

November 21, 2016

Losing the Philippines: Part 1

(There will be no report published over the Thanksgiving holiday. Part 2 of this report will be issued on December 5.)

In May, Rodrigo Duterte was elected president of the Philippines, winning 39% of the vote. He is the first resident of the island of Mindanao to hold the office, making him a political outsider. An unconventional political figure, he is considered populist in the mold of Turkish leader Recep Erdogan or Indian PM Narendra Modi.

Although Philippine economic growth has been generally strong, with per capita real GDP rising 4.2% last year, the general feeling was that only the political elites were benefiting from the growth. Crime and poor infrastructure were the primary concerns of the election and Duterte promised to address both of these issues.

In fact, on the former, Duterte has unleashed a crackdown on drug dealers¹ with such fury and lack of due process that he has been facing criticism from the West. Duterte's response has been to vigorously² reject these charges and, in general, opinion polls suggest the policy is popular with the general public.

¹ Some 4,800+ have been killed so far. See: https://en.wikipedia.org/wiki/Philippine_Drug_War.

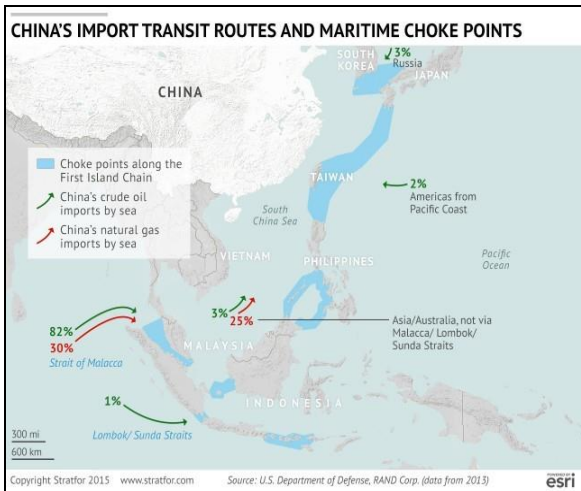
² He described President Obama in derogatory terms, leading to the cancellation of a one-on-one meeting. See: <https://www.washingtonpost.com/news/worldviews/wp/2016/09/06/the-son-of-whore-story-is-about-so-much-more-than-dutertes-dirty-mouth/>.

Perhaps the most controversial action Duterte has taken has been to embrace China and reject its long-standing ally, the United States. If this rupture in relations continues, it will significantly change regional geopolitics.

In Part 1 of this report, we will begin with an examination of the geography of the Philippines, discussing its geopolitical importance. From there, we will offer a history of U.S./Philippine relations. In Part 2, we will use this history to discuss Duterte's recent foreign policy moves. It does appear that Duterte is moving his country to at least a neutral stance and downgrading the American relationship. If true, it would seem that one of the signature foreign policy goals of the Obama administration, the "pivot" to Asia, has essentially failed. We will conclude with the potential impact of Duterte's actions and their prospective effects on financial markets.

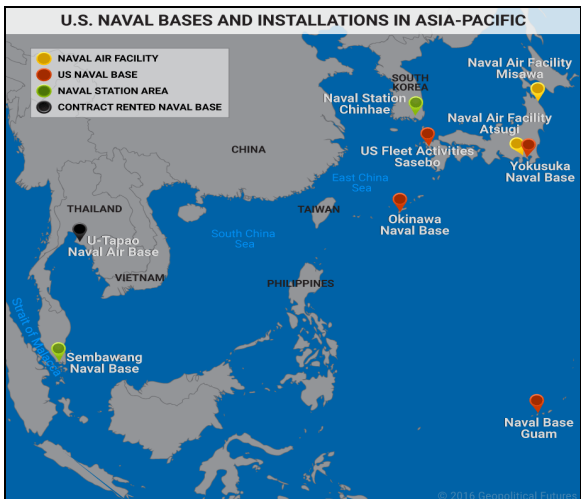
Geopolitics of the Philippines

The Philippines is part of the first island chain that surrounds China.



(Courtesy of Stratfor.com)

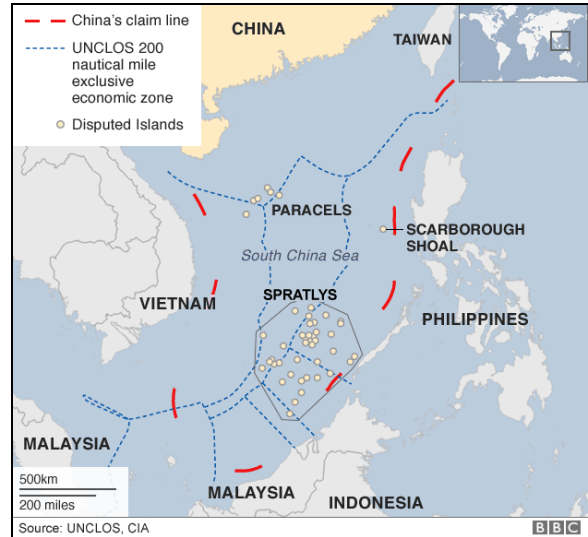
The map above shows the key chokepoints for shipping in the Far East. As shown on the map below, the U.S. has the Sembawang Naval Base near the Strait of Malacca which, in case of an American blockade, would force shipments on the way to China well into Indonesia. Even if they got past U.S. interdiction, U.S. control of the waters around the Philippines, Taiwan and Japan means the U.S. could likely close off most shipping to China.³



