Philippines

Buoyant private consumption and a rebound in government spending drove strong economic growth in 2012. A rise in net exports also contributed to GDP growth. Robust expansion is projected over the next 2 years, based on buoyant consumption and an improvement in investment. Inflation is moderate and expected to remain so. The challenge is to translate solid economic growth into poverty reduction by generating more and better jobs.

Economic performance

Sustained growth in private consumption, a recovery in government spending, and positive net exports lifted GDP growth to 6.6% in 2012, or 4.8% in per capita terms. Inflation eased to a 5-year low, and external accounts were healthy.

Private consumption rose by 6.1% and contributed the most to GDP growth from the expenditure side (Figure 3.28.1). Buoyant consumption was driven by higher remittances from overseas Filipino workers, a slight gain in employment, and low inflation. Remittances increased by 6.5% to $23.4 billion (up by 3.8% in strengthening Philippine pesos).

Government spending rebounded from the low levels seen in 2011, when governance reforms slowed budget disbursements. Higher spending on public infrastructure, alongside expansion in private construction and investment in equipment, pushed up fixed capital investment by 8.7% (Figure 3.28.2). Growth in investment was supported by improvements in the domestic business environment and declining interest rates. Fixed investment as a ratio to GDP edged up in 2012 but was still modest at 19.7%. A rise in net exports also contributed to growth, in contrast with 2011, when net exports fell.

From the production side, the service sector, accounting for over half the economy, remained the dominant growth driver. Its growth accelerated to 7.4%, which contributed nearly two-thirds of GDP growth. Retail trading accounted for one-fourth of services’ growth, consistent with robust private consumption. Other key subsector contributors were finance and real estate services, business process outsourcing (BPO), and those associated with tourism.

Industry’s performance improved last year. Manufacturing expanded by 5.4%, with strong growth in food processing in particular. However, the communications equipment subsector, which includes semiconductors, shrank owing to weak export demand. Construction and utilities expanded, so that industry as a whole accounted for one-third of GDP growth. Agricultural output rose by 2.7%, mainly a result of higher production of rice and maize.
Notwithstanding strong GDP growth, inflation eased in 2012 to average 3.2% (Figure 3.28.3). Better harvests tempered food inflation. Broadly stable global commodity prices and an appreciating peso helped to contain price pressures.

Modest inflation and the fragile international economy prompted Bangko Sentral ng Pilipinas, the central bank, to reduce policy interest rates by 100 basis points in 2012, trimming the overnight borrowing rate to 3.5% and the overnight lending rate to 5.5%. Bank lending interest rates eased and credit extended to the private sector increased by 17.8%.

Government spending on infrastructure jumped by 58%, after a decline of 29% in 2011 (Figure 3.28.4), but it still fell short of the budget target. Under-spending of budgeted allocations held the fiscal deficit to 2.3% of GDP (Figure 3.28.5), below the programmed level but a slightly wider deficit than in 2011. The ratio of tax revenue to GDP improved to 12.9%, though it, too, did not meet the government’s target.

External accounts were in good shape. Merchandise exports rose by 8.5% in US dollar terms, a turnaround from a 6.3% fall in 2011. This recovery was driven largely by higher shipments of machinery and transport equipment, wood manufactures, furniture, fruit and vegetables, processed food, and beverages. Shipments of electronics continued to fall, though at a slower pace than in 2011. Imports grew by 5.1% in value so that the merchandise trade deficit narrowed by 5.3% to $14.8 billion. Trade in services produced a smaller surplus than in the previous year. After taking into account the substantial remittance inflows, the current account surplus rose slightly to $7.2 billion, equivalent to 2.9% of GDP (Figure 3.28.6).

Portfolio investment inflow rose by 14.9% to $4.7 billion and foreign direct investment by 9.8% to $2.0 billion—still low compared with other Southeast Asian countries. The overall balance of payments recorded a surplus of 3.7% of GDP, lifting gross international reserves to $83.8 billion at year-end. Reserves cover 12.0 months of imports and 10.5 times short-term external debt.

