

# **Case study: Growth Diagnostic for the Philippines**

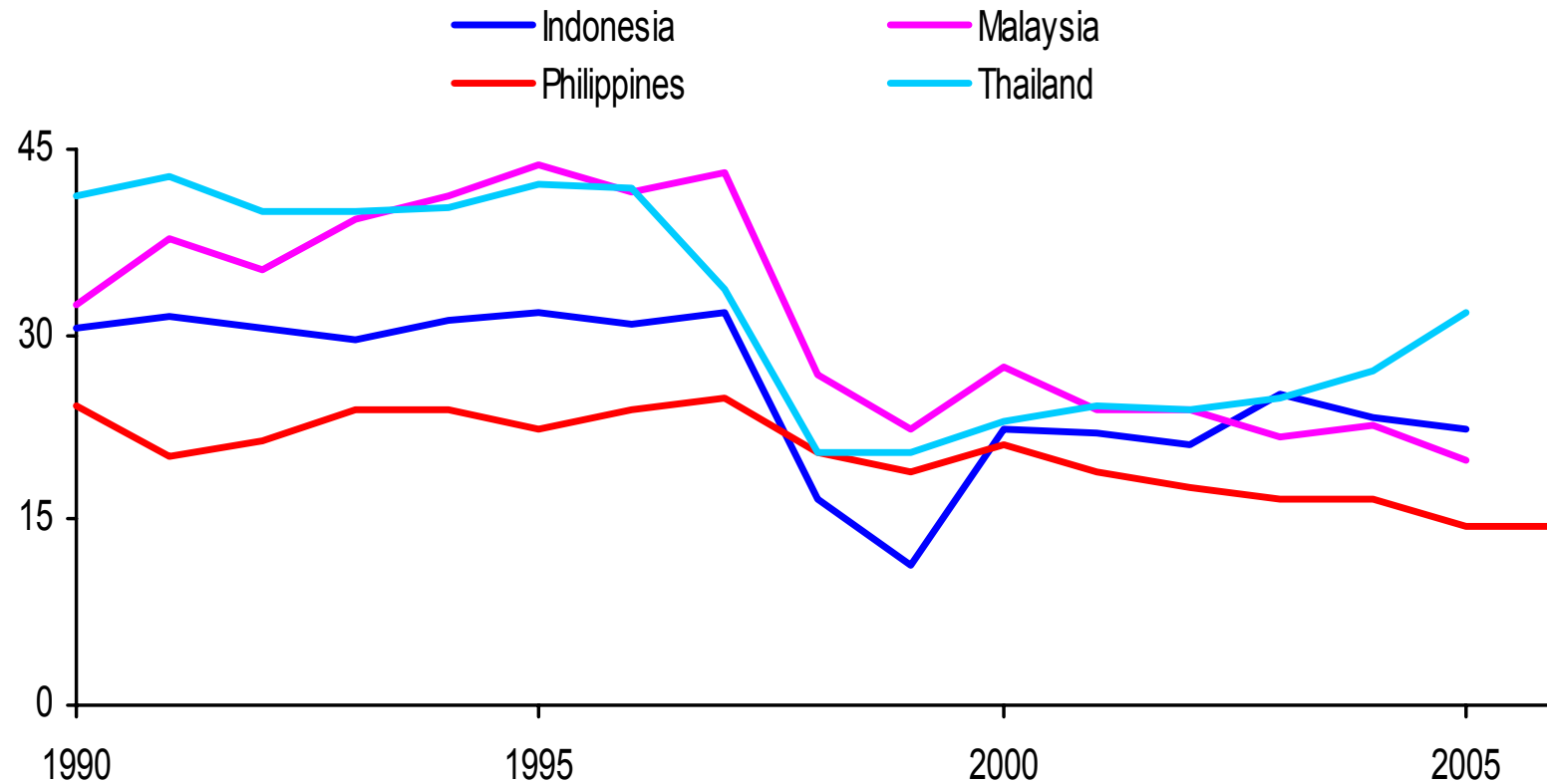
Workshop on Diagnostic Approaches

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# 1. Philippine Development Experience

- Annual per capita GDP growth of 1.4% during 1961-2006, much lower than many of its East and Southeast Asian neighbors.
- Despite GDP growth is picking up in recent years (reaching 7% in 2007), [domestic investment](#) has remained sluggish and its share to GDP continued to decline.

