ARTICLE FOR THE EDGE

THE PHILIPPINES CONTINUES TO ITS UPWARD MARCH

The Philippine economy has defied the naysayers, continuing to grow at a rapid pace that has placed it as Southeast Asia's fastest growing nation. Encouragingly, the Duterte Administration's respected economic policy team has built on past reforms to introduce new initiatives to strengthen the base for future growth. However, while President Duterte remains popular and retains the political initiative for now, his controversial policies and aggressive style do pose political risks which have to be monitored carefully.

**The short to medium term prospects are good but watch some emerging risks**

The economic data has been generally positive, showing an economy that is growing robustly with the external accounts and inflation the only areas where there might be some concern:

- **Buoyant private consumption**: Consumer spending has remained robust, powered by rising incomes and an expanding middle class. The proposed tax cuts for the middle class, should provide further support to domestic demand. Remittances from overseas workers, a key driver of consumer spending are growing strongly. While demand for Filipino workers in the Middle East has weakened, deployments to other parts of Asia continue. The weak Peso has also increased the local currency spending power of remittances.

- **Strong investment reflects business optimism**: Investment has led growth, growing by 15.0% y/y in the fourth quarter of last year, just a tad slower than 18.6% in the third quarter. In the first 11 months of 2016 net Foreign Direct Investment (FDI) inflows were up 25.4% from the same period in 2015. Proposals to boost infrastructure spending have encouraged FDI in manufacturing and finance.

- **Forward looking indicators are positive**: Purchasing manager surveys show new orders, including new export business, are growing nicely. Business confidence remains very high and booming imports of capital goods suggest that investment spending in coming months will continue to grow strongly.

There are three risks that bear watching in the coming year:

- **Inflationary pressures are mounting**: With the Peso falling to a ten-year low, imported inflation will become more of a concern. Inflation is accelerating – 3.3% y/y in February, up from 2.7% in January. Rapid growth means that there is not much slack in the economy, and as resources are strained, there is a risk that inflation could rise further. Fortunately, the country's independent central bank has built a record of credibility in containing inflation and can be expected to take tough actions to restrain inflation.

- **External account deterioration**: After a long period of current account surpluses, the Philippines registered a deficit of 1.2% of GDP in the last quarter of 2016. The economic boom has led to a surge in imports, especially of capital goods while export growth has remained lacklustre. We believe that a developing country such as the Philippines should be running a current account deficit so long as it is not too large, is driven by productive investment and is well-funded. But the reality is that, in the current environment of frequent bouts of risk aversion and the likelihood of a faster pace of US monetary tightening, investors tend to look askance at deteriorating external accounts. With the Peso already battered, the external accounts remain a risk.

- **Business environment challenges**: In mid-February, Environment Secretary Gina Lopez cancelled 75 mining contracts, following an earlier move to shut down more than half of the Philippines' operating mines. There is some reason to believe that there had been environmental misconduct by some mining firms but the sweeping and abrupt nature of the ban has aroused serious concerns over how supportive policies will be of FDI. If this issue is not resolved soon, foreign investors will be deterred. At risk are sectors largely driven by foreign investment, such as business process outsourcing (a key source of growth which has driven private consumption as well), manufacturing and financial services. The government's bid to promote public-private partnerships to develop infrastructure will also suffer.

**Longer term: there is a reasonable chance of acceleration to above 7% growth**

President Duterte's economic policy team is beginning to address some of the obstacles that have deterred economic acceleration:

- **Tax reforms will help**: First, the administration will reduce personal and corporate income tax rates while expanding the base for value-added taxes by reducing exemptions. Excise taxes will also be restructured. These proposed changes are likely to come into effect by 1H17 and bode well for fiscal sustainability.

- **Attracting foreign investment**: Duterte plans to amend constitutional limits on foreign investment. Tax incentives are also being offered to foreign investors.

- **Greater ease of doing business**: Duterte hopes to replicate his track record in Davao which he governed before becoming President. There, he reduced the number of days to open a business to seven days, just one of many changes that improved business conditions there. Implementation of the competition law and the national competition policy should enhance competition as well as improve the operating environment for businesses. Duterte's moves are already being recognised – the Philippines rose by 12 spots to rank 58th in the 2017 Index of Economic Freedom (IEF) of the Heritage Foundation.

- **Making Mindanao a new growth pole**: Mindanao not only has one of the highest concentrations of mineral resources in world, but is also less susceptible to typhoons that cast a dark cloud over other parts of the country. The House of Representatives has approved proposals to create rail and power bodies in Mindanao which will help boost the provision of necessary infrastructure. However, peace efforts with Muslim insurgents and with the Communist New People's Army who operate in Mindanao have encountered obstacles. Duterte has to also make more progress to overcome these delays to the peace process in Mindanao if he is to realise his ambition of making the region a new engine of growth.

