ECONOMIC ANALYSIS

Philippines | Is Duterte ready to clear high bar?

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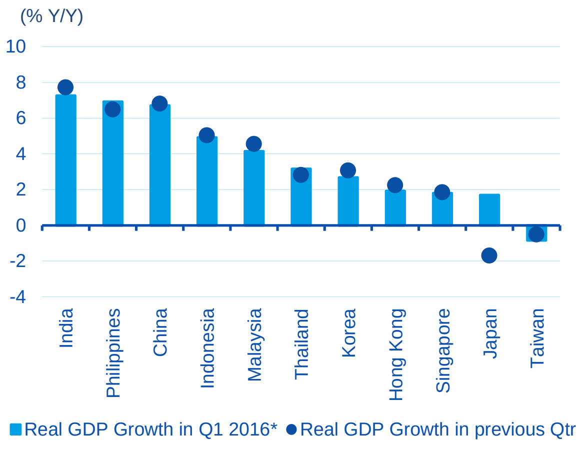
Summary

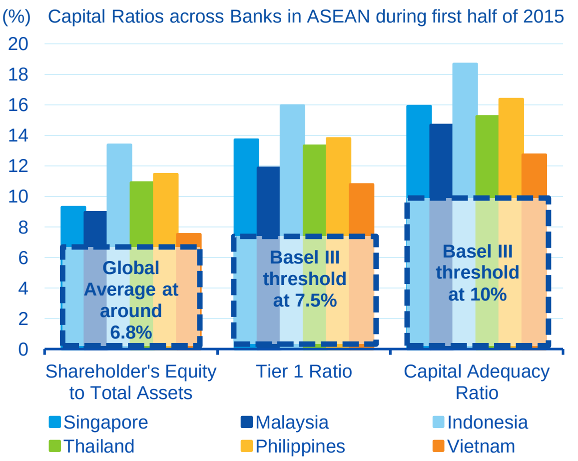
- Philippines' presumptive President-elect Rodrigo Duterte will take office on June 30th. The long serving Davao city mayor has a high bar to clear as he takes on the reform mantle from Benigno Aquino III, who was instrumental in delivering impressive economic performance despite a tough external environment.
- Once known as the 'Sick Man of Asia', Philippines has today transformed itself into Asia's growth leading economy, with real GDP growth averaging 6.2% y/y over the past six years, underpinned by effective policy reforms, low inflation, sound external fundamentals, fiscal discipline, and a healthy banking system.
- Outgoing President Aquino's regime was marked by several key economic reforms, including a boost to infrastructure spending through PPP, strengthening state finances with new sources of revenue, an anti-corruption campaign, conditional cash transfers to poor, and expansion of universal education.
- To maintain investor confidence, Duterte needs to hit the ground running by not only leveraging Aquino's good work but also addressing social-economic issues which continue to plague Philippines, namely the lack of inclusive growth amid high poverty levels and income inequality, inadequate education and healthcare facilities, weak institutional framework, corruption, crime, and yawning infrastructure gaps.
- Initial investor concerns over team Duterte's lack of economic policy clarity have eased following its announcement of an 8 point economic agenda and a pledge to continue reforms set in place by Aquino regime. Duterte seeks to improve economic competitiveness of Philippines by replicating the successful Davao city model. As we await further details on Duterte's policy agenda, we examine the state of Philippines economy so as to ascertain key macroeconomic challenges facing the new administration. We believe that policy implementation risk will remain a factor influencing investor sentiment in Philippines going forward, which will also test Duterte's ability to deliver through quick quality moves.

Figure 1
Philippines ranks amongst Asia's foremost growth leading economies



*Where not released, 4Q15 GDP data is used. Source: BBVA Research, CEIC database

Figure 2
Philippines banking sector is well capitalized



Source: BBVA Research, Bloomberg

Rodrigo Duterte takes on the reform mantle from Benigno Aquino III

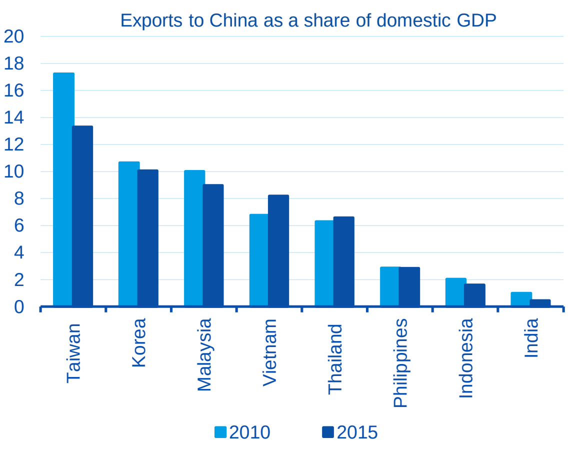
On May 9th, the decisive Philippines presidential election win for Rodrigo Duterte, a long serving Davao city mayor known for his tough talk and a violent crackdown on criminals, got investors nervous. With the bar on economic performance and reform implementation set high by outgoing President Benigno Aquino III, Duterte's unclear economic policy agenda, his lack of national political network and his heavy-handed tactics to eliminate crime raised doubts over his ability to successfully leverage Aquino's reform efforts which have restored macro financial stability and bolstered economic growth in the Philippines. Reassuringly, initial apprehensions have eased significantly since with team Duterte being quick to announce an 8 point economic policy agenda alongside a pledge to continue reforms set in place by the Aquino regime. Duterte seeks to improve economic competitiveness of Philippines by replicating the successful Davao city model. As we await further details on Duterte's economic policies, we examine the state of Philippines economy so as to ascertain key macroeconomic challenges facing the new administration. We believe that policy implementation risk will remain a concern for investors in the near to medium term, which would also test Duterte's ability to deliver through quick quality steps. Contingent on continued economic reform momentum, a stable socio-economic and political environment, and productive public spending, we expect Philippines to record a healthy 6.5% average annual real GDP growth in 2016 and 2017, a gradual pick up from 5.8% in 2015 as stronger domestic demand offsets weaker net exports.

