Abstract (summary)

As recently as 2008, the economies of Southeast Asia received roughly less than half as much foreign direct investment as China did. Four years later, in 2012, they pulled to within spitting distance ($111 billion versus $121 billion). This surge in international interest reflects the region's attractive demographics and, even more so, its impressive recent economic performance. Giant Indonesia soared during the last half decade, boasting high growth, low inflation, an extremely low debt-to-GDP ratio, strong foreign exchange reserves, and a top-performing stock market. But it is the Philippines, the region's other archipelago, that is now providing the biggest upside surprise. The Philippine economy expanded by 6.6% in 2012, exceeding most economists' predictions, and was among the fastest-growing economies in the world in the first half of 2013, expanding by 7.6%. The Philippines enjoys some of the same strengths as Indonesia. With the second-largest population in ASEAN, at 106 million, the Philippines has also enjoyed consumption-led growth and similarly benefits from high domestic demand.

Full Text

As recently as 2008, the economies of Southeast Asia received roughly less than half as much foreign direct investment as China did. Four years later, in 2012, they pulled to within spitting distance ($111 billion versus $121 billion). This surge in international interest reflects the region's attractive demographics and, even more so, its impressive recent economic performance.

The ten countries of the Association of Southeast Asian Nations (ASEAN) represent a collective market of 620 million people, significantly larger than that of North America, Latin America and the Caribbean, the eurozone, or the Middle East and North Africa. They are home to a young, large, and growing labor pool, as well as a growing and increasingly consumption-oriented middle class. The ASEAN countries posted a
combined GDP of over $2.2 trillion in 2012—larger than Russia's GDP and almost the same size as Brazil's—and many economists expect that number to double by 2020. ASEAN's five core countries—Indonesia, Malaysia, the Philippines, Singapore, and Thailand—have been growing as fast as any other regional grouping in the world over the past five years.

Impressive as this pack has been, two of its members have stood out as particularly promising. Giant Indonesia soared during the last half decade, boasting high growth, low inflation, an extremely low debt-to-GDP ratio, strong foreign exchange reserves, and a top-performing stock market. But it is the Philippines, the region's other archipelago, that is now providing the biggest upside surprise. The Philippine economy expanded by 6.6 percent in 2012, exceeding most economists' predictions, and was among the fastest-growing economies in the world in the first half of 2013, expanding by 7.6 percent. (Despite the destruction of Typhoon Haiyan, which had just ravaged the country as of this writing, the Philippines' growth rate for all of 2013 is expected to remain above 6.5 percent.) The Philippine Stock Exchange Index has posted record highs since President Benigno Aquino III came into office in 2010, and approvals for foreign investment have more than doubled in that period. The country's inflation is low, its foreign exchange reserves are high, and its public debt is steadily declining. As a result, all three of the major credit-rating agencies upgraded Philippine sovereign debt to investment grade in 2013: the first such rating in the country's history.

Past performance, however, is not necessarily indicative of future prospects. So what is to be expected of these two island nations in the years ahead?

JAKARTA'S STRAITJACKET

Indonesia, with more than 250 million citizens, isn't just the largest country in ASEAN; it is the fourth largest in the world. Thanks to abundant natural resources, a massive domestic market, and solid macroeconomic policymaking, it has grown by more than five percent a year on average for more than a decade. In the five years leading up to 2011, it more than doubled its exports (from $84 billion to $204 billion), and many experts started calling for it to be added to the BRICS group of major emerging markets. Today, however, the picture looks far less rosy. Indonesia's current account went into deficit in the fourth quarter of 2011, its trade balance followed suit the following spring, and the rupiah was one of Asia's worst-performing currencies in 2012, with its value dropping by almost six percent. Those trends accelerated in 2013, as the country's trade and current account deficits ballooned and as the rupiah slumped still further. Indonesia quickly went from being hailed as a new economic superstar to being dubbed by Morgan Stanley as one of the world's "fragile five" countries, owing to the vulnerability of its currency to foreign capital outflows. The weak rupiah is raising the cost of imported goods, exacerbating inflationary pressures, and eroding Indonesian purchasing power—significant factors for an economy whose growth is overwhelmingly consumption-driven.

