reason for the sluggish growth in credit, especially relative to other countries in the region, is the high statutory reserves and liquidity requirements of 10% and 11%, respectively. In fact, banks place a relatively high share of their invested funds into government securities (foreign and domestic) accounting to 14.3% of banks' assets. In any event, the banks' holdings of government securities have dropped somewhat (1.3 percentage points) as a result of the improved government fiscal situation and reduced issuance of government securities, but also of lower demand in anticipation of the increase in risk weight for foreign currency-denominated sovereign bonds under Basel II[4].

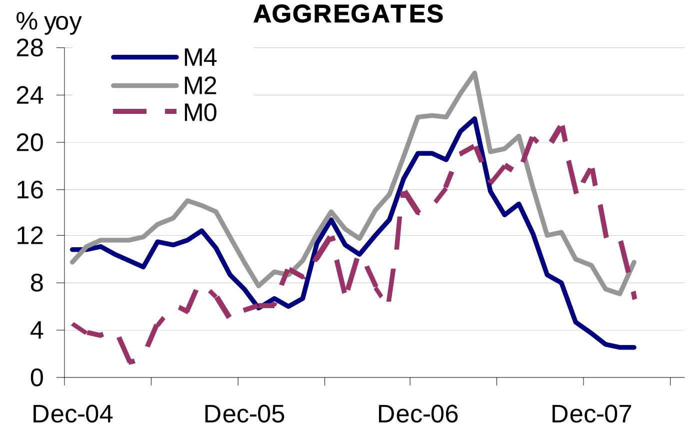
PHILIPPINES: CREDIT vs GDP GROWTH



Source: ERD BBVA

In addition to the purchase of government securities, since May 2007 the authorities have encouraged banks, state pension funds and government corporations to deposit funds in relatively high-yielding[5] short-term special deposit accounts in the central bank to manage liquidity. The use of these special deposits has helped offset the increase in foreign assets of the banking system, which come from the balance of payments surpluses in recent years. The result has been a deceleration of growth in the monetary aggregate (M4) to 2.6% at end-March 2008 from a peak of 26% in April 2007.

PHILIPPINES: MONETARY AGGREGATES

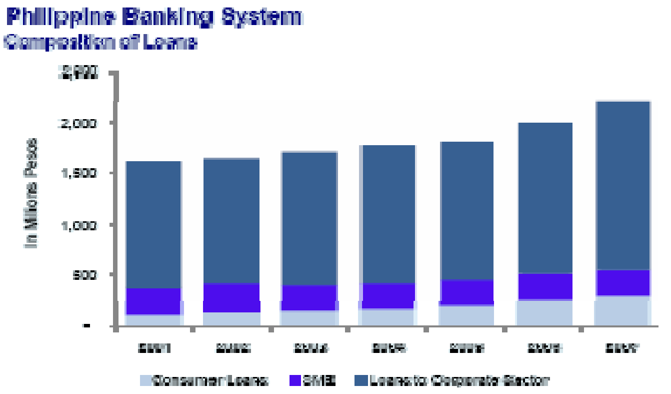


Source: Thomson Financial, ERD BBVA

As for the composition of credit to private sector in 2007, corporate loans accounts for the bulk of the total loan portfolio (TLP) with over 60% followed by small and medium enterprises (SMEs) at 19.6% and consumer loans (13.7%).

[4] Risk weighting increased from zero to 33% in 2007, 67% in 2008 and 100% in 2009.

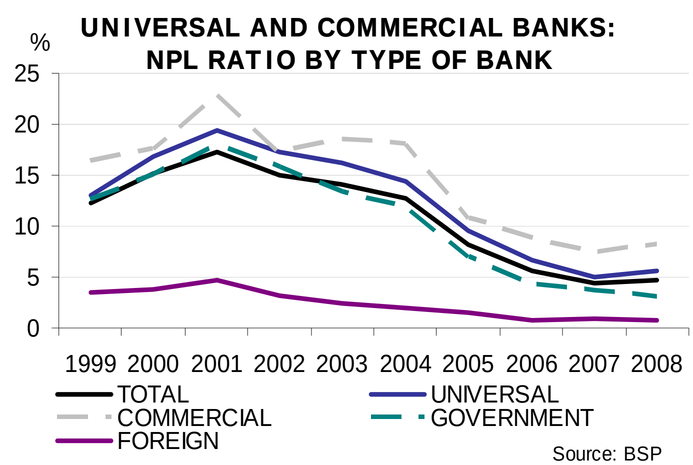
[5] 6% annualized yield.