# Domestic Investment as a Share of GDP

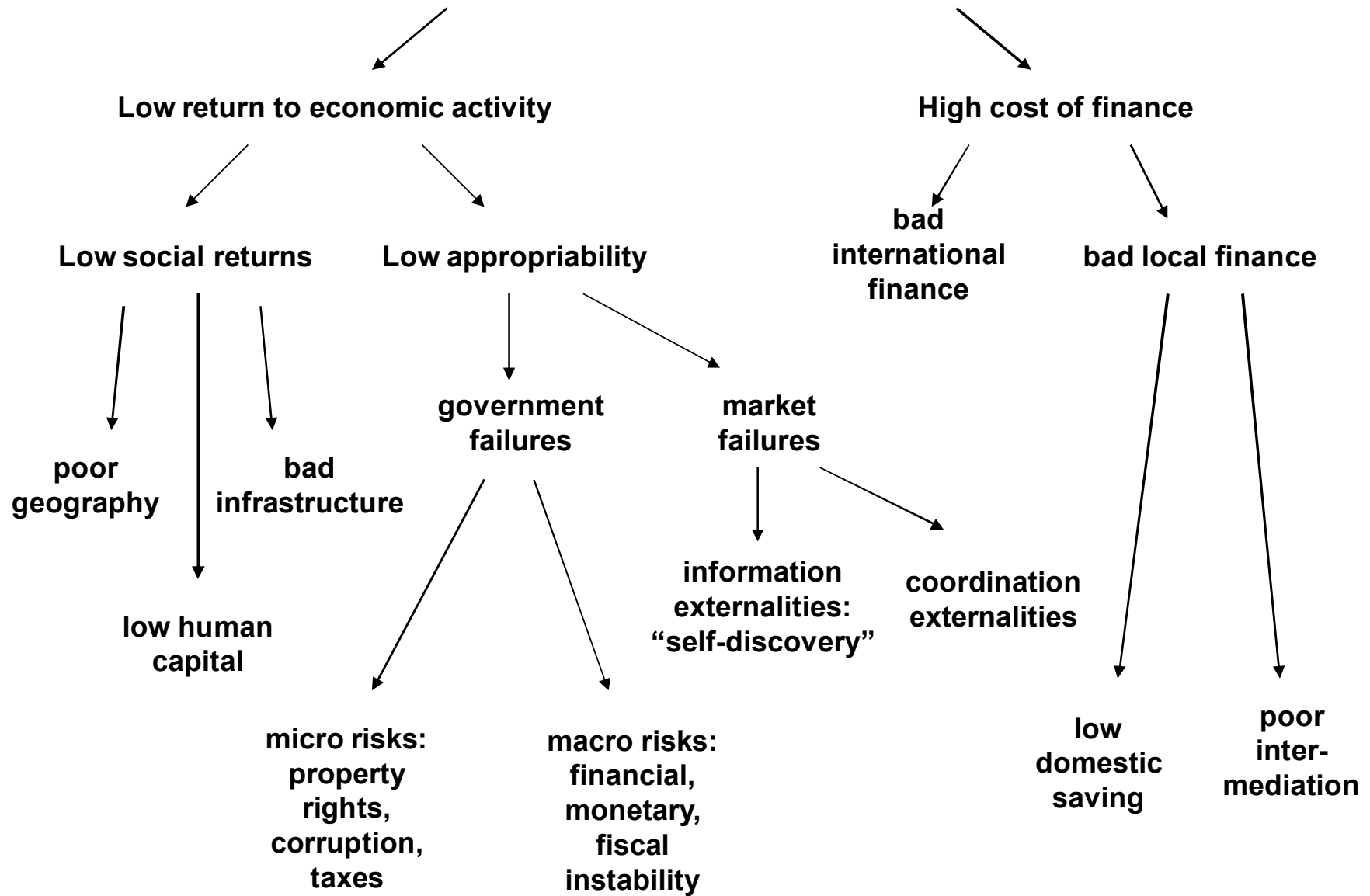


GDP = gross domestic product.

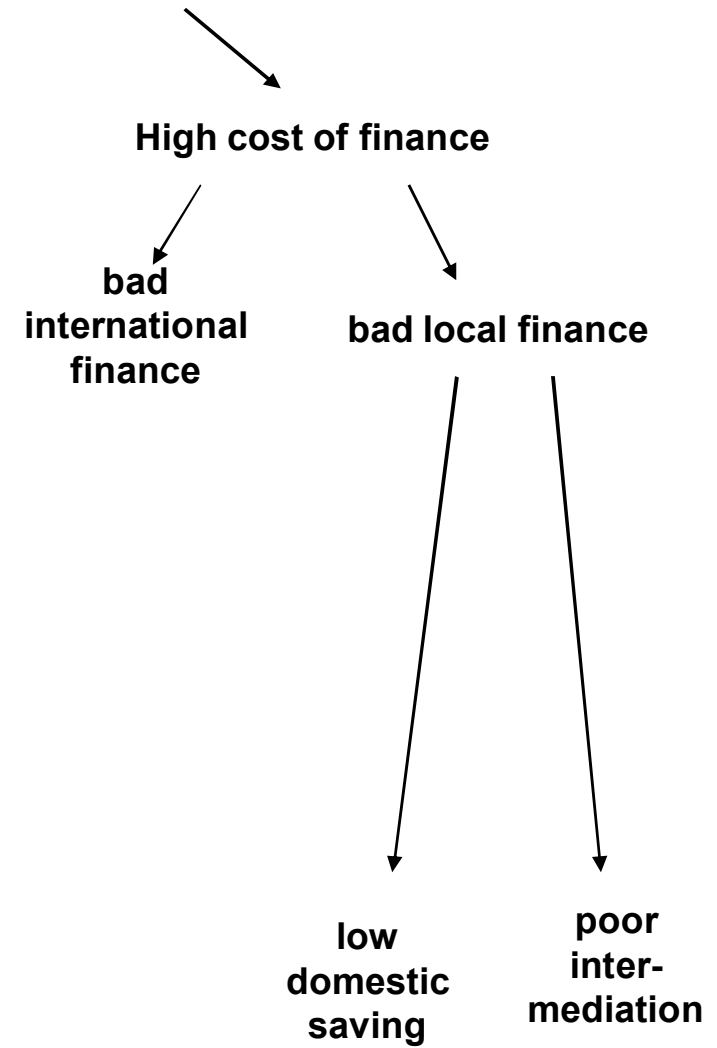
Investment = gross domestic capital formation.

Source: Data from NSCB (various years) and WDI.