Some of these problems can be attributed to the retreat of capital from emerging markets in anticipation of changes to the U.S. Federal Reserve's policy of quantitative easing. But Indonesia's currency and stock market were hit far harder than those of its peers in mid-2013, and Indonesia did not recover as quickly when the Federal Reserve ended up keeping its foot on the stimulus pedal last fall. Investors correctly saw Indonesia's deficits as symptomatic of broader structural imbalances in the country's economy, and they remain concerned that Jakarta has no strategy for responding to its numerous challenges.

Among these are the fact that Indonesia's export sector is overly dependent on commodities, a handful of which, including coal, rubber, palm oil, and mineral ores, account for over 50 percent of the country's exports. Indonesia was a major beneficiary of the commodities boom between 2009 and 2011, when revenues for key resources rose exponentially. But those same commodities experienced precipitous price
drops throughout 2012 and 2013, and prices are expected to remain low for some time. The decline in prices has largely been a function of decreased demand from China, yet increases in supply have also played a role, due to the proliferation of small miners in Indonesia who get licenses at the local level.

The biggest source of Indonesia's recent problems, however, has been its shrinking exports of oil and gas, thanks to declining production and rising consumption at home. Indonesia has been a net importer of refined oil since 2004, but for most of the years thereafter, it has remained a net exporter of crude oil and natural gas. In 2013, however, Indonesia experienced huge crude oil deficits, and the revenue it took in from exporting surplus domestic gas also dropped dramatically. The declines in crude oil production and natural gas exports highlight the problems that plague Indonesia's energy sector, including regulatory uncertainty, corruption, and a trend toward criminalizing commercial disputes. Rising resource nationalism has also paralyzed a number of major oil and gas projects, as the government and powerful domestic business interests have tried to squeeze foreign contract holders. With a young and growing middle class, Indonesia will have to either improve its investment climate in order to increase production at home or else be condemned to an ever-greater reliance on imported energy.

Manufacturing, meanwhile, has also fallen behind: exports of electrical appliances, iron and steel, chemicals, cars, auto parts, and computers all declined in the first nine months of 2013 compared with the same period in 2012. At the same time, Indonesia has started importing significantly more of just about everything, especially oil and gas. Indonesia's fuel subsidies are among the highest in the world, which encourages profligate consumption. And as the rupiah weakens, the import bill is going up.

The absence of sufficient domestic processing capability to make refined fuels and petrochemicals represents another structural problem. Indonesia needs 1.3 million barrels of refined crude oil per day, but its existing refineries produce only 770,000 barrels a day. Meanwhile, Indonesia’s failure to attract the investment necessary to expand value-added manufacturing and processing industries at home has left the country increasingly dependent on a growing range of imports. From 2007 to 2012, for example, imports of textiles, electrical appliances, iron and steel, chemicals, cars, auto parts, computers, fertilizers, processed food, and feed increased significantly. Indonesia is going to have to learn how to make much more of what it needs at home if it is to turn its rapidly growing consumer class into an economic opportunity rather than a burden.

Indonesia needs domestic investment not just to correct its growing imbalances but also to create more and better-quality jobs. With over half the population now under the age of 30, the proportion that is of working age will rise significantly over the next decade. Attracting job-creating investments in manufacturing will require a more flexible labor regime, improved infrastructure, lower transportation costs, education reform, and more legal and policy certainty.

Jakarta is starting to make headway on some elements of this agenda, specifically allocating more of its budget to infrastructure spending, passing needed eminent domain laws to accelerate infrastructure projects, and bringing a growing number of corruption cases against powerful politicians and officials. The government has also made progress on reducing the overall level of poverty. But after years of complacency on economic reform, fed by the commodities boom and easy credit, the government now faces a long to-do list. With legislation and presidential elections looming in 2014, however, leadership is in short supply, nationalism and populism are on the rise, and the appetite among the major political parties for reform appears limited. This suggests a period of stagnation and further backsliding is ahead, at least until a new administration takes office in October 2014.