- **Social welfare push**: The Duterte Administration is adamant about reducing poverty levels. Conditional cash transfer programs have been expanded, pensions raised for retirees and support for overseas Filipino workers has been enhanced. Not only should these initiatives improve prospects for equitable growth, they also serve to bolster domestic demand.

- **A big infrastructure push**: The government is showing leadership in this critical area. Traffic congestion is being prioritised, road and expressway projects are being commissioned in addition to the upgrading of rail networks. Amendments to the Public Private Partnership (PPP) Law should see infrastructure development broaden across various sectors. Efforts to improve the planning and implementation of PPPs and a Right of Way Act are underway will help speed up the implementation of public infrastructure. Thus far 16 infrastructure projects worth around PHP440bn have been approved, with plans to spend a further PHP861bn on infrastructure this year.

Overall, the economics team in the administration has impressed and there is growing confidence that they will be able to deliver on their promises.

**What can go wrong? Politics!**

Aside from the risk from the deterioration in the external accounts, the key risk is political.

Duterte would have faced challenges even if he had abjured his controversial ways. With his roots in Leyte and Davao, Duterte is not from the traditional Manila political elite. More than that, he has chosen to challenge this long ruling elite by threatening to attack some of the cartels and oligopolistic practices that they control and which have held the country back for decades. He has also shown disdain for the highly influential Catholic Church, even accusing a priest of molesting him when he was a child.

Many observers point to Duterte's high approval rating (83% in January according to a Pulse Asia survey) as evidence that his political position is unassailable. However, Philippine leaders usually command high approval in their first year in power but rapidly lose popularity after that. Similarly, the apparently firm hold he has over the Senate and the House of Representatives is similarly misleading – political loyalties are notoriously fickle and undependable as many of Duterte's predecessors have found out.

Against this background, there are reasons to be concerned about political risks:

- **Extra-judicial killings are a black spot – and have an economic impact**: Duterte won the election on a promise to rid the Philippines of the scourge of illegal drugs within six months. Eight months on, the killing of a South Korean businessman by rogue drug enforcement officers forced Duterte to temporarily suspend the anti-drug campaign which many believed included extrajudicial killings that had been sanctioned. The war on drugs has been popular with the lower income groups who have borne the brunt of rampant drug-related crimes. Surveys show that the wave of extra-judicial killings since Duterte came to power (some 7,000 according to some estimates) retains popular support – although even many supporters did admit to being concerned about their own safety as a result. But for investors, the blithe way in which the administration has treated extra-judicial killings raises critical questions about the rule of law. The killing of the South Korean businessman also brought home the risks of pursuing such a strategy in the context of a highly corrupt police force. Unless crime and the drug trade are eradicated as a result of these extreme measures, the sense of security amongst ordinary citizens will eventually diminish, and the reversal of sentiment against Duterte could be very strong.

- **There is already growing pushback against Duterte**: Former President Fidel Ramos – who remains highly respected – was an early supporter of Duterte but he has now come out to criticise Duterte over the extra-judicial killings and over his leadership style of making policy decisions without consulting his Cabinet. Ramos worried that Duterte's war on drugs would distract him from addressing pressing economic issues and by fostering a culture of impunity in the Philippines, would create long term problems. The arrest of a longstanding Duterte critic, Senator Leila de Lima, on drug trafficking charges that she denies has also aroused concern. De Lima had led a series of Senate investigations into allegations that police officers were offering themselves as hired killers and were involved in the extra-judicial killings. Lower house representative Gary Alejano has now filed an impeachment motion against Duterte over a range of charges including conflicts of interest, assets concealment and extrajudicial killings. However, with Duterte's allies in control of both the House of Representatives as well as the Senate, an impeachment motion will go nowhere, for now. Still, prominent political leaders continue to press their case against Duterte, including Senator Antonio Trillanes IV. Duterte has also engaged in a long running squabble with Vice-President Leni Robredo who remains a potential challenger. And groups affiliated with the Catholic Church have started to mobilise protests and rallies against the extra-judicial killings.

In short, while Duterte appears dominant for now, he is vulnerable and if he is not careful, the political challenges against him will grow into something much more serious.

**The bottom line**

The Philippines economy is on a good footing and this can continue so long as the inflationary and current account pressures can be contained. But this progress can easily be undone by political misjudgements. Duterte has brought strength and fierce determination which the country needs but his political initiatives are controversial and are entangling him in unnecessary distractions – that is why politics remains a potential obstacle.

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