Remittances and capital inflows buoyed the peso, which appreciated by 6.6% against the US dollar to its highest rate in 5 years. In other financial markets, the Philippine Stock Exchange index climbed by 33% in 2012 to a record high; capital raised through the exchange doubled from 2011. Spreads narrowed between Philippine government bonds and US treasuries.

Economic prospects

The forecasts assume that the government makes further progress on reforms to improve the investment climate and that legislative elections in May 2013 go smoothly.

Private consumption is expected to remain a key driver of growth, underpinned by remittances and positive consumer sentiment (Figure 3.28.7). These transfers from overseas Filipinos have accelerated since the second half of last year. The number of deployed overseas workers in 2012 rose by 6.7%. Domestic employment is projected to increase this year, and election-related spending will lift consumption in the first half of 2013.
As for private investment, a survey of businesses in February 2013 showed they were optimistic (Figure 3.28.7) and planned to increase hiring. Imports of capital goods rose by 14% in 2012, a sign of positive business sentiment. Bank lending for production rose by 15.2% in February 2013 from a year earlier (Figure 3.28.8), and the buoyant stock market has facilitated corporate expansion.

For the first time, the country achieved an investment grade credit rating in March 2013, bolstering the investment climate. Fitch raised its sovereign rating on long-term foreign-currency denominated debt to BBB– from BB+. It cited the Philippines’ strong external balance sheet, resilient economy, improved fiscal management, and decline in government debt relative to GDP.

Fiscal spending will support economic growth, although not to the extent seen in 2012 when it rebounded from low levels. Government spending is programmed to rise by 13% in 2013, excluding interest payments. Reforms to speed up budget spending are making progress. Revenue is benefiting from higher taxes on tobacco and alcohol, effective January 2013, which will contribute to the goal of reining in the budget deficit to 2.0% of GDP in 2013–2016.

Robust consumption and investment and election-related spending bode well for expansion in the service sector. The BPO subsector is projected to grow by about 20% annually through 2016. The government is targeting large increases in tourist arrivals, from 4.3 million last year to 10.0 million by 2016. To support that aim, it is investing in tourism-related infrastructure and encouraging the expansion of air services.

Growth in manufacturing production quickened in the second half of 2012, and exports of semiconductors turned up late in the year. Construction is expected to maintain solid growth. High demand for housing and office space is spurring private construction, supported by low interest rates. The government has raised its budget for infrastructure in 2013 and a program to create public–private partnerships for infrastructure development, which started sluggishly, is gathering some momentum.

A projected pickup in exports of electronics will contribute to growth in merchandise exports in 2013. Rapidly growing Southeast Asian markets now buy 19% of the Philippines’ exports, up from 13% in 2008. However, robust domestic demand suggests that imports will be considerably higher, so that net external demand weighs on GDP growth this year.

On the balance of these factors, GDP growth is forecast at 6% for this year, with a similar pace anticipated in 2014 (Figure 3.28.9). Growth in remittances and services exports will contribute to current account surpluses of around 3% of GDP.

Inflation is seen edging up to a moderate 3.6% this year owing to robust domestic demand and the higher taxes on tobacco and alcohol. These tax hikes added 0.5 percentage points to inflation recorded at 3.2% in the first 3 months of 2013. The firm peso and soft global commodity markets are expected to offset part of the upward pressure on prices generated by strong domestic demand in 2014, containing inflation to a forecast 3.8% (Figure 3.28.10). Inflation at these rates would be well within the central bank’s target range of 3%–5%, giving it the option of keeping policy interest rates accommodative to growth.
Concerned about risks associated with volatile capital flows, the monetary authorities last year moved to curb speculative inflows by prohibiting deposits from nonresidents in its special deposit account facility and cutting interest rates on these accounts. They also imposed a higher capital requirement for banks’ holdings of non-deliverable forwards, which could be used for speculative purposes, and tightened rules governing these instruments. The central bank strengthened its oversight of bank lending for real estate to more closely monitor the impact of capital inflows. Bank balance sheets remain healthy overall: capital adequacy ratios are well above the 10% minimum statutory requirement (16.9% for universal and commercial banks in June 2012), and nonperforming loans are in the low single digits.