**Low levels of private investment and entrepreneurship**



# Low levels of private investment and entrepreneurship

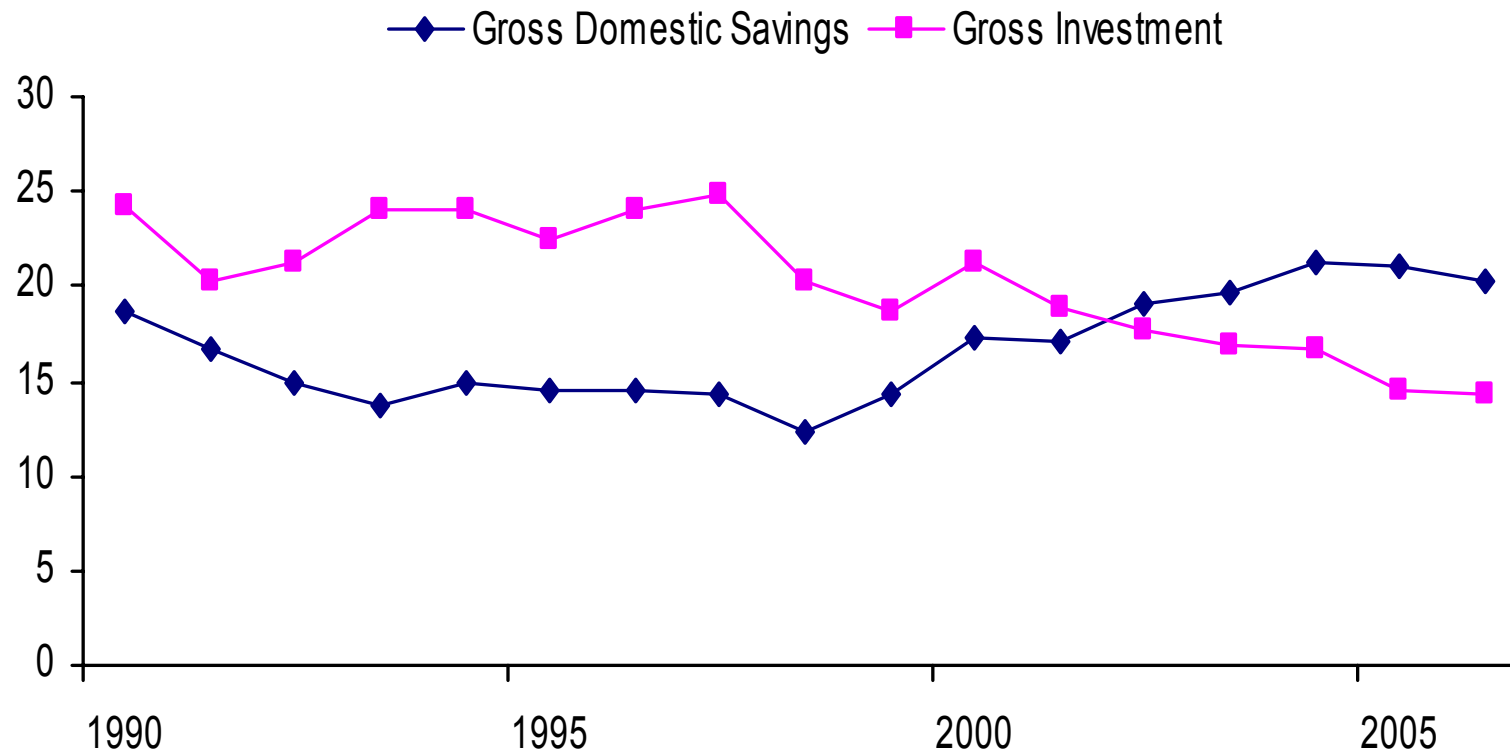


## 2. Binding Constraints to Growth

- Aggregate [domestic savings](#) rate is modest in the Philippines but may not be a critical constraint to growth at present given that (i) the ratio of gross domestic savings to GDP has exceeded the ratio of gross domestic investment to GDP since 2002; (ii) the current account has been in surplus during the same period; and (iii) large remittances helped offset trade account deficit and reduce external indebtedness
- [Efficiency of domestic financial intermediation](#) could be improved but may not be a critical constraint as reflected in the deposit-lending interest rate spread comparable to that of Thailand.



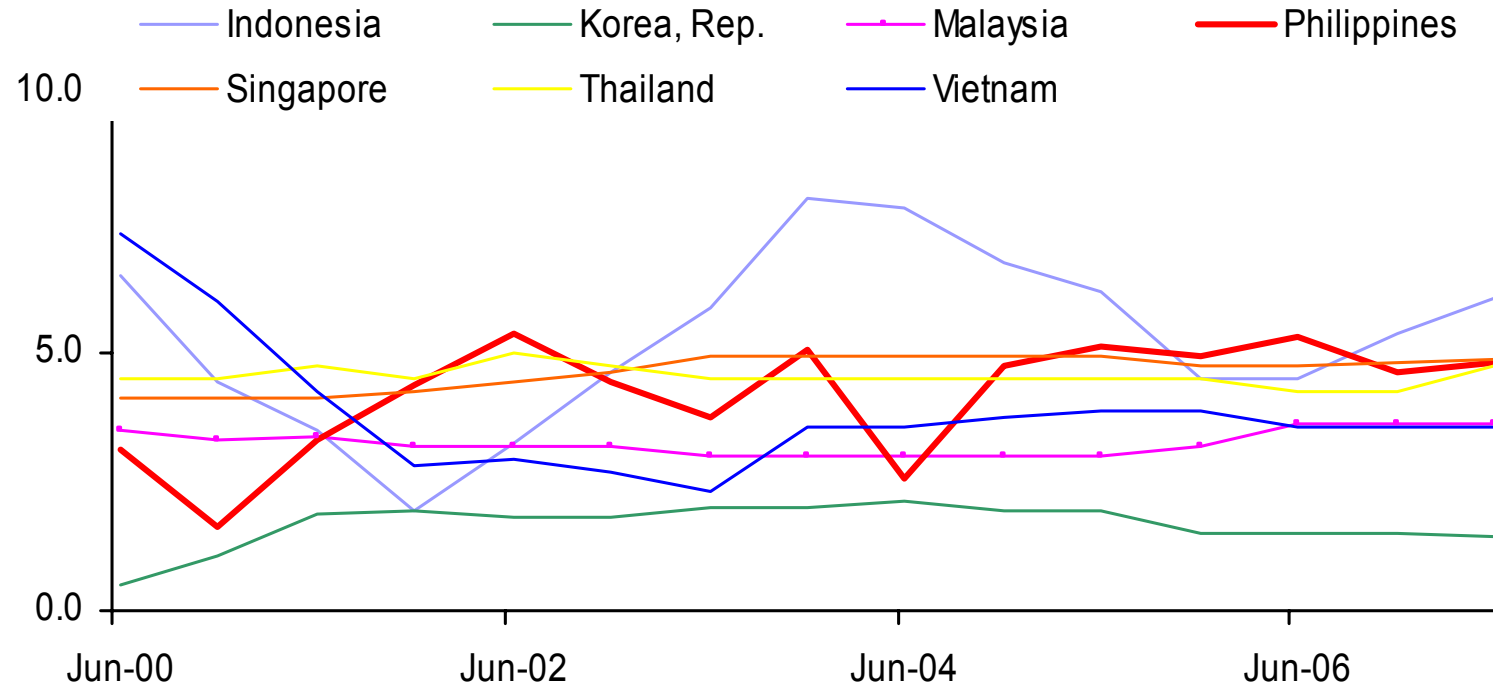
## Gross Domestic Savings and Investments as a Share of GDP (in %)



Source: Data from NSCB (various years)



