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PHILIPPINE ECONOMY WILL **TAKE THE LEAD**

The Philippine government growth initiatives will heat up the economy so the central bank should respond instantly

The Philippine peso is currently trading at its lowest level to the dollar since the past 10 years. The peso has even lost 12% year to date against the euro. If the development in the foreign exchange market is seen as a forecast then the signal is an increasing concern about the economy of the Philippines – the country with one of the world's highest GDP-growth rates.

It is uncertain whether the Philippines becomes the world champion in GDP growth this year but I am convinced it will happen in 2018. The government will work hard to achieve the gold medal through major infrastructure investments combined with significant tax reforms. When an Emerging Markets country suddenly launches huge and partially government funded growth programs, one instantly thinks of a ballooning public deficit and lower credit ratings. The Philippines still has major structural problems like a slow working public administration, corruption, etc. but one should not underestimate the country's fiscal strength and room to manoeuver. Looking at something quite basic like the government debt relative to GDP, the Philippines belongs in the global premier league along with countries such as Switzerland, Denmark and China as graphic one shows. Here, one has to remember that the United States and half of the Eurozone members have a government debt of between 100 and 130 pct. of GDP which means that these countries do not have just one cent of fiscal flexibility.

But the stake that the Philippine government has placed on the table is so huge that the growing budget deficit will make economists and analysts from rating agencies sweat. In the election year 2016 the fiscal budget deficit was increased to 2.4 pct. of GDP with a further expansion this year. However, the government claims that even in 2018 the budget deficit will not exceed 3 pct. of GDP but precisely the budget deficit will attract extensive attention in the coming 6 months.

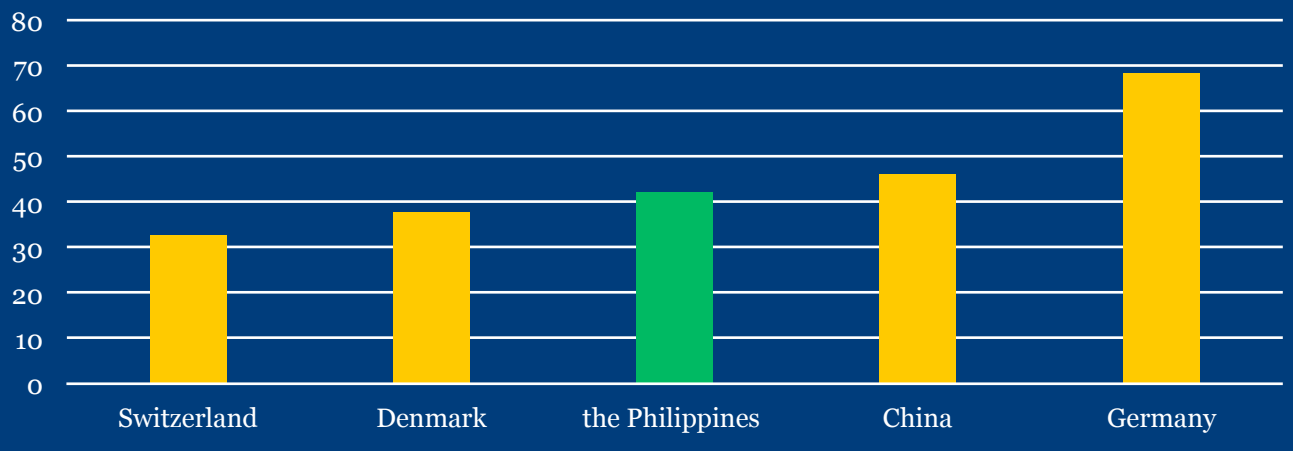
During the past year, the infrastructure growth package and the tax reform have been presented. My assessment has so far been that the funding of the initiatives were unclear. It increases the risk of the government exceeding the deficit target - so I keep my critical position.

However, after this risk has been highlighted, I regard some of the coming growth initiatives for the rest of this year and 2018 largely as good and even very constructive. It has almost become a slogan for the government to say, "Build! Build! Build!" as the infrastructure investments, mainly roads and railways, provide immediate growth and later ensure growth when more goods can be transported. However, I remain saying, "Internet! Internet! Internet!" As I argue this kind of infrastructure investment is at least as important for the Philippines.

An example that supports my view will soon surface originating from a good reform-like initiative which we will get more information about in mid-August. Every second year the government publishes a „negative list" stating the maximum foreign ownership of Philippine companies.