Source: Bangko Sentral Ng Pilipinas

The biggest proportion of consumer loans in 2007 at 36.3% was residential real estate loans which have experienced a faster growth of 12.7% year-on-year in 2007 than other kinds of loans. According to the central bank, the biggest demand still comes from overseas Filipinos and their resident relatives. Credit card and auto loans sustained an uptrend of 24% and 29.6%, respectively. In aggregate, both of them accounted to nearly 42% of consumer loans.

The most notable credit development is the improvement in asset quality as a result of sales of non-performing loans (NPLs) and foreclosed property assets, rising property prices (increasing the value of the bank's remaining foreclosed properties), higher provisioning and stronger balance-sheet growth since 2004. Tax measures have provided incentives to clean up bank's books and unload their non-performing assets (NPAs) by entering into joint-ventures agreements with property developers, special purpose vehicle-related transactions, public auctions and debt write-offs. As a result, the non- performing loans ratio dropped to 5.8% in 2007 from 18.8% in 2000, and it is expected to fall further to 4.5% in 2008. Similarly, its non-performing asset ratio (NPA) dropped to 13.2% in 2007 from its peak of 28.4% in 2001. The risk of NPLs rising again is small, due to a stagnant loan growth despite more rapid economic growth and lower interest rates in recent years.



On solvency, banks maintained a capital adequacy ratio of nearly 14%, well below the 18.1% level in 2006 but still above the minimum required of 10%. The reduction in the capital adequacy ratio was mainly due to the introduction of Basel II[6] in July 2007 (the standardized approach) and as a result, an increase in risk weighted assets. Overall, compliance ratio with the prescribed CAR, on a solo basis, stood at 83.2% (705 banks out of 847 banks), with only three universal/commercial banks failing to comply with the required minimum amount of capital as of end-December 2007.

FUTURE DEVELOPMENTS

The industry consolidation process will continue strongly encouraged by the authorities, as the system remains excessively fragmented; as of end 2007, the central bank regulated 847 banks and 6,380 non-bank financial institutions. In fact the top 5 by market share account to 50% of banks' assets, similar to the banking structure in Indonesia but less than other emerging countries in the region such as Vietnam or even when compared to more developed regional peers such as Australia, Hong Kong and Singapore. The authorities are concerned that bank offices are excessively concentrated in Metro Manila whereas their presence in secondary cities, except Cebu, remains scarce.

Regulation and supervision of banks has improved with the internal reorganization of the central bank and the passage of key legislation, including the introduction of Basel II. A key regulation passed in 2008 is the Credit Information System Act, which aims to establish a centralized credit information bureau.

Beyond banking reform, the authorities encourage the development of domestic capital markets and the issuance of private debt, which is currently hampered by absence of international credit rating agencies established in the Philippines.

[6] The IRB approach should be introduced by 2010.

SCHEDULE 1: FINANCIAL INSTITUTIONS UNDER BSP SUPERVISION REGULATION

PHILIPPINES: PHYSICAL NETWORK

A. FINANCIAL INSTITUTIONS UNDER BSP SUPERVISION/REGULATION

as of end of period

TYPE OF FINANCIAL INSTITUTIONS (FIs)	End-December 2007		
	TOTAL	HEAD OFFICE	OTHER OFFICES
BSP SUPERVISED/REGULATED FIs	**21,394**	**7,234**	**14,160**
I. BANKS	**7,744**	**847**	**6,897**
A. Universal and Commercial Banks	4,275	38	4,237
Universal Banks	3,801	17	3,784
Private Domestic Banks	3,372	11	3,361
Government Banks	414	3	411
Branches of Foreign Banks	15	3	12
Non-Expanded Commercial Banks	474	21	453
Domestic Banks	388	7	381
Subsidiaries of Foreign Banks	70	3	67
Branches of Foreign Banks	16	11	5
B. Thrift Banks [1/]	1,336	82	1,254
C. Rural and Cooperative Banks	2,133	727	1,406
Rural Banks [1/]	2,011	682	1,329
Cooperative Banks	122	45	77
II. NON-BANK FINANCIAL INSTITUTIONS	**13,643**	**6,380**	**7,263**
A. With Quasi-Banking Functions	31	12	19
B. Without Quasi-Banking Functions	**13,612**	**6,368**	**7,244**
NSSLAs [2/]	116	77	39
Pawnshops	13,391	6,207	7,184
Others	105	84	21
III. OFFSHORE BANKING UNITS	**7**	7	

[1/] Including Microfinance-Oriented Banks

[2/] Refers to non-stock savings and loan associations

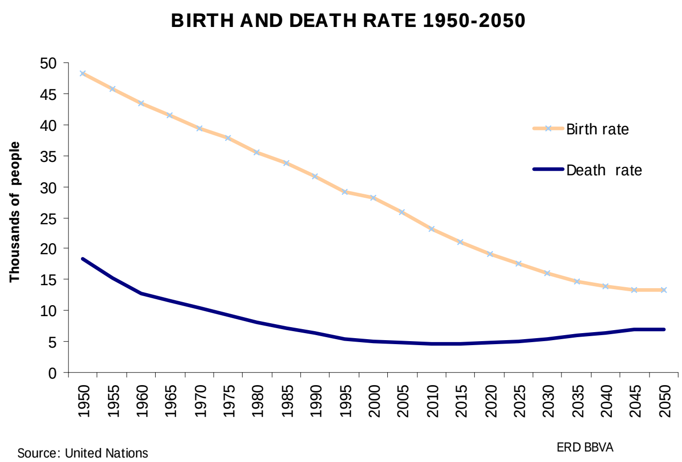
Source : BSP, ERD BBVA

Demography

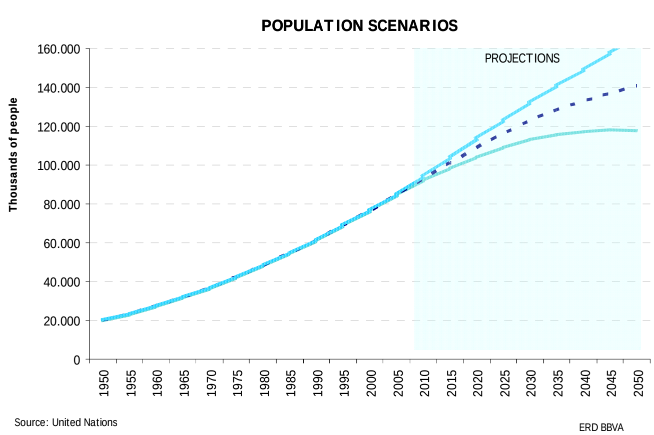
July 2008

DEMOGRAPHIC PROJECTION

The latest Census of Population (POPCEN 2007) conducted by the National Statistics Office placed the Philippine population at 88,574,614 people as of August 2007. The average annual growth rate is of 2.1% for the period 2000 to 2007, and according to United Nations estimations, population in the Philippines will overpass 140 millions inhabitants in 2050.

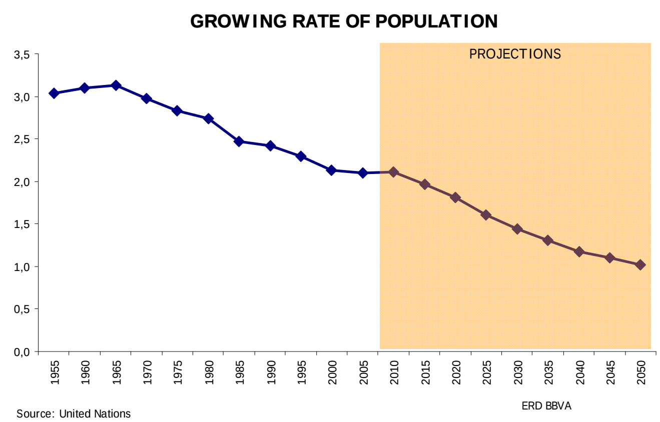


The Philippines have been largely a rural country, although nowadays it has one of the highest ratio of city dwellers in Southeast Asia, with almost 60% of the population living in urban areas. The Manila metropolitan area is by far the largest city in the country with 14.75 million inhabitants.



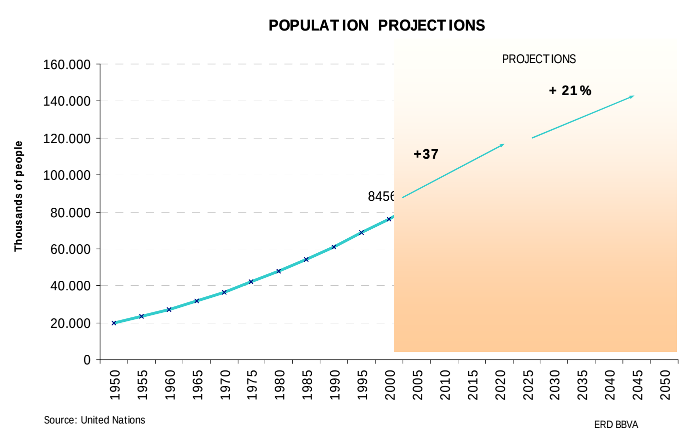
DEMOGRAPHIC TRANSITION

Philippines finds itself in the “second stage” of the demographic transition where the sharp decline in birth rates and mortality rates means that the society is ageing at the same time as the working age population (15 to 65 years) is increasing.



POPULATION STRUCTURE

Population in the Philippines is predominantly young. The median age is 21 years, the same as the median five years ago and there are almost equal numbers of males and females.



Of the total population, about 38.5 million (50.36%) are females while 38 million (49.64%) are males. Out of 38

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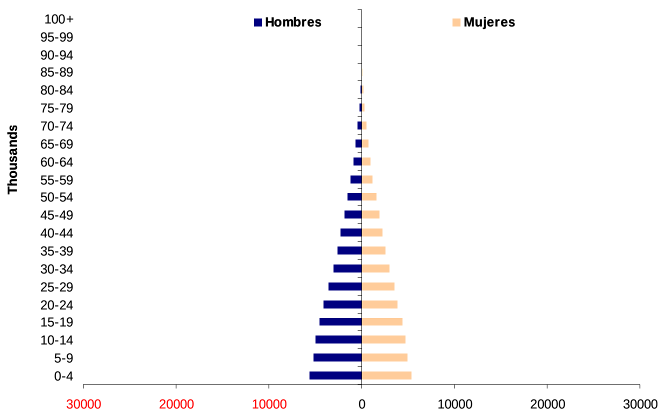
million females in the Philippines, the total population of women in child-bearing ages (15-49 year old) was recorded at 19.4 million (51.04%). Philippines has the highest fertility rate in Southeast Asia, at 3.5 births per woman, and the country continues to have one of the highest maternal mortality ratios (MMR).

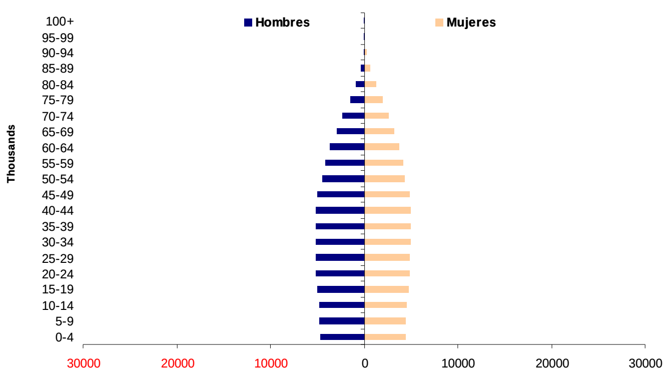
Infant mortality rate among households in the poorest quintile is 2.3 times higher than among the richest quintile, while the under-five mortality rate is 2.7 times higher. This inequality is also evident in the differences in health-seeking behaviour between different income groups. Overall, life expectancy at birth is 64 years for males and 71 years for females.

POPULATION PYRAMIDE 2005



Source: United Nations ERD BBVA

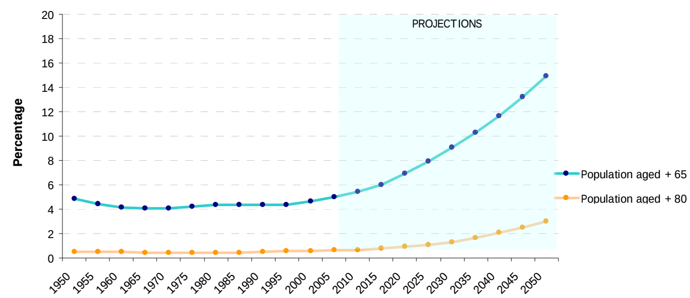
POPULATION PYRAMIDE 2050



Source: United Nations ERD BBVA

The age structure of the Philippine population is a typical broad base at the bottom consisting of large numbers of children and a narrow top made up of a relatively small number of elderly.

DEVELOPMENT OF OLD POPULATION



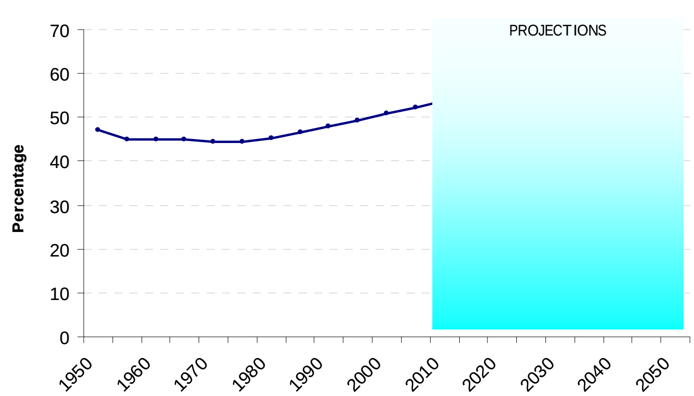
Source: United Nations ERD BBVA

Young dependents belonging to age group 0-14 year old comprise almost 37% of the total population and old dependents (65 year old and over) account for 3.8%. On the other side, the economically active population (15 to 64 year old) accounts for more than 60% of the total and it is expected to reach 67.4% by 2050. By that time it is expected that the old will increase their share to almost 13% while the children will account for less than 20%. Therefore, the population in the Philippines is and will continue to be predominantly young.

MIGRATION

Emigration: Population migration is also an important factor in the country's population growth. By December 2004, an estimated 8.1 million Philippines (nearly 10% of the country's 85 million people) where working and/or living abroad, in nearly 200 countries. In recent years, a "culture of migration" has emerged, with millions of people eager to work abroad despite the risks and vulnerabilities they are likely to face.

WORKING AGE POPULATION 25-64 YEARS



Source: United Nations ERD BBVA

PENSION SYSTEM

The social security programmes in the Philippines are the oldest and most comprehensive income arrangements in

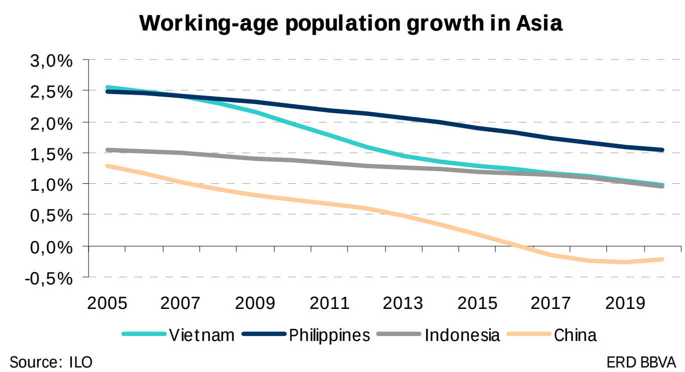
Asia. The Government Services Insurance System (GSIS) the social security programme- is targeted to public sector workers (civil servants and military people) and the Social Security Scheme (SSS) to the private sector workers. SSS offers old age pension and a lump-sum payment in case of sickness, death and disability. This program was extended to all workers in the private sector as well as to certain self-employed workers. Nevertheless, the country has excluded certain types of workers, like domestic servants, from the security net. Like in most Asian countries, the main challenge of the pension system is its low coverage.

Labor Markets

July 2008

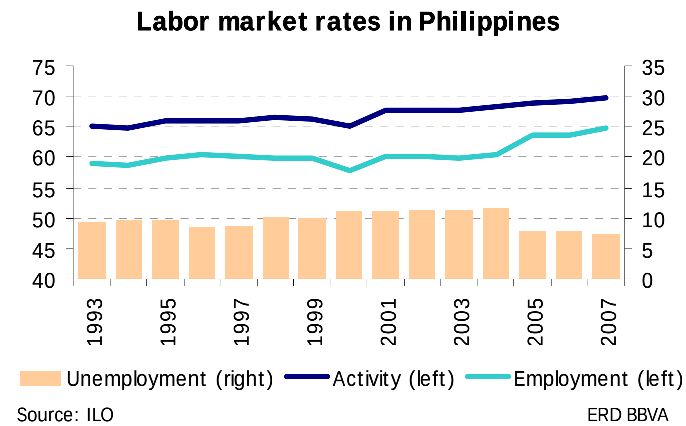
WORKING-AGE POPULATION

Growth in the working-age population contributes to sustain economic growth. In the Philippines, total population and working-age population will keep on growing in the medium term at a relatively fast pace, and among the highest rates in the region. According to the UN projections, working-age population (15-64 year old) will grow between 2.5% and 1.5% annually up to 2020.



EMPLOYMENT RATE

There is a limited slack from participation and unemployment rates. Since 2000, participation rate has increased nearly five points (up to 69.8% in 2007), and unemployment rate has been reduced by 3.9 points (down to 7.3% in 2007). These improvements have allowed the Philippines to align its main labor indicators to those observed in other emerging Asian economies. The employment rate (workers over population > 15 year old) reached 64% in 2006, vs. 65% on average in China, Indonesia or Vietnam.



LABOR FLEXIBILITY

Labor rigidities are similar to those observed in the rest of emerging Asian economies, albeit with higher informality. *Doing Business 2008* indicators (World Bank) show that the labor market regulation burden in the Philippines is relatively heavy, although to a lesser extent than the rest of regulations. Philippine ranks 122 over 178 economies (similar to Mexico), while in the global indicator *Easy of doing business*, the Philippines goes down to the 133rd.

The main rigidities stem from hiring restrictions (minimum wage is almost 70% of productivity and there is a restrictive framework to extend fixed-term contracts), despite lower non-wage labor costs. Nevertheless, the shadow economy, close to 45% of GDP, may contribute to increase its flexibility[7].

[7] Schneider, F. (2007): “Shadow Economies and Corruption All Over the World: New Estimates for 145 Countries”, *Economics E-journal*, July.

HUMAN CAPITAL

Human capital indicators are positive. According to UN data, the ratio of labor force with secondary education is 40%, which compares positively with the 20% in Indonesia. World Bank statistics reduce this figure down to 22%, still much higher than other emerging Asian peers[8] . In any case, additional efforts should be made to narrow the gap to industrialized economies (70%).