# Spread between Lending and Deposit Rates selected ASEAN+3 countries



Source: IFS



## 2. Binding Constraints to Growth

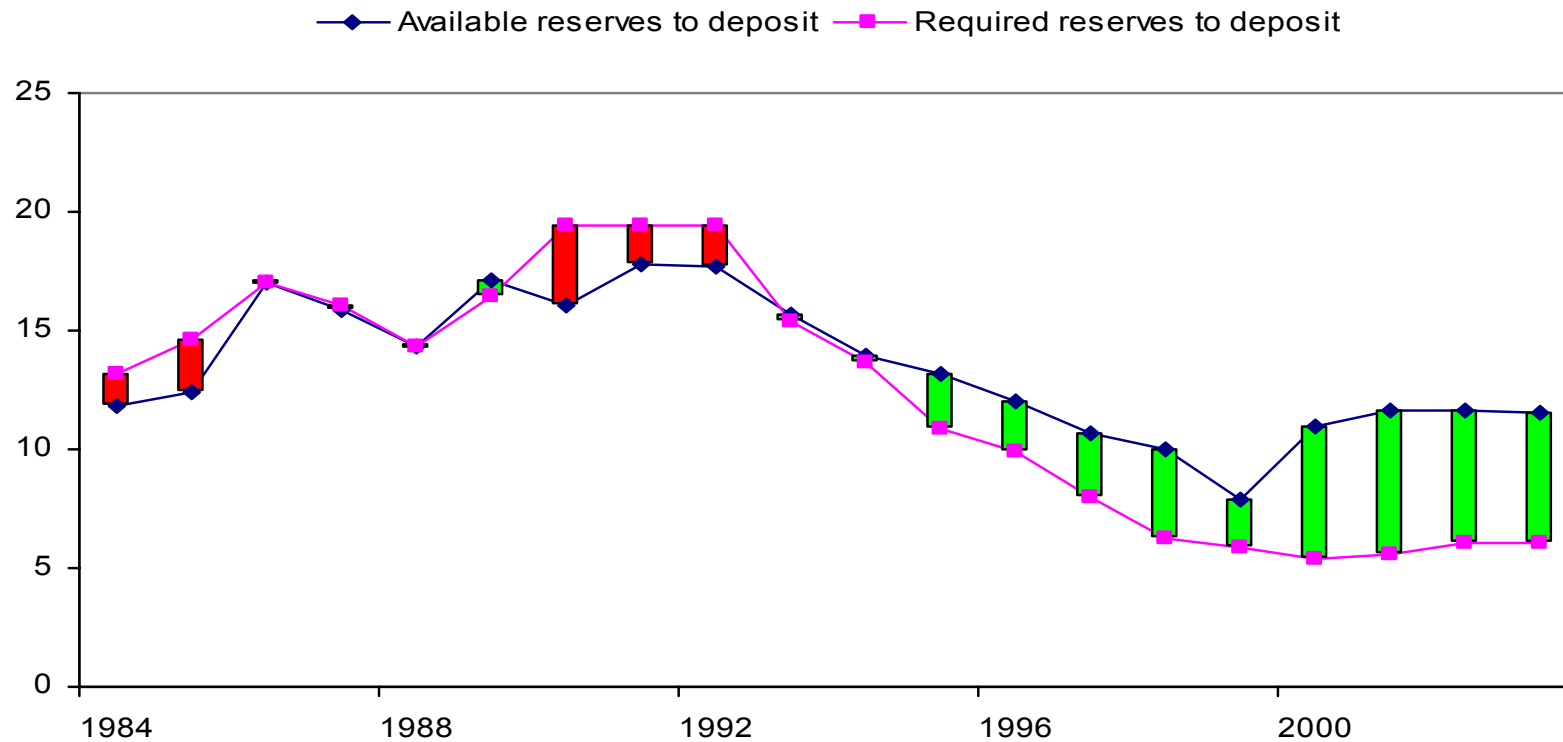
### A. Cost of Finance

- Growth of real domestic credit has not recovered since the 1997 financial crisis, but this appears to be more a problem of weak borrowing appetite of the corporate sector or lack of sound borrowers than lack of liquidity in the banking system, as reflected in the [excess reserves](#) of commercial banks
- [Lending rates](#) is currently low by historical standards and real lending rates are comparable to some Asian neighbors
- Access to international financial markets has been improving as reflected in the declining [sovereign spreads](#).

**Hence, cost of finance is *not* a binding constraint.**



# Reserves Assets to Deposit Ratios of the Banking Sector

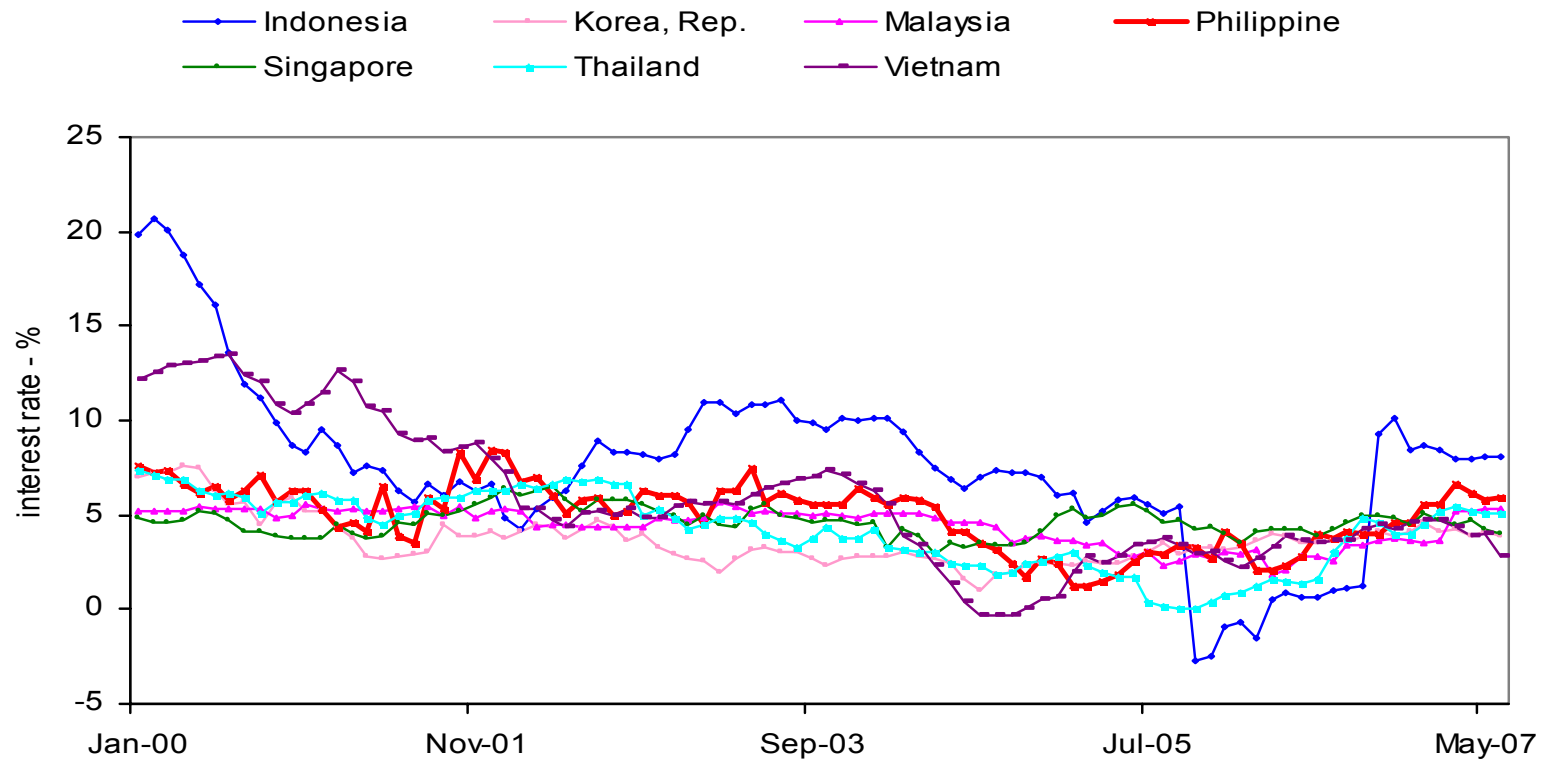


Note: green bar indicates that available reserves are more than required reserves and red bar indicates the reverse