The government’s credibility as an instrument advancing reform has been enhanced by the higher excise taxes on alcohol and tobacco, which will help to fund health care for the poor, and the passage of the Responsible Parenthood and Reproductive Health Act. Governance reform, too, has made progress, though much remains to be done. The 2012 Transparency International Corruption Perceptions Index ranked the Philippines 105th of 176 countries, still low but above Indonesia and Viet Nam, which had been ahead of the Philippines in 2011.

In its Global Competitiveness Report 2012–2013, the World Economic Forum elevated the Philippines by 10 places last year, to 65th of 144 economies, with marked improvement in terms of the macroeconomic environment. However, the country remained behind Malaysia at 25th, Thailand at 38th, and Indonesia at 50th, held back by low rankings notably on infrastructure, among other measures. Corruption and government bureaucracy remain concerns for investors, though there is a perception these issues are being addressed.

Progress achieved in the Bangsamoro framework agreement, a roadmap for a political settlement between the government and the Moro Islamic Liberation Front, could jump-start development on the large southern island of Mindanao.

Risks to the economic outlook include excessive portfolio capital flows. Portfolio investment registered with the central bank surged in the first 2 months of 2013 (Figure 3.28.11). Surging inflows risk sparking asset inflation, a rapid appreciation of the peso that would hurt export competitiveness and diminish the peso value of remittances, and excessive upward pressure on credit growth. A sharp reversal of the inflows would disrupt financial markets and business confidence.

**Policy challenge—generating employment**

Higher rates of economic growth over recent years have not made a serious dent in the employment problem in the Philippines. Unemployment at 7% in 2012 and underemployment at 20% understate how serious the problem is. The deployment of large numbers of workers overseas masks the full extent of the labor market weakness. An estimated 7 million Filipinos, equivalent to about 17% of the domestic labor force, have left the country to work, taking the total number of Filipinos living abroad to more than 10 million.
Further, 40% of those working within the country are classified as vulnerable—unpaid family workers and the self-employed, mostly in the informal sector.

A survey by the Social Weather Stations polling organization last year showed that 52% of respondents rated themselves as poor, the highest percentage since 2008. National poverty incidence in the latest family and income expenditure survey, conducted in 2009, was 26.5%, an improvement on 33.1% in 1991 but still high.

Despite the acceleration in GDP growth last year to 6.6%, employment growth slowed to 1.2%, with nearly all the new jobs generated by services (Figure 3.28.12). The Business Processing Association of the Philippines estimates that the rapidly expanding BPO industry will employ 926,000 full-time employees by the end of 2013, or 2% of the total labor force. BPO hires mostly skilled workers, however, which does not offer much hope to the large pool of unskilled labor. Tourism and related services employ 4 million people, or 10% of the labor force. Other services including finance and retailing also show consistent growth. Still, the service sector cannot absorb all new entrants to the workforce, which is growing by about 2% a year.

A stronger industrial base, particularly in manufacturing, could generate a wide range of jobs. But the development of manufacturing in the Philippines has lagged most other larger countries in Southeast Asia. The share of manufacturing in GDP declined to 22% in 2012 from 26% in 1990. Manufacturing in the Philippines provides only 8.3% of total employment, a much smaller contribution than in comparable countries (Figure 3.28.13).

Spurring industrial development requires broad-based reform to address the long-standing challenges of under-provision of infrastructure, an unfriendly investment and business environment, and poor governance. In the past 2 decades, steps have been taken on these fronts, as trade restrictions have been liberalized, the licensing system simplified, and a sound financial system established. More recently, governance reforms and gradual improvements in infrastructure have enhanced the investment environment.

While such reforms are crucial, by themselves they may not be enough to attract substantial new manufacturing investment in the near term. Targeted interventions aimed at manufacturers may be required. The challenge is to identify constraints on the development of particular industries and formulate policies to deploy against them. That requires considerable consultation with the industries concerned.

A window may be opening for the Philippines to pursue such a targeted policy, in light of renewed interest by some manufacturers to invest in Southeast Asia at a time that the improvements in the Philippines’ investment environment are being recognized. Moreover, labor markets are tightening and wages rising more rapidly in several Asian countries that compete with the Philippines for manufacturing investment.