

Fitch's outlook revision on the Philippines could be the first of a series

The Philippines recently received a negative outlook from Fitch ratings, will others follow?



We've only just begun?

The Philippines received a negative outlook from Fitch ratings on 12 July on its BBB long term foreign currency debt rating with the agency citing the following:

1. Downside risks to medium-term growth prospects as a result of "scarring effects".
2. Challenges associated with unwinding extraordinary stimulus measures and restoring public finances.

The pandemic has weakened countries' debt profiles (lower revenue collections coupled with increased spending) but so far, we've noted only a handful of downgrades or outlook revisions in the ASEAN region. Perhaps ratings agencies have been more lenient given the fallout from the pandemic? In early 2021, Fitch ratings indicated that it would push back credit ratings actions to 2022 while S&P recently echoed this sentiment suggesting that downgrades were unlikely for at

least a year or two[1]. For the time being it does appear that some ratings agencies are giving sovereigns a little more latitude but how long will this trend last?

If outright ratings downgrades are off the table in the near term, how about credit rating outlook revisions? Could the Fitch outlook revision on the Philippines be the first of several to follow in Asia? Would a sovereign such as Indonesia, which received a negative outlook from S&P in 2020 on its BBB rating, possibly be in line for a credit outlook revision as well from Fitch or Moody's?

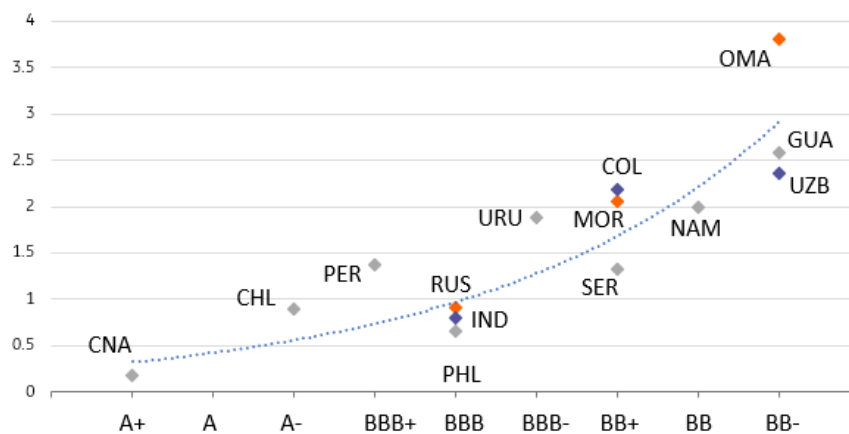
We look at some factors that ratings agencies will likely be tracking to gauge whether a country like Indonesia could be lined up for an outlook revision in the near term. Furthermore, we also look at the possibility that ratings agencies do pull the trigger on outright ratings downgrades in 2022 should these trends persist.

An outright sovereign credit downgrade for either the Philippines or Indonesia would in some cases bring them to the edge of the investment grade universe (BBB-), one misstep away from a likely heavy sell-off should either of them lose their investment grade status. The volatility experienced by Colombian bonds and currency after the twin S&P and Fitch downgrade to "junk status" in 2021 offers some takeaways for ASEAN and a situation that regional players would likely want to avoid. Currently the Philippines and Indonesia are both rated BBB by Fitch and we note the challenges they could face should either of them be downgraded to junk status.

[1] "Will COVID-19 Waves Wash Away Sovereign Credit

Support In Asia-Pacific?", S&P Global ratings, 22 August 2021

Spreads of select EM sovereigns over US Treasuries



Source: Refinitiv

Growth prospects and restoring public finances

Fitch highlighted "downside risks to the medium-term growth prospects" as one of its reasons for revising the Philippine outlook from stable to negative. Protracted periods of recession could lead to "scarring effects" as nations face elevated unemployment and slow investment, lowering potential output. This may necessitate even more fiscal spending down the road (unemployment programs and or capital outlays) which in turn exert additional pressure on public finances. This

focus on growth prospects is highlighted even more as the Delta Covid-19 variant has shuttered much of ASEAN.