Source: Data from BSP (2007)



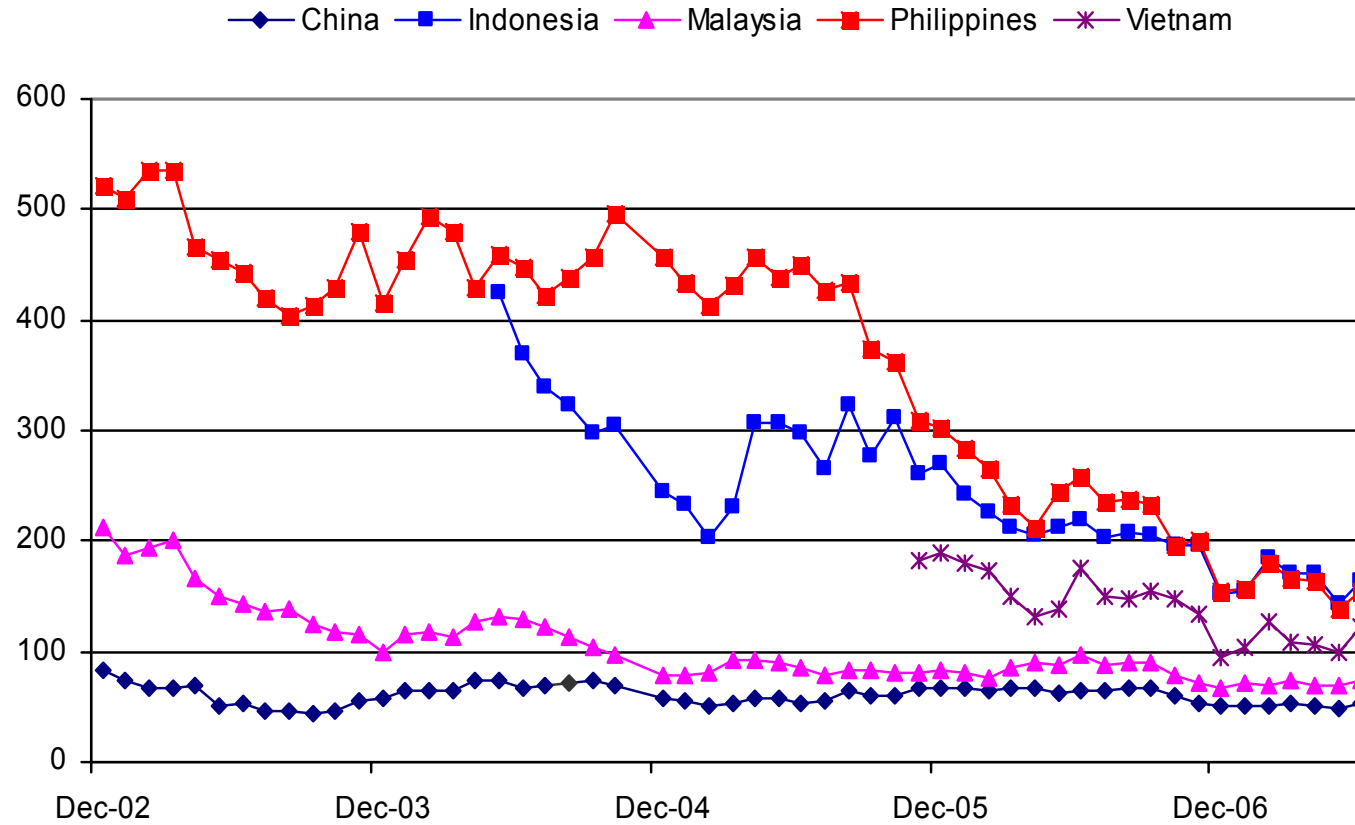
# Real domestic interest rate of selected ASEAN+3 Countries



Source: Data from IMF (2007)



# Comparison of Sovereign Spreads basis points



Source: JP Morgan



**Low levels of private investment and entrepreneurship**



**Low return to economic activity**



**Low social returns**



**poor  
geography**



**bad  
infrastructure**



**low human  
capital**

## 2. Binding Constraints to Growth

### B. Social Returns to Investments

#### 1) Human Capital

- [Unemployment](#) among educated workers is high
- Most out migrant workers are employed in low paying and low skill occupations
- but may be scarce in emerging industries especially in the high-skill services sector, which is evident in the [wage premium](#) for tertiary education

**Human capital is therefore, *not* a critical constraint under the current industry structure.**



# Unemployment rates by educational levels in the Philippines

Education levels	Unemployment rate (%)		Contribution to total Unemployment (%)	
	2002	2006	2002	2006
<b>No grade completed</b>	<b>0.2</b>	<b>0.0</b>	<b>1.5</b>	<b>0.5</b>
<b>Elementary</b>	<b>2.1</b>	<b>1.0</b>	<b>20.8</b>	<b>14.0</b>
Not completed	1.0	0.4	9.6	6.0
Completed	1.1	0.6	11.2	8.1
<b>High school</b>	<b>4.3</b>	<b>3.3</b>	<b>42.7</b>	<b>45.5</b>
Not completed	1.4	0.9	14.2	12.1
Completed	2.9	2.4	28.5	33.4
<b>College</b>	<b>3.6</b>	<b>2.9</b>	<b>35.0</b>	<b>40.0</b>
Not completed	1.8	1.5	17.4	21.0
Completed	1.8	1.4	17.6	19.0
<b>Total</b>	<b>10.2</b>	<b>7.3</b>	<b>100.0</b>	<b>100.0</b>

Sources: BLES



# Rates of Returns by Education Levels and Sector

	1997	2000	2003
<b>By educational levels</b>			
Primary education	2.50	2.42	2.22
Secondary education	6.75	5.57	5.16
Tertiary education	19.80	17.62	16.57
<b>By sectors</b>			
Agriculture sector	0.84	0.96	0.89
Industry sector	7.57	7.01	7.23
Service sector	11.42	9.90	9.36

Source: Study estimates based on FIESs and LFSs.