THE THRILLA IN MANILA
The Philippines enjoys some of the same strengths as Indonesia. With the second-largest population in ASEAN, at 106 million, the Philippines has also enjoyed consumption-led growth and similarly benefits from high domestic demand. Thanks to reforms put in place after the 1997-98 Asian financial crisis, the Philippines, like Indonesia, has a strong banking system, with large amounts of capital on hand and a low incidence of loans in default. Respected technocrats run key economic portfolios in both countries and produce sound macro-economic management.

The two economies also share many of the same challenges. They are both vulnerable to severe natural disasters. They have low tax-to-GDP ratios, limiting government revenue. They both suffer from inadequate infrastructure, high logistical costs, and rigid labor regimes, which have restricted the expansion of their manufacturing sectors. The Philippines' exports are nearly as dominated by electronics as Indonesia's are by commodities, and shipments of electronic components and semiconductors, which account for over 50 percent of Philippine exports, have slumped due to a drop in global demand. As a result, the Philippines has run a substantial trade deficit in recent years.

Unlike Indonesia, however, the Philippines' current account has been in surplus since 2003, ending an era of perennial balance-of-payments crises. Indeed, the Philippines' current account surplus exceeded that of the rest of Asia in 2012 and is projected to keep growing. This success is the result of two key factors: the substantial flow of remittances from the more than ten million Filipinos working abroad and a dramatic expansion in the Philippines' service sector, thanks to huge growth in business-process outsourcing.

A high birthrate and a lack of jobs at home has for years sent millions of Filipinos to look for work abroad. Almost ten percent of the population now lives overseas, and remittances from this group, which represent nine percent of GDP, have grown by double-digit rates since 2002. With the working-age population forecast to expand for the next 50 years, the outflow of people will continue, as will the money they send home. These remittances help keep consumption up, especially among the poor and the unbanked, and they are among the sources of foreign exchange least sensitive to economic shocks. During the Asian financial crisis, for example, remittances helped stabilize capital flows and shield the peso from depreciation. Similarly, the peso fell by only five percent in 2013, while the rupiah dropped by 18 percent.

Another distinctive feature of the Philippine economy is the large role of the service sector, accounting for 57 percent of GDP in 2012. The Philippines is now the second-largest center of business-process outsourcing in the developing world, after India. The industry is estimated to have created about 800,000 jobs, originally mostly in lower-end call centers but increasingly also in fields such as engineering, medicine, and accounting. The government deserves credit for facilitating this growth through investments and fiscal incentives.

Still, the Philippines continues to struggle on a number of key fronts. High economic growth has yet to translate into more jobs and less poverty. Unemployment has stubbornly remained above seven percent—higher than in any other core ASEAN state—for the past six years, and underemployment has stood at roughly 20 percent during the same period. With over one million Filipinos entering the labor force each year, the service sector alone cannot absorb them all, especially since the manufacturing and agricultural sectors have been shedding jobs. No surprise, then, that poverty has barely declined in recent years or that the country's per capita GDP is the lowest among ASEAN's core five.

To reverse these trends, the country has to create jobs for semi- and unskilled workers in manufacturing and agriculture. But doing that, in turn, will require attracting more foreign investment, which for the Philippines is currently among the lowest in Asia, reaching only $2 billion in 2012 (compared with the $20 billion that went to Indonesia).
Investment in the Philippines has stayed so low because the country's economy remains one of the most restrictive in the world, with constitutional provisions limiting foreign ownership of Philippine companies to 40 percent in a broad range of sectors. Manila must address this problem, as well as regulatory bottlenecks, infrastructure shortcomings, and confusion about the overall direction of its economic policies. The land reforms that were passed during the administration of the current president's mother, Corazon Aquino, for example, have not had their intended effect, as uncertainty over property rights has limited investment in the agricultural sector. The Philippines is one of the most mineral-rich nations on earth. However, policy flip-flops have ground mining investment to a halt, and infrastructure projects have suffered a similar fate.