Figure 3
Philippines lacks inclusive growth and adequate infrastructure

	Indicators for Philippines	2016	2015
1	Ease of Doing Business Ranking	103	97
		2012	**2000**
2	Income share held by highest 10%	33.4	36.3
		2015	**2009**
3	Poverty headcount ratio at national poverty lines (% of population)	21.1	22.9
		Rural	**Urban**
4	Account at formal financial institution (% of population)	19.5	37.1
		2015	**2014**
5	Investment to GDP Ratio (%)	20.2	20.9

Source: BBVA Research, World Bank, Bloomberg

Figure 4
Philippines exposure to China slowdown is low



Source: BBVA Research, Haver Analytics database

Philippines' stellar economic performance masks key areas of weakness:

Once known as the 'Sick Man of Asia', Philippines has today transformed itself into one of Asia's foremost growth leading economies, with real GDP growth averaging 6.2% y/y over the past six years, underpinned by effective policy reforms, sound external fundamentals, fiscal discipline, and a healthy banking system. At 5.8% y/y in 2015 and 6.9% y/y in Q1 2016, Philippines real GDP growth has far outpaced ASEAN average growth of around 4.5% (See Figure – 1). Favourable terms of trade, benign inflation, low interest rates, robust remittance inflows and productive government spending has aided Philippines domestic demand over the past year, in turn offsetting weak external demand. Strong domestic demand has supported corporate balance sheets and job creation while concerted fiscal consolidation efforts – fiscal deficit around 0.5% over the past three years – have helped reduced the net general government debt burden.

Furthermore, a sound external financing position for the Philippines is characterized by a surplus current account balance on the back of rising remittance inflows, lower oil prices and relatively healthy services exports, especially business process outsourcing, tourism, healthcare and maritime. Other factors enabling external fundamentals include low levels of gross as well as short term external debt, low reliance on external savings by banks and corporates, and low and long term nature of external government borrowings. Philippines maintains a net external creditor position with its official reserves and financial sector external assets exceeding gross external debt while its import coverage ratio is sufficiently high with international reserves sufficient to cover 10 months of imports. Meanwhile, a relatively strong Philippines banking sector is underpinned by low levels of NPLs (around 2% of total advances), adequate liquidity levels, and it's largely deposit funded and relatively domestic oriented nature with limited links to the external markets (See Figure – 2). Domestic financial stability is aided by strong oversight by the Central Bank (BSP), which has kept private sector debt and real estate prices growth in check. The Central bank has been successful in anchoring inflation at low levels while improving the effectiveness of monetary policy transmission through adjustments to the reverse repo auction mechanism and a term deposit auction facility.

Bulk of the credit for bolstering Philippines economic growth goes to outgoing President Aquino, whose regime was instrumental in rolling out several key economic reforms over the past six years. These included a boost to infrastructure spending through Public Private Partnership (PPP) program, strengthening state finances with new sources of revenue such as the 'sin tax' on tobacco and alcohol that raised USD 2.3 billion for health care, an anti-corruption campaign, USD 5 billion in conditional cash transfers to poor, a family-planning program, and expansion of universal education. The government's efforts to expedite public-private partnership projects and improvements in public infrastructure has helped crowd in private investments.

Aquino's stellar record of sound economic management is not without its blemishes

Several social-economic issues continue to plague Philippines. These include the lack of inclusive growth amid high poverty levels and income inequality, poor education and healthcare facilities, weak institutional framework, corruption, crime, and yawning infrastructure gaps (See Figure – 3). The Philippines society suffers from high income inequality and a high poverty rate, meaning that the gains of economic progress have not reached the masses. Poverty level in Philippines has hardly improved since 2009, from 22.9% to 21.1% living under poverty line in 2015 (on less than USD 3.23 a day). The level of financial inclusion is low with only 31% of all adults in the Philippines owning a bank account. Also, there is large disparity in financial access across the income distribution. The share of adults with bank account is much higher in the top 60% of income distribution than in the bottom 40 percent. Furthermore, the share of informality in non-agricultural employment is higher than 70% in the Philippines as per ILO estimates.