## 2. Binding Constraints to Growth

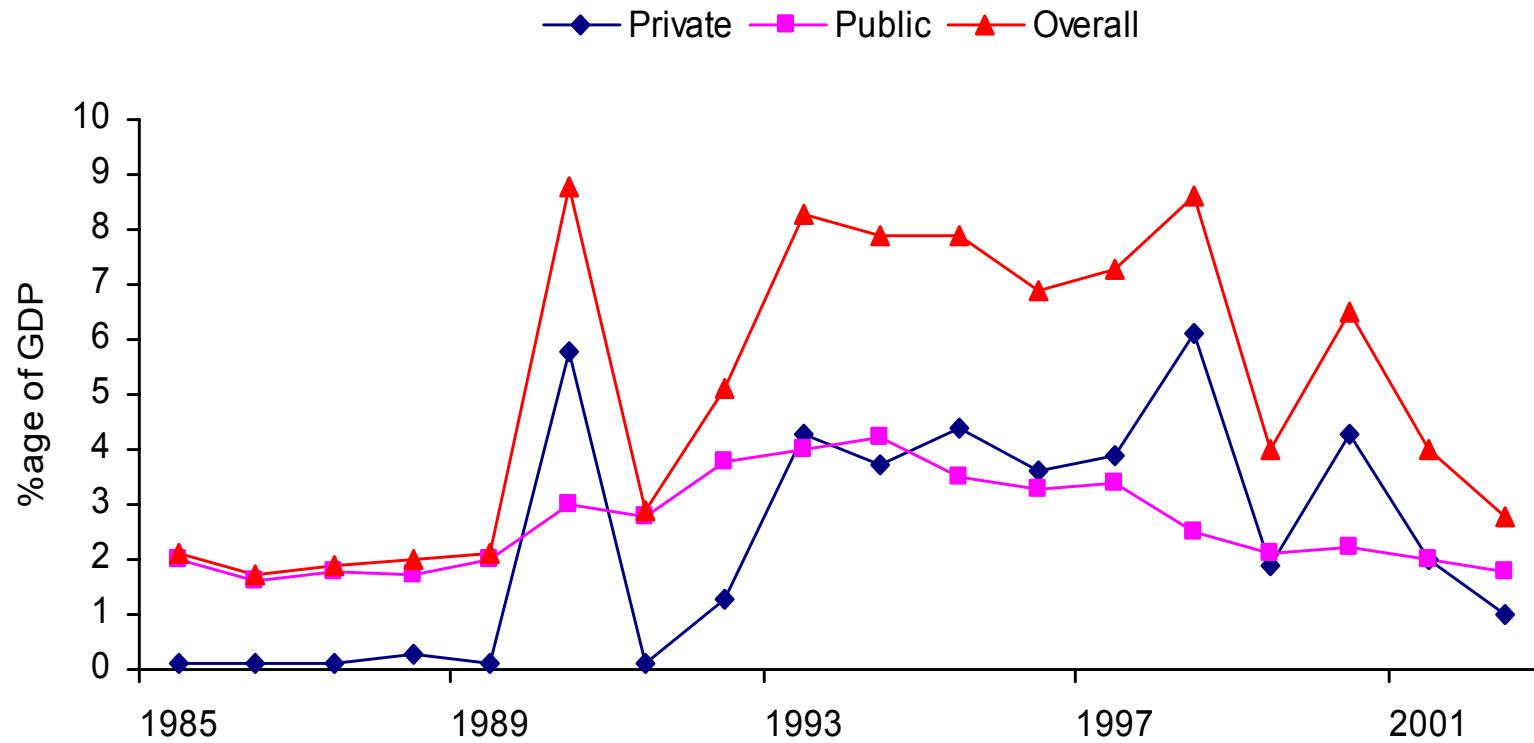
### B. Social Returns to Investments

#### 2) Infrastructure

- [investment in infrastructure](#) has been low and erratic and [development expenditure](#) has been low relative to other countries in the region
- Overall infrastructure quality [ranks low](#) relative to other Asian countries
- Expensive and unreliable [electric supply](#) and inefficient [transport](#) network are the two most critical constraints to growth.



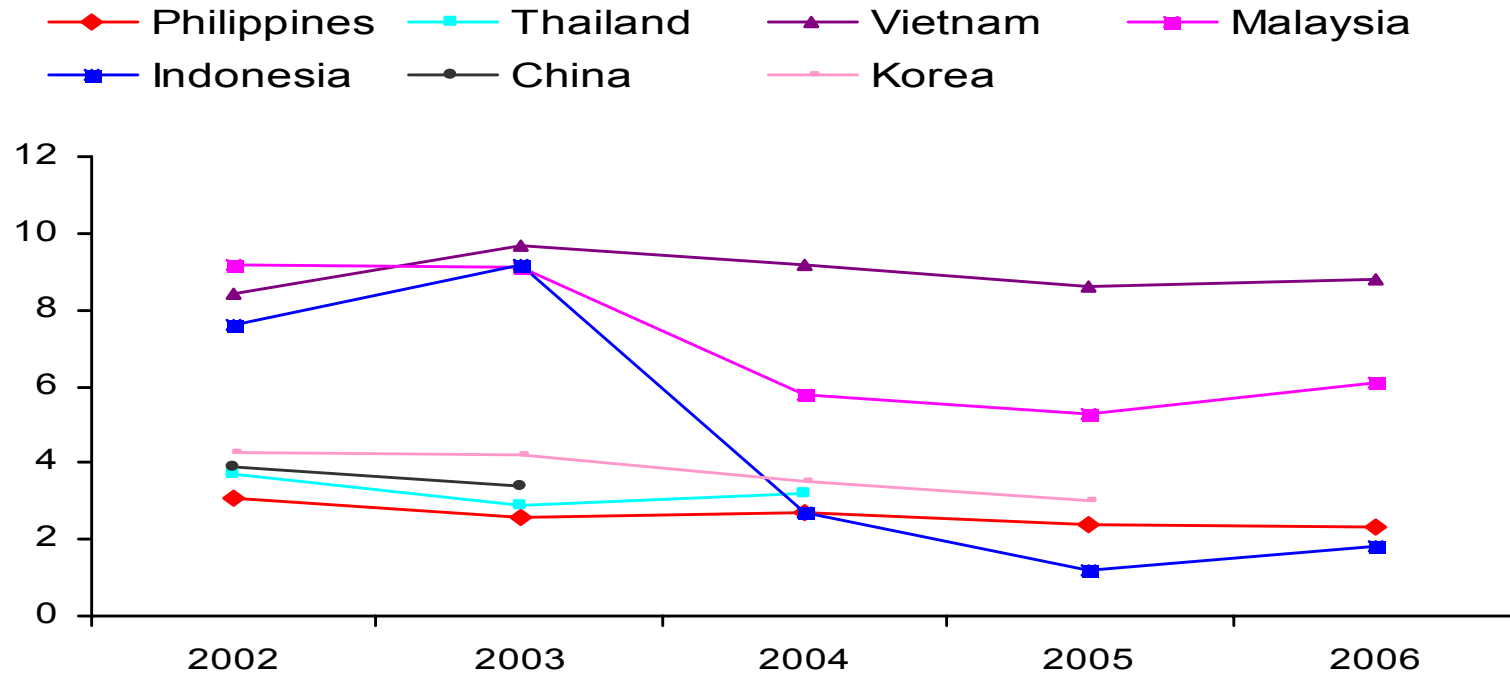
# Public and Private Sector Investments in Infrastructure