Manila's to-do list, then, is nearly as long as Jakarta's. But whereas Indonesia has not passed any meaningful reforms in nearly a decade, the Philippines, under Benigno Aquino III's bold leadership, has taken real steps to address some of its challenges. In the first three years of his six-year term, Aquino has been relentless in fighting corruption and has implemented reforms to improve transparency and efficiency in government spending and tax administration. Despite fierce opposition from the Catholic Church, he won passage of a landmark reproductive health bill to help the country's poor gain access to birth control. He liberalized the aviation industry by adopting an "open skies" policy, enabling the entry of long-prohibited foreign carriers and giving the Philippines' underperforming tourism industry a boost. He has challenged vested business interests by passing a sin tax on tobacco and alcohol to reduce the overall consumption of these products and to improve government finances, implemented a conditional cash-transfer program to provide a social safety net for the poor, and expanded access to education and health care. On the political side, he reached a framework agreement for a new peace deal with the country's largest insurgent group. For these and other reasons, Aquino enjoys unprecedented popular support for a president halfway through his presidency, as shown by his coalition's decisive victory in the May 2013 midterm elections. The president is also well received abroad: his record has earned the Philippines significantly improved scores on a number of global surveys. During his tenure in office, the Philippines has moved up 26 spots on the World Economic Forum's Global Competitiveness Index. The Philippines beat Indonesia on Transparency International's 2012 Corruption Perceptions Index, moving up 24 spots (to 105); Indonesia fell 18 spots (to 118). And the Philippines jumped 30 notches on the World Bank's 2014 Ease of Doing Business Index, reversing years of decline and again surpassing Indonesia.

As a result of these improvements, the Philippines is well placed to withstand the expected return to volatility in global capital and equity markets when the U.S. Federal Reserve ends its quantitative easing in 2014 (as it is expected to do). The Philippine central bank will have significantly more leeway than its Indonesian counterpart, for example, to maintain a flexible monetary policy and to take measures to spur growth. Although the Philippines is unlikely to continue booming at the pace it managed in early 2013, which was driven in part by election-induced stimulus measures, growth is expected to remain above six percent in the coming years. (Typhoon Haiyan may impact this forecast.) By contrast, the World Bank and the International Monetary Fund have significantly downgraded Indonesia's 2013 and 2014 growth forecasts, to just over five percent. THE REFORM IMPERATIVE

Indonesia's many strengths, including its size, natural resource wealth, strategic location, consumer-driven economy, and resilient financial system will continue to attract investment and bolster the country's economic prospects in the years ahead. But the next president will need to return to a path of reform if Indonesia is to retain its competitive edge.

The Philippines, on the other hand, has momentum behind its reform efforts and a popular president with three years left in his term. This provides a compelling platform for growth moving forward. But to make the most of the country's opportunities, Aquino will first need to manage the humanitarian disaster
wreaked by Typhoon Haiyan as quickly, efficiently, and compassionately as possible. Then, he will need to push forward with structural reforms, especially constitutional changes necessary to promote foreign investment. The president has shown little enthusiasm for this project thus far, but a range of forces, especially the evolution of public opinion, may well push him toward change.

All major business groups now support the relevant constitutional amendments, reflecting a change in the country’s political economy, as Filipino oligarchs now feel that they have more to gain than lose from the introduction of new foreign capital and competition. The shift in opinion on liberalizing the economy also reflects public support for the Aquino administration’s decision to draw closer to Washington, a result of Manila’s strained relations with Beijing over maritime boundary disputes. Support is growing among Filipino elites for joining the U.S.-led Trans-Pacific Partnership, a regional free-trade agreement that would also help open up the Philippine economy. This stands in stark contrast to Indonesia, where no constituency speaks in favor of joining the TPP and where the polity as a whole is turning more nationalist and increasingly favoring protectionism.

In the end, it may be this evolving public consensus in favor of openness and transparency that provides the most promise in the Philippines. Revelations in late 2013 that legislators had siphoned off huge sums of pork-barrel funds for personal use and that the office of the president had also misused discretionary funds sparked a public outcry so strong that Aquino may have to go even further than intended in fighting corruption in order to maintain his moral authority.

If he does, the president could leave his country with an impressive and lasting legacy—unlike the outgoing Indonesian president, Susilo Bambang Yudhoyono, who will leave behind nearly a decade of missed opportunities to advance economic and political reform when he steps down in 2014.

Sidebar
Up, up, and away: the Philippines’ stock market, Manila, May 2013

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