We can expect ratings agencies to monitor nations with slowing growth as this translates to soft revenues, wider fiscal deficits and ultimately higher debt levels. Deteriorating debt metrics may present challenges to overall debt consolidation and weigh on credit ratings, although indirectly, should sovereigns resort to taking on foreign debt to plug deficits.

External vulnerability will likely become a factor...again

The global economy was forced into a standstill at the height of the pandemic with the impact on external positions varying across countries. Indonesia and the Philippines saw improved external balances in 2020 as the overall downturn in economic activity resulted in softer import demand.

In the coming months, we can expect increased pressure on countries' external balances as import demand returns while portfolio flows become more volatile amidst the projected Fed policy normalisation. Ratings agencies will once again be monitoring external positions as this measures a sovereign's ability to source foreign exchange for debt servicing. Furthermore, a deteriorating external position may signal an increased likelihood a sovereign would tap the overseas bond market as traditional sources of foreign currency (trade, remittances, etc) fall short of requirements.

Imminent unwind

Fitch also flagged the "possible challenges associated with unwinding the exceptional policy response to the health crisis and restoring sound public finances" for the Philippine outlook downgrade. In a bid to steady financial markets and to support real sector activity during the pandemic, authorities resorted to bold and even unorthodox stimulus efforts on both the fiscal and monetary front. Furthermore, we've witnessed the once-taboo blurring of lines between the fiscal and monetary realm as several central banks in Asia dove into quasi-quantitative easing and or debt financing all in the name of "economic recovery".

For the most part, investors have turned a blind eye to such schemes but as the pandemic drags on, it appears that some ratings agencies are increasingly worried about how sovereigns can successfully exit from the tangled pandemic-related fiscal-monetary stimulus measures. Although some have made a case for these policies to remain "for as long as the pandemic will last" we may need to identify sovereigns that will struggle to disentangle from an increasingly complicated web of "extraordinary" stimulus policies.

Lined up for a downgrade?

With ratings agencies likely tracking fiscal metrics, the external position and the complications associated with exit strategies, we look at whether 1) Indonesia is also lined up for a possible outlook downgrade by Fitch or Moody's and 2) whether both the Philippines and Indonesia could face potential outright ratings downgrades in 2022.

Dealing with delta

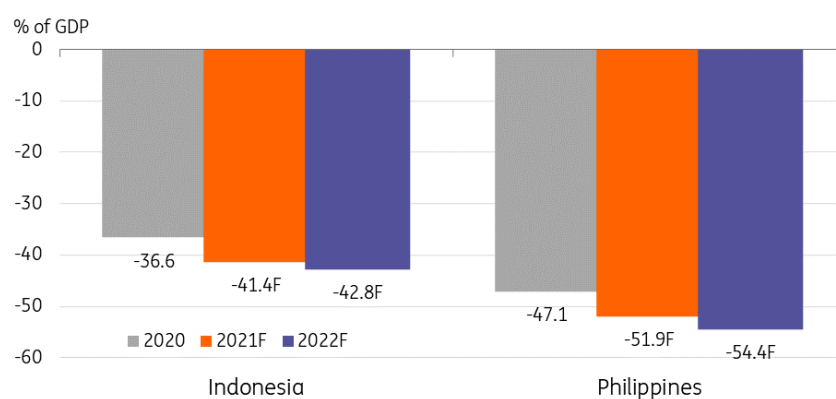
Both Indonesia and the Philippines started 2021 with hopes for a decent rebound after falling into recession the previous year. More than mid-way through 2021, the growth outlook has dimmed

after waves of Covid-19 infections forced authorities to heighten mobility restrictions, crucial for these two consumption driven economies. GDP expectations have been whittled down from the first round to the second round of IMF forecasts, but we note the steeper decline for the Philippines. It is worth pointing out that Indonesia saw a substantially less severe GDP contraction in 2020 of -2.0% compared to the Philippines -9.6%.