Source: Meeting the Infrastructure Challenge 2005, World Bank



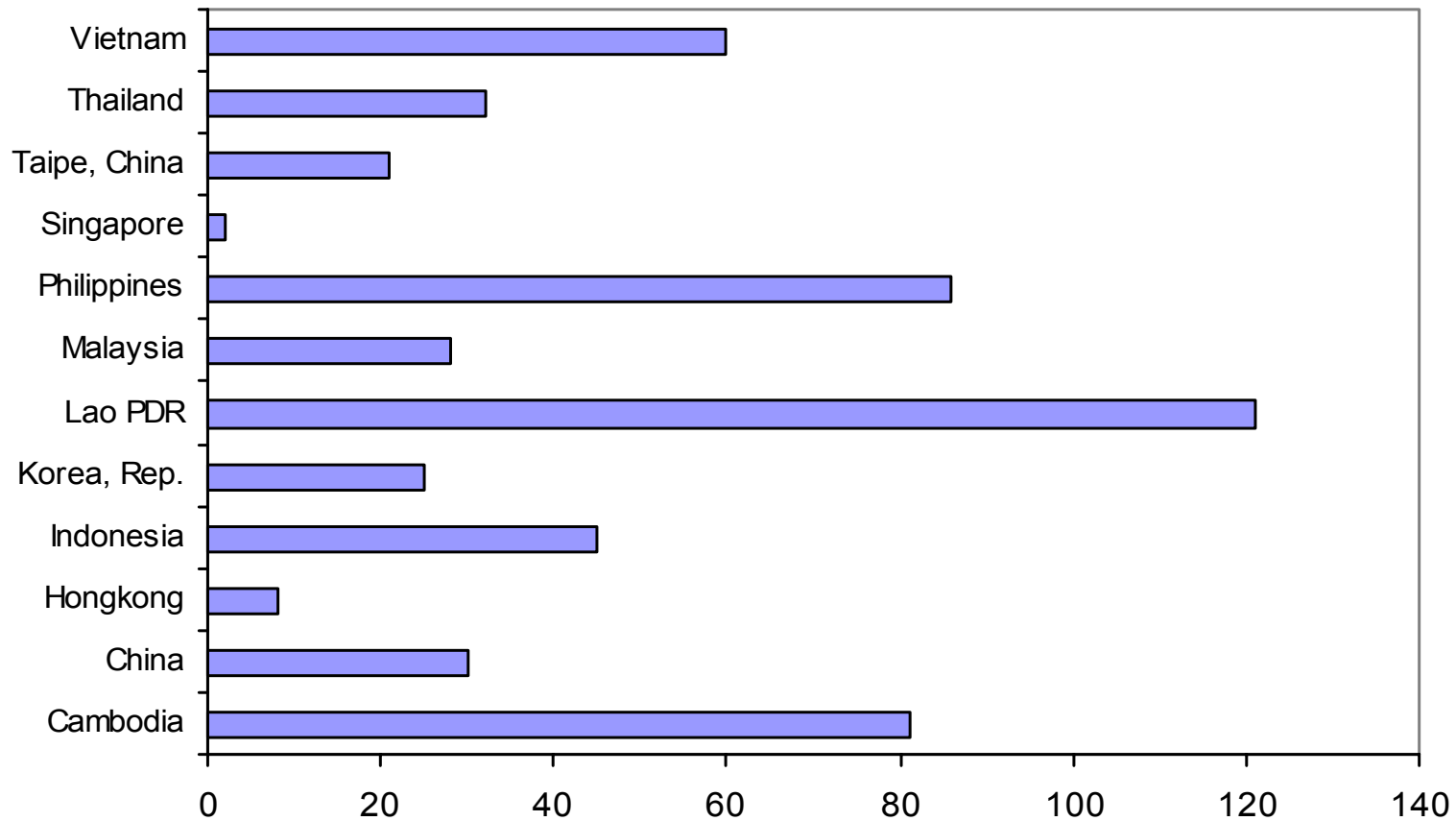
# Development Expenditures as % of GDP



Source: ADB Key Indicators, 2007



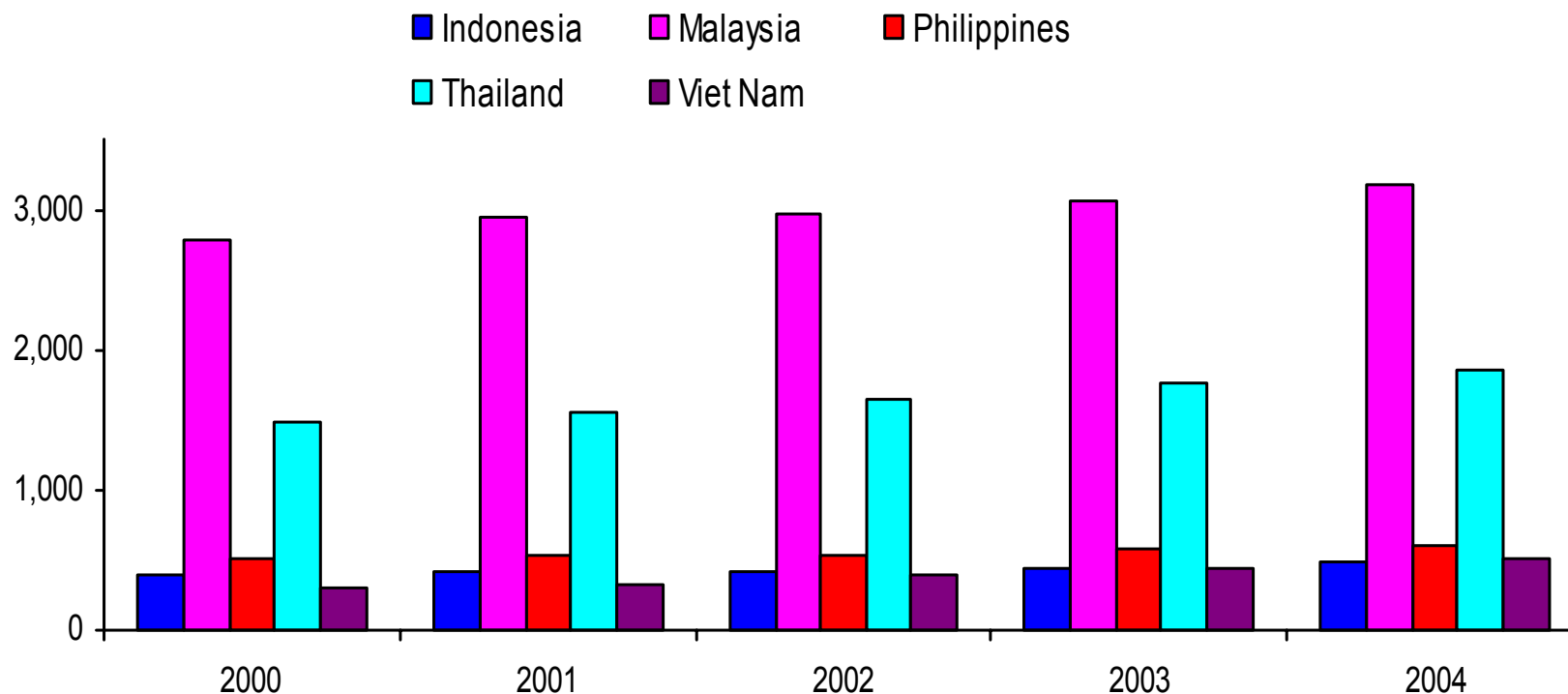
# Infrastructure Quality Ranking 2006-2007



Note: Study ranked 150 countries, a higher ranking indicates poorer infrastructure quality  