***Graphic 1*:**

GOVERNMENT DEBT AS PCT. OF GDP



Source: FRED, Fed St. Louis, USA

Probably the allowed maximum foreign ownership of Philippine telecommunications companies increases from 40 to 70 pct. From different stakeholders it is voiced that this sector is characterized by inefficiency and in particular the bad internet infrastructure across the country being a major issue. If the government wishes to increase foreign ownership in the telco sector the potential new investors will focus on expanding the data infrastructure right away.

However, the most constructive reform is the tax and VAT reform shortened to CTRP. The government claims that 83 pct. of all ordinary taxpayers do not have to pay income taxes in the future. For example, the many employees in call centres are expected to be below the threshold for income taxation. These employees represent the growing middle class – not many countries in the world can say that even a part of the middle class is exempted from paying income tax. The reform means that only the highest incomes will experience increased tax payments. As mentioned, I argue that there are still uncertainties about financing the reform but there is no doubt that the reform also increases GDP growth.

The ambitious growth plans makes me focus on the Philippine Central Bank (Bangko Sentral ng Pilipinas) with excitement – will the central bank show strong independence and react with a monetary policy tightening?

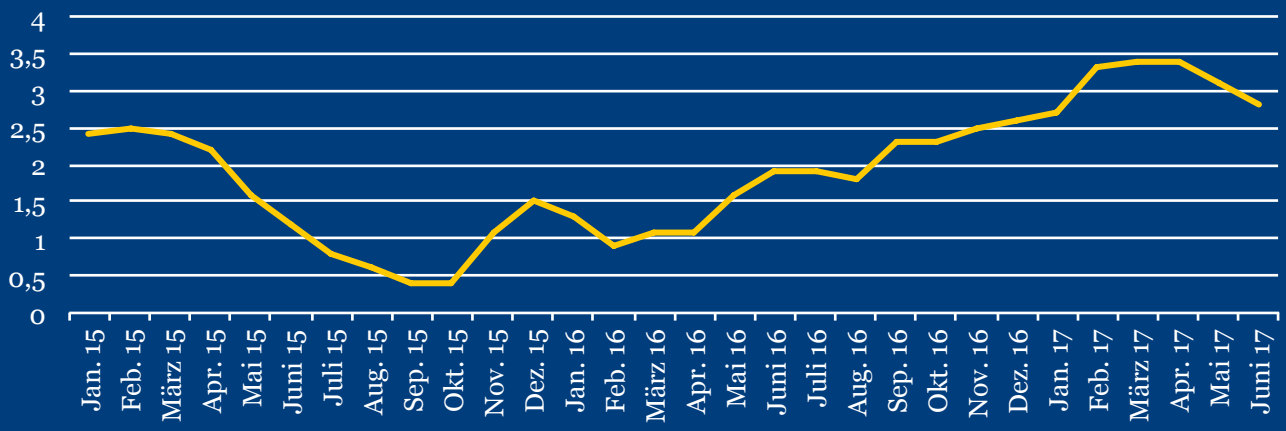
Since the beginning of the year, several economists have predicted that the central bank would raise interest rates twice in 2017. In line with many other emerging market countries, Bangko Sentral ng Pilipinas has chosen to keep calm despite that the U.S. central bank Fed is in a sort of a hiking cycle. It is in itself a monetary easing that the peso has dropped in value which comes on top on the expected heavy public spending via infrastructure investments and the tax reform. This cocktail can make any economy running too hot, and it can happen pretty fast indeed.

Therefore, it would add to the confidence among international investors if the central bank raised interest rates twice in the second half of this year. It is not sufficient that the inflation is back at a relatively low level (graphic two) because it is just a function of global inflation developments.

The rate hikes will generate some volatility in the Philippine stock market, though I do not expect it to result in a negative return for the second half of the year. On the contrary, the growth case in the Philippines is strong which will attract investors. Personally, I am upbeat on the outlook. Further, my expectation is that two interest rate hikes will not weaken domestic growth in the Philippines at all and at the very least it will stabilise the peso. I even consider it likely that the peso will increase by approximately four pct. towards the U.S. dollar before the coming New Year. By reversing the trend for the sliding peso, the central bank would create a further monetary policy tightening as a response to the very ambitious growth plans. This kind of monetary policy leadership always confirms the responsible and independent position of any central bank – and it secures the trust in the local financial market.

***Grafik 2*:**

PHILIPPINE - YEARLY INFLATION IN PCT.



Source: Philippine Statistics Authotity

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