Better economic performance may have translated to relatively more sound fiscal metrics for Indonesia, as it posted a deficit-to-GDP ratio of 6.1% in 2020 compared to the Philippines' -7.5%. Meanwhile, Indonesia expects this ratio to dip to -5.6% in 2021 while the Philippines is expecting a further deterioration to -9.4%. We can argue that Indonesia has fared better on this front in terms of level for 2021 (Indonesia at -5.6 vs Philippines -9.4%) and direction as the Philippines' position is deteriorating while Indonesia's is improving.

Meanwhile, Indonesia's overall debt levels also appears to be less worrisome with its debt-to-GDP ratio expected to deteriorate to 41.4% in 2021 (from 36.6%) while the Philippines' is forecast to settle at 51.9% in 2021 (from 47.1%).

Indonesia and Philippines Debt-to-GDP ratio



Source: IMF

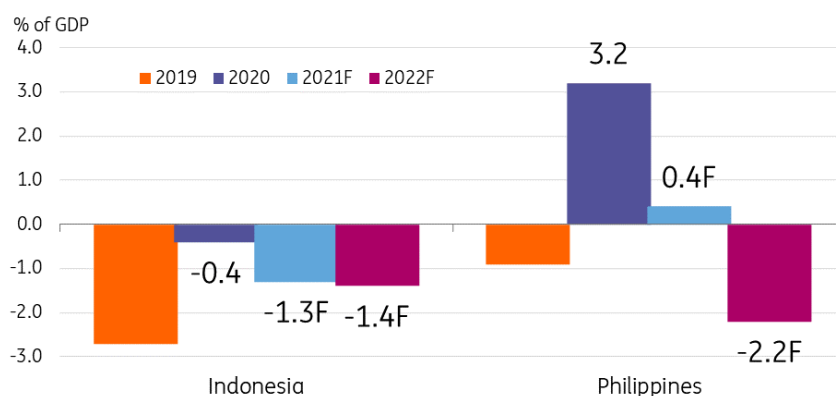
External position

Both the Philippines and Indonesia saw improved external positions in 2020 as import implosions led to better current account balances. However with their respective economies re-opening, we've seen a reversal of this trend with the Philippine trade deficit widening to an average of \$2.9bn in 2021 (from \$1.8bn) while Indonesia's trade surplus narrowing to an average of \$1.9bn (from \$2.4bn).

General dollar strength coupled with the current trends on external trade have forced both IDR and PHP to depreciate 3.4% and 4.8%, respectively with prospects for the Fed taper likely to push emerging market currencies to weaken further before the end of the year. Should the current depreciation trend be sustained for IDR and PHP, this may force authorities to draw down on reserves to service foreign debt obligations, which could trigger even more depreciation for their currencies.

Indonesia in this case appears to be the more vulnerable of the two given the wider current account gap relative to the Philippines, but we note that the external position deterioration for the Philippines appears to be more substantial.

Indonesia and Philippines Current account-to-GDP ratio



Source: IMF

Disentangling from the web of extraordinary stimulus

Both Indonesia and the Philippines have dabbled in [unconventional monetary-fiscal policy](#) over the past year with authorities suggesting that these emergency measures may be around for some time. Indonesian authorities have attempted to write Bank Indonesia’s (BI) debt financing scheme into the constitution as the current practice is only currently covered by a presidential decree. Meanwhile, the Philippine “debt financing-lite” program has been rolled over three times with the subsequent cash advances upsized to Php540 bn from the initial Php300 bn. BSP Governor, Ben Diokno, has vowed to keep support in place “for as long as needed”.

Both central banks deploy bond purchase schemes which amount to quantitative easing although bond purchases have been limited to the local bond markets so far.

In terms of exit strategy, both Indonesia and the Philippines have recognized the importance of developing such a strategy although details have not been shared since. And given the move by Indonesian lawmakers to legalize the central bank’s debt-financing we would expect the eventual unwinding of Indonesia’s unconventional monetary policy to be complicated should this scheme be written into law, a potential red flag likely watched by ratings agencies.

Meanwhile, the Philippines has not given a definitive timeline on the eventual end of the central bank’s cash advance programme. And with the fiscal situation deteriorating, we expect authorities there to keep the ongoing arrangement as the loss of BSP support would likely lead to a sudden surge in debt costs at a time fiscal metrics are dangerously stretched.