Source: Connecting to Compete: Trade Logistics in the Global Economy, WB



In terms of electricity: From 2000-2004, the Philippine's per capita power consumption level is 1/3 of Thailand and 1/5 of Malaysia.

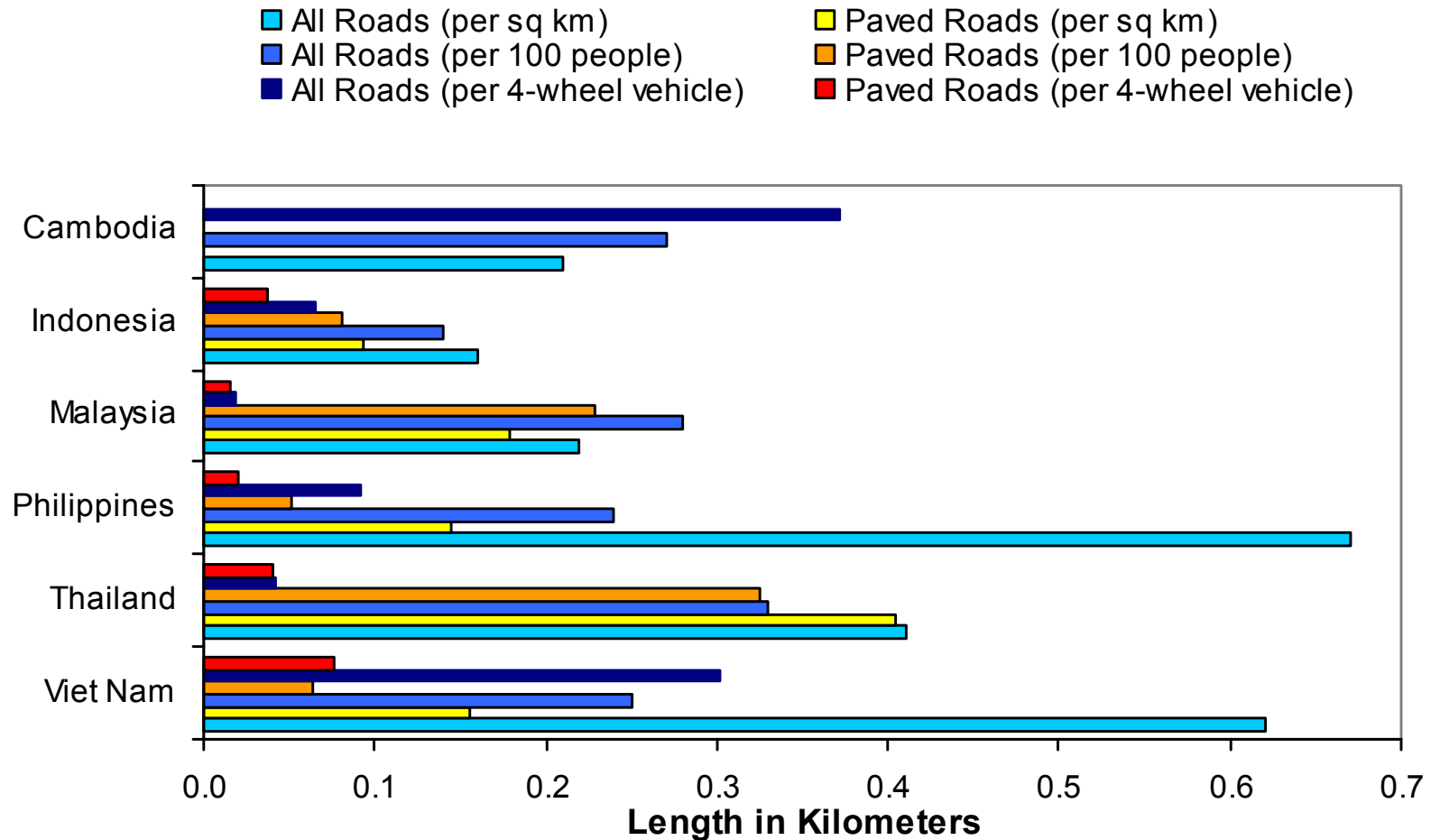


Power consumption is in kilowatt-hour.

Source: Data from World Bank *World Development Indicators*, various years.