Meanwhile, the on-going weakness in external demand coupled with domestic infrastructure gaps, particularly in the transportation and energy sector remain a key drag on Philippines growth outlook. Despite government efforts, investment to GDP ratio in Philippines has remained stagnant at 20% over the past six years (20.2% in 2015 from 20.5% in 2010). Philippines remain's a lower middle income economy with a weak institutional and governance framework that hampers policy effectiveness. Bureaucratic delays in getting new business and construction permits and weak contract enforcement have worsened Philippines' ease of doing business ranking in 2016 to 103 from 97 last year according to the World Bank.

Duterte needs to ensure socio-economic and political stability alongside effective reform implementation

Prima facie, team Duterte's 8-point economic agenda (See Table-1) ticks the right boxes. It is wide ranging and attempts to leverage upon Aquino's good work by expediting PPP enabled infrastructure development, introducing critical legislative reforms to attract greater FDI across sectors, address governance issues across key revenue generating departments, focus on capacity building and productivity improvements in the agriculture sector, developing a progressive tax system, improving land tenure security and land titling process, and investing in social good through conditional cash transfer programs, improving healthcare and education system. This apart, Duterte's distinctive reform promise is his vow to replicate the Davao city model across the nation. Doing so would mean creating positive conditions for businesses to flourish by 1) Cutting down the number of days in business permit issuance – local government offices in Davao were asked to issue local business permits within 72 hours in 2014, and a 2) violent crackdown on crime. On the later, Duterte has gone a step ahead by pledging to restore death penalty, impose a ban on smoking and drinking alcohol in public places, and allow policy to shoot on sight people suspected of involvement in organized crime. We think Duterte's ambitious plans to end crime in 6 months by curbing various social freedoms is fraught with risks, not just in terms of ensuring compliance across Philippines but also in its potential to undermine social harmony and fuel political instability, if executed hastily. In this context, Duterte needs to ensure that socio-economic and political stability is preserved in the Philippines while effectively implementing policy reforms aimed at improving the business climate and addressing the infrastructure gap.

Equally important are financial reforms to allow more efficient and risk based intermediation of savings towards productive investments. With banks not in the best position to fund long gestation projects, further developing bond markets and other forms of long term finance should be high on Duterte's agenda. Strengthening Philippines' institutional and governance framework and ensuring better coordination amongst different authorities is key to improve the overall operating environment for businesses in the region.

Finally, being a primarily domestic demand driven economy (Trade openness at 58% vs. 130% for Thailand), external demand slowdown has had a limited impact on Philippines growth prospects. Also, its exports to China as a share of GDP are significantly low at just 3% (See Figure – 4). Nevertheless, from a medium term perspective, as global demand recovers, policy efforts to boost exports growth are crucial. Philippines's low unit labor cost and quality labor supply comprising young and educated population and a flexible labor market bodes well for its exports prospects. More than a third of Philippines exports are to Trans-Pacific Partnership (TPP) member countries, in turn providing a strong incentive for the Duterte regime realize economic and trade liberalization in Philippines so as to join the TPP. Doing so, could help spur needed reforms and boost overall productivity, deepen regional supply chains, harmonize market access, which can boost regional trade in services and in turn help growth.

Table 1

Rodrigo Duterte administration's 8 point economic agenda

1	**Boost infrastructure spending:** Maintain infrastructure spending ratio at 5% of GDP, expedite public-private partnership infrastructure program to address existing bottlenecks in PPP projects.
2	**Attract FDI inflows:** Ease foreign ownership limits, follow Davao City model to improve ease of doing business, eliminate graft, crime, and enhance security. Push for constitutional reforms (amending restrictive provisions in the 1987 constitution) to lift limits on foreign companies from holding majority stake in specific industries.
3	**Enhance government revenues:** Reform the Bureau of Internal Revenue and Bureau of Customs to mitigate corruption and improve tax collection.
4	**Modernize agriculture sector, improve farm productivity:** Provide for better irrigation facilities, boost agriculture processing technology. Enhance farmer market access and develop agriculture value chain by forging partnerships with agribusiness farms.
5	**Develop a progressive tax system:** Indexing tax collection to inflation and progressively update income tax bracket.
6	**Addressing land administration and management related issues:** Ensure security of land tenure, particularly in rural areas, and improve the process of land titling in order to attract higher foreign direct investments.
7	**Expand and improve conditional cash transfer program**: Involves indexing the conditional cash transfer program to inflation to benefit low income earners, to provide greater welfare assistance to rural poor. Expand coverage of the Philippines Health Insurance Corp to include more beneficiaries, particularly those living in rural areas.
8	**Strengthen basic education system:** Expand training programs across different skill sets – maths, thinking and communication skills - , while widen the existing scholarship program for tertiary education so as to increase employability of youth.

Source: BBVA Research, Bloomberg

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