Unconventional policy	Indonesia	Philippines
Debt financing	Full	Lite
Quantitative easing	Full	Full

Exploring the depth of Asia’s unconventional central bank easing, October 2020, Think.ing.com

Verdict: Indonesia could escape outlook revision in 2021 but 2022 a bit hazy

Although Indonesia is reeling from a wave of the Delta Covid-19 variant, its growth prospects appear to be relatively more positive compared to those for the Philippines. The slightly better

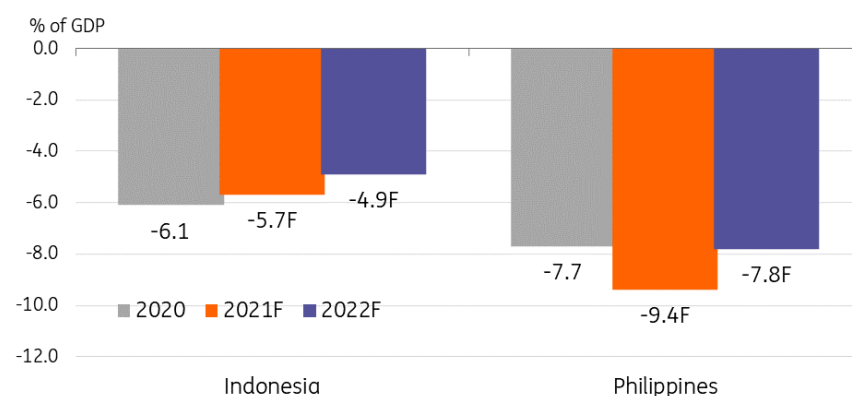
growth outlook suggests that Indonesia may have a better chance of hitting its 5.7% deficit-to-GDP ratio for the year while the Philippines may struggle to contain its deficit-to-GDP ratio at -9.4%, especially if the current Covid wave extends further into 3Q. Relatively better deficit trends for Indonesia suggest an increased likelihood for fiscal consolidation as well with the Philippines currently saddled with a 60.4% debt-to-GDP ratio as of 1H 2021.

On the external front, we recognize the narrowing of Indonesia's trade surplus, but we note that the export resurgence has helped offset a substantial pickup in imports. This could limit the impact on Indonesia's current account and external position. Further deterioration of the current account into deficit by 2022, will, however, be a cause of concern.

In terms of its exit strategy, we highlight that the proposed amendments to the constitution allowing debt financing have yet to pass into law which at the very least suggest that the practice could still be temporary. Pledges from BI officials that "burden sharing" is temporary appears to have allayed concern for now. However, the central bank may need to eventually unveil concrete steps on how they plan to craft and implement an exit strategy especially with the scheme extended into 2022.

With a slightly better growth outlook and fiscal balance, Indonesia may sidestep a potential ratings outlook downgrade in the near term. And although a near-term outlook revision remains unlikely, the sustained deterioration of the external position coupled with legalizing the central bank debt financing programme may increase the likelihood of a potential outlook revision in 2022. Furthermore, an outright sovereign credit rating downgrade could follow should fiscal consolidation be delayed in the 12 months following the outlook revision.

Indonesia and Philippines Deficit-to-GDP ratio



Source: DoF Philippines and Ministry of Finance Indonesia

Verdict: Philippines in the crosshairs, possible downgrade in 2022

The situation for the Philippines may be a bit more precarious as authorities struggle to contain the budget deficit while debt levels balloon. We expect the BSP to extend the ongoing debt financing scheme into 2022 with budget deficits likely widening due to subdued revenue collection efforts. This could complicate the central bank's exit strategy as fiscal authorities become increasingly dependent on central bank financing. Meanwhile, we note the mounting challenges on the external front with the expected deterioration of the current account complicated further by a

depreciating peso as the Fed gears up for taper and eventual rate hike down the line. Should growth momentum stall and fiscal and external metrics deteriorate further over the coming months, the Philippines may be in-line for a foreign currency credit rating downgrade by July 2022.