(Used with permission from *Geopolitical Futures*, <http://geopoliticalfutures.com/the->

³ Similar fears led Japan to bomb Pearl Harbor in 1941.

philippines-role-in-us-strategy/



(Source: UNCLOS, CIA)

This chart shows the competing claims in the South China Sea. China has claimed the “nine-dash line” that virtually controls all the waters in the area, including Scarborough Shoal, which has also been claimed by the Philippines.

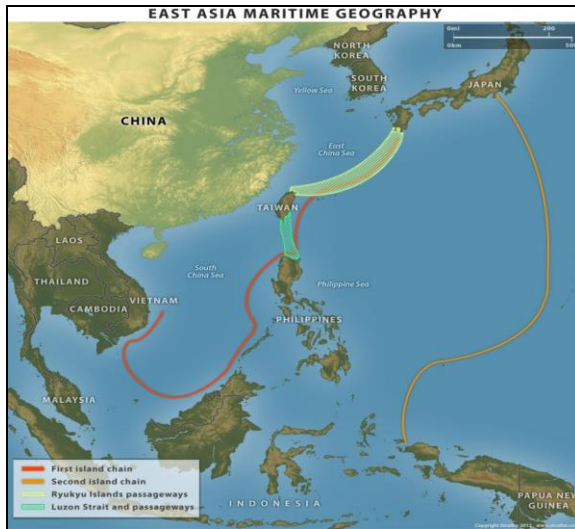
China’s Navy⁴ took effective control of the shoal in 2012. In response, the Philippines, under Duterte’s predecessor, Benigno Aquino III, sued in the Permanent Court of Arbitration at The Hague. In July, the court returned its verdict, strongly rejecting China’s claims of the nine-dash line and ruling in favor of the Philippines.⁵ China was furious about the outcome of the trial and vowed to ignore it. As with most international law, there is no enforcement mechanism (unless, of course, the U.S. decides to intervene), therefore winning in court was more of a moral victory. On the other hand, it made China look bad and

⁴ Officially, the People’s Liberation Army-Navy, or PLAN.

⁵ <http://www.nytimes.com/2016/07/13/world/asia/south-china-sea-hague-ruling-philippines.html>

would likely lead other nations to take similar steps, further weakening China's image.

Although the U.S. pivot to Asia is not officially about containing China, it is generally accepted (and rather obvious) that the U.S. intends to use the island chains to prevent China from becoming a true "blue water" navy.



(Courtesy of Stratfor.com)

As this map shows, the Philippines are a critical element of the first island chain. Thus, keeping this island nation as an ally is an important goal for the U.S.

A Short History

Although human history in the Philippines is long (it's estimated that the first known human settlement was 67,000 years ago), our focus will be on the period of American involvement. The U.S. first became involved in the Philippines as part of the Spanish-American War. This war against Spain began in 1898 with its primary theater in the Caribbean.⁶ Prior to that war, in 1896,

⁶ One of the geopolitical imperatives for the U.S. was to secure the Port of New Orleans. Without clear control of that port and surrounding waters, the massive Mississippi/Missouri/Ohio River system that

the Philippine revolution against Spanish rule was already underway. The Spanish-American War did spread to the Philippines, where the U.S. decisively defeated the Spanish Navy in the Battle of Manila Bay. Philippine rebel groups initially supported U.S. actions and increased their attacks on Spanish forces. By June 12, 1896, the rebels, who controlled nearly all the land area of the Philippines except Manila, declared independence. Neither the U.S. nor Spain recognized the rebel government.

The Treaty of Paris in 1898 ended the Spanish-American War and led Spain to cede Cuba, the Philippines and other territories to the U.S. The independent Philippine government objected to the treaty and tensions rose. American forces controlled Manila, while the countryside was in the hands of various rebel groups. By February 1899, war had broken out between U.S. and Filipino forces, marking the beginning of the Philippine-American War. In June, the independent government of the Philippines formally declared war on the U.S. American forces prevailed and the conflict officially ended on July 2, 1902, although insurgent groups continued to fight well into 1913 with the last of the insurgents surrendering on the island of Mindanao.

