

PHILEQUITY CORNER (5/9/05)

By Ignacio B. Gimenez

Laying the Groundwork with a credible VAT bill

We may be accused of belaboring the VAT issue (which we have dwelt with for 3rd consecutive issue), but since we believe this is most crucial to our economy right now, we cannot help but overstress its importance.

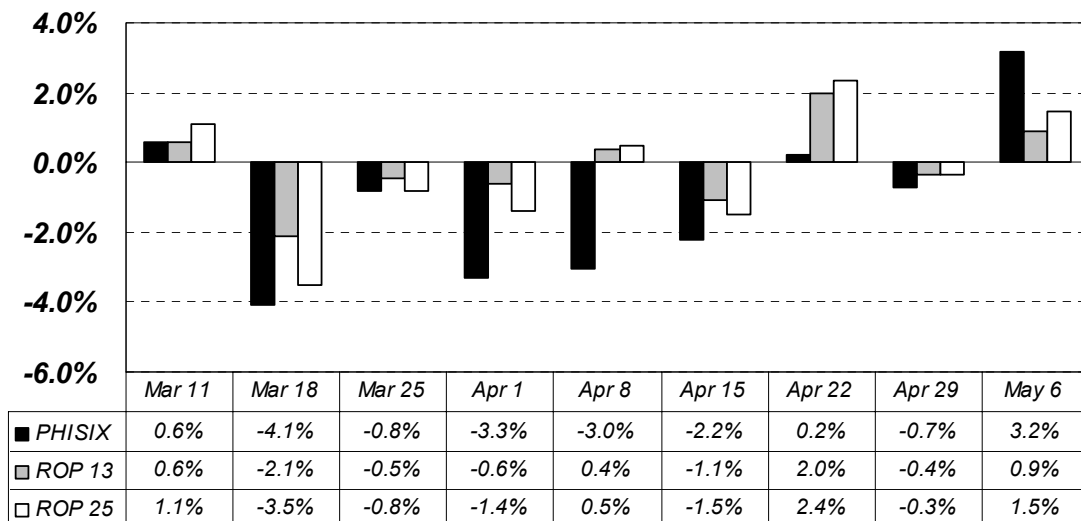
First things first and it is putting the fiscal house in order. We all know that the root of the fiscal problem is the long-term decline in the revenue effort. So far, attempts to strengthen tax administration (thru registration checks, prosecution of tax evaders, lifestyle checks, etc.), including belt-tightening efforts have only stopped the decline in the tax to GDP ratio but have yet to reverse the trend. A momentous VAT bill, therefore, is crucial in laying down the groundwork or the foundation, so to speak, on which subsequent fiscal adjustments would stand.

As we mentioned in our previous article, it looks like President Arroyo will be given standby authority to increase the VAT rate from 10 percent to 12 percent. In fact, the heads of the Senate and House bicameral panels met last week to craft the language of the standby authority provision in the VAT reform bill.

We also said that while it may not be a perfect solution of an immediate 12 percent through Congress, the market can live with it as long as it can deliver the required revenue targets.

As a result, market prices reacted favorably with the Philippine Composite Index (PHISIX) making its biggest gain in 12 weeks, up 3.2% week-on-week. Likewise, Philippine bonds more than recovered what they lost in the previous weeks.

Weekly Performance - PHISIX & ROPs



All indications now point that the VAT bill is going to be approved soon. Tbill rates also fell across the board last week. Even the Philippine Peso continued to strengthen against the US dollar – breaching the P54:\$1 level and closing at two-year highs.

Peso/US\$ Exchange Rate (2003 to 2005)



We have been expecting a significant peso appreciation since the start of the year but this has been derailed by the delay in the VAT bill. The passage of a 12% VAT rate with no exemptions should push the exchange rate towards the P52:\$1 level.

Likewise, the stock market should continue to rebound if only to correct its excessive decline. As we have shown in a previous article, the PHISIX fell by as much as 16% from its high while its regional peers only registered single digit losses.

Despite the rally last week, however, foreign investors continue to be net sellers in the market. Thus, while the market may have already reached an intermediate bottom, we expect it to take more time consolidating and building a stronger base, before it can even attempt to test the previous PHISIX high at 2172. We also anticipate it to be stock picker's market with only select issues leading but with most stock prices being range bound. This is like being back to square one with the market picking up the pieces and trying to regain lost confidence.

On the macroeconomic front, the Philippines may finally get a credit upgrade once a credible VAT bill is in place and other fiscal adjustments set in. This would then lead to lower interest rates, a stronger peso and higher stock and bond prices.

The need for a wage increase and a transport fare hike would also be minimized once cost-push pressures from high oil prices are mitigated by a stronger peso. This makes the swift passage of the VAT bill more urgent than ever.

In the long-run, positive momentum from these reforms would translate to higher economic growth thru resurgence in foreign investments and domestic credit expansion. This means additional jobs and improvement in family incomes. Further benefits to the public would be in the form of higher social welfare spending, which implies higher quality education, better health services and improvement in public infrastructure.

While we cannot accomplish all these at once, we can achieve them one step at a time. And just like a brick layer building a house, we cannot build on our economy and move forward without setting a solid foundation. To sum it up, a credible VAT bill to back up the fiscal reform program should ensure that the Philippine economy, with its large external financing requirements and high debt levels, would not collapse on its own weight.

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