Labor indicators summary

Philippines. Main labor market indicators

	1996-2000	2001-2005	2006	2007
Population				
Million	72.819	80.156	84.477	85.884
Active population				
Million	29.628	34.857	38.294	39.521
Employment				
Million	27.075	30.756	32.636	33.560
Unemployment rate				
Per cent	9,7	10,7	8,0	7,3
Informality				
% Employment	---	---	---	---
% GDP	43,4	44,9	---	---
Rigidity				
Doing Business Ranking	---	---	122 / 178	123 / 178
Human capital				
PISA Ranking	---	---	---	---
Secondary	---	---	21,7	---
Tertiary	---	---	25,7	---

Source: ILO, WB-Doing Business 2008, World Bank (2006) and Schneider (2007)

[8] World Bank (2006): *Meeting the challenges of secondary education in Latin America and East Asia*. Washington.

Energy

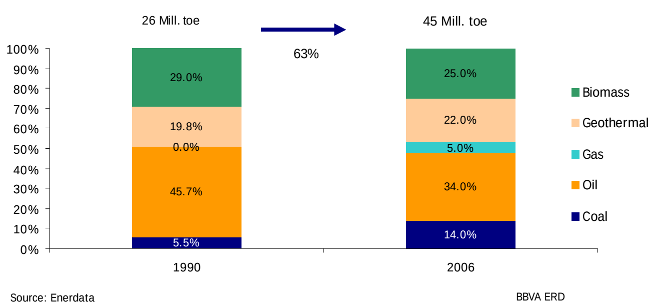
July 2008

GENERAL OVERVIEW

The Philippines has relatively few fossil resources. Oil and gas production started in 2001 mainly due to the development of new offshore deepwater deposits.[9] The country is self sufficient in natural gas but coal and oil output is modest in relation to consumption needs, so the country imports more than 75% and 95% of its coal and oil needs.

Oil is the main primary energy source and is mainly used for transportation. Traditional biomass is largely used by the residential sector and certain industries whereas coal and natural gas, whose share over the energy mix is growing quickly (especially gas), are mainly used for power generation.

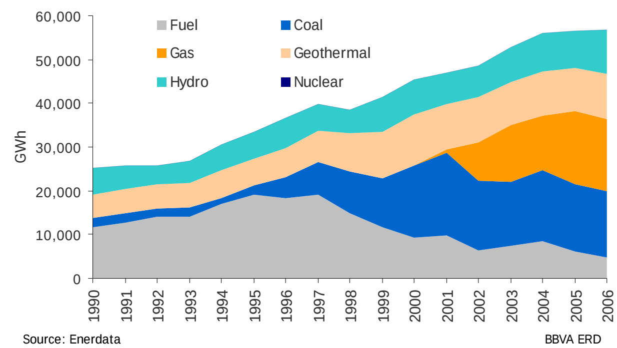
Total Primary Energy Supply by source. Philippines 1990-2006



Conventional thermal sources make up the largest share of the Philippine electricity supply, comprising 65% of the total in 2006. For a long time fuel oil was the main source for power generation. However, the country has strived to promote the development of domestic energy sources to displace oil imports. First, coal took the lead but since 2001 the Philippine's government is promoting the increased usage of natural gas-fired power plants.

The Philippines is also the world's second-largest producer of geothermal energy (behind the United States), which it uses to produce electricity at a lower cost than thermal and even hydro stations. The government has set a goal of increasing the installed capacity by 50% within a decade, which would turn the Philippines into the largest geothermal energy producer in the world.

Gross electricity generation by source. Philippines1990-2006



According to the International Energy Agency (IEA) the electrification rate is at 80%. The residential sector consumes one quarter of the total final energy used (60% of it being traditional biomass), whereas transport and industry consume approximately one third of it each.

The energy intensity of the Philippines has decreased by 18% since 2000. At present it is more than twice that of the OECD countries but considerably lower than that of most of its peers among developing economies.

However, no new generation supply is expected to come on stream in the near term so, based on government estimates, the Philippines could enter a power supply shortage as early as 2010-11 if adequate capacity additions are not in place.

[9] Almost all natural gas and oil reserves are located off-shore, in the Malampaya field.

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