The U.S. was conflicted over its new imperialist position. The founding of the U.S. was based on the desire for independence from a colonial power and so gaining colonies itself was troubling. On the

allowed for the material bounty of the American Midwest could not have been easily used for shipping to other parts of the U.S. and the world. That's why Gen. Andrew Jackson routed the British forces there despite the treaty that ended the War of 1812, and also why Spanish control of Cuba was a problem. Simply put, hostile control of Cuba put the security of this key port at risk. Thus, gaining control of Cuba was critically important.

other hand, as noted above, the Philippines are a geopolitical prize. If the U.S. had not taken control, it is highly likely that European powers or Japan would have moved to overthrow the nascent Philippine government. Faced with that prospect, the McKinley administration reluctantly decided to take control of Philippine territory. However, given America's history, the U.S. steadily moved to create conditions that could grant the country its independence.

The process toward independence accelerated during the Great Depression as labor unions and sugar interests did not want to compete with Philippine low labor costs or cheap sugar. In 1933, Congress passed (over President Hoover's veto) the Hare-Hawes-Cutting Act, which started the process of independence. However, the Philippine legislature rejected the proposal, opposing parts of the bill that gave the U.S. control of naval bases in the Philippines. Under the Roosevelt administration, the Tydings-McDuffie Act established the Commonwealth of the Philippines, which gave the country its own constitution and self-governing legislature, although foreign policy would remain under the U.S. After a decade, the Philippines would be granted independence. This bill was approved.

The move to independence was interrupted by Imperial Japan's attack on the U.S. in 1941. Ten hours after the assault on Pearl Harbor, Japan launched a surprise attack on Clark Air Base. Over the next year, Japan took control of the Philippines as Gen. Douglas MacArthur declared Manila an "open city" to prevent its destruction. Japan declared the Philippines independent in 1943; however, it should be noted that an effective insurgency of U.S. and Filipino forces prevented Japan from ever gaining complete control over the islands. In October 1944, MacArthur backed up his

famous vow of "I will return" that he had made in 1943 as Allied forces began the Philippines Campaign. The Battle of Leyte Gulf was the largest naval battle in history as the Allied and Imperial Japanese navies squared off in what was to be the beginning of the liberation of the Philippines. Fighting on the islands of the Philippines continued until the end of WWII.

In April 1946, elections were held for the first president of the Philippines. Manuel Roxas won. The U.S. formally relinquished sovereignty on July 4, 1946. However, the economy remained dependent on the U.S. for reconstruction and, in order to secure this support, the new government granted 99-year leases to the U.S. on a number of military bases. In 1951, the U.S. and the Philippines agreed to a mutual defense treaty; this allowed the latter government to rely on American defense for its security, allowing it to focus on other issues.

Since independence, there have been several peaceful transitions of power, with five different presidents ruling the country until Ferdinand Marcos won the office in 1965. He was the first president to win reelection, gaining a second term in 1969. Rising unrest, a communist insurgency and the emergence of the Moro National Liberation Front, which wanted an independent Muslim nation on the island of Mindanao, led Marcos to declare martial law in 1972. He ruled by decree and maintained martial law until it was officially ended in January 1981. New elections were held but the opposition, crippled by arrests during the martial law era, boycotted the election. Marcos won handily and was given a six-year term under terms of the new constitution.

In 1983, following the assassination of opposition leader Benigno Aquino, Jr., popular dissent rose. The U.S. raised

pressure on Marcos to hold elections, which occurred in February 1986. Marcos was declared the winner but poll watchers reported massive voter fraud. The Philippine military and the U.S. withdrew its support for Marcos, who was forced to flee. Aquino's widow, Corazon, became the new president. Corazon created a new constitution with six-year presidential terms. Duterte represents the sixth transition of power.

As the Cold War ended, growing dissatisfaction over the extensive U.S. military presence led to the decision to force the U.S. to abandon its bases in the Philippines in 1991. Filipinos felt the bases were an intrusion on sovereignty and, with the communist threat mitigated, the U.S. was willing to give up the facilities.

The reduced presence of American military power and the growing strength of China have led the latter to claim greater sovereignty in the region, based on the above "nine-dash" map. China has been engaging in a "land grab" across the South China Sea, taking control of outcroppings and shoals, expanding them and building military installations. The PLAN lacks that

capacity for operations far from shore. But, these bases act as substitutes for this projection of power.

In response, as noted above, the Benigno Aquino III administration filed a complaint at The Hague, claiming that China had encroached on its territory by taking control of the Scarborough Shoal. In addition, in 2014, the U.S. and the Philippines agreed to the Enhance Defense Cooperation Agreement (EDCA). This agreement gave the U.S. permission to occupy and use eight military bases. The U.S. agreed to support anti-insurgent training and to participate in joint military exercises. As evidence of the unpopularity of this action, Aquino passed the agreement via executive order, apparently fearing it wouldn't survive a vote in the legislature.

Part 2

In the next report, we will examine the behavior of President Duterte, discuss the consequences of losing the "pivot to Asia" and conclude with market ramifications.

Bill O'Grady
November 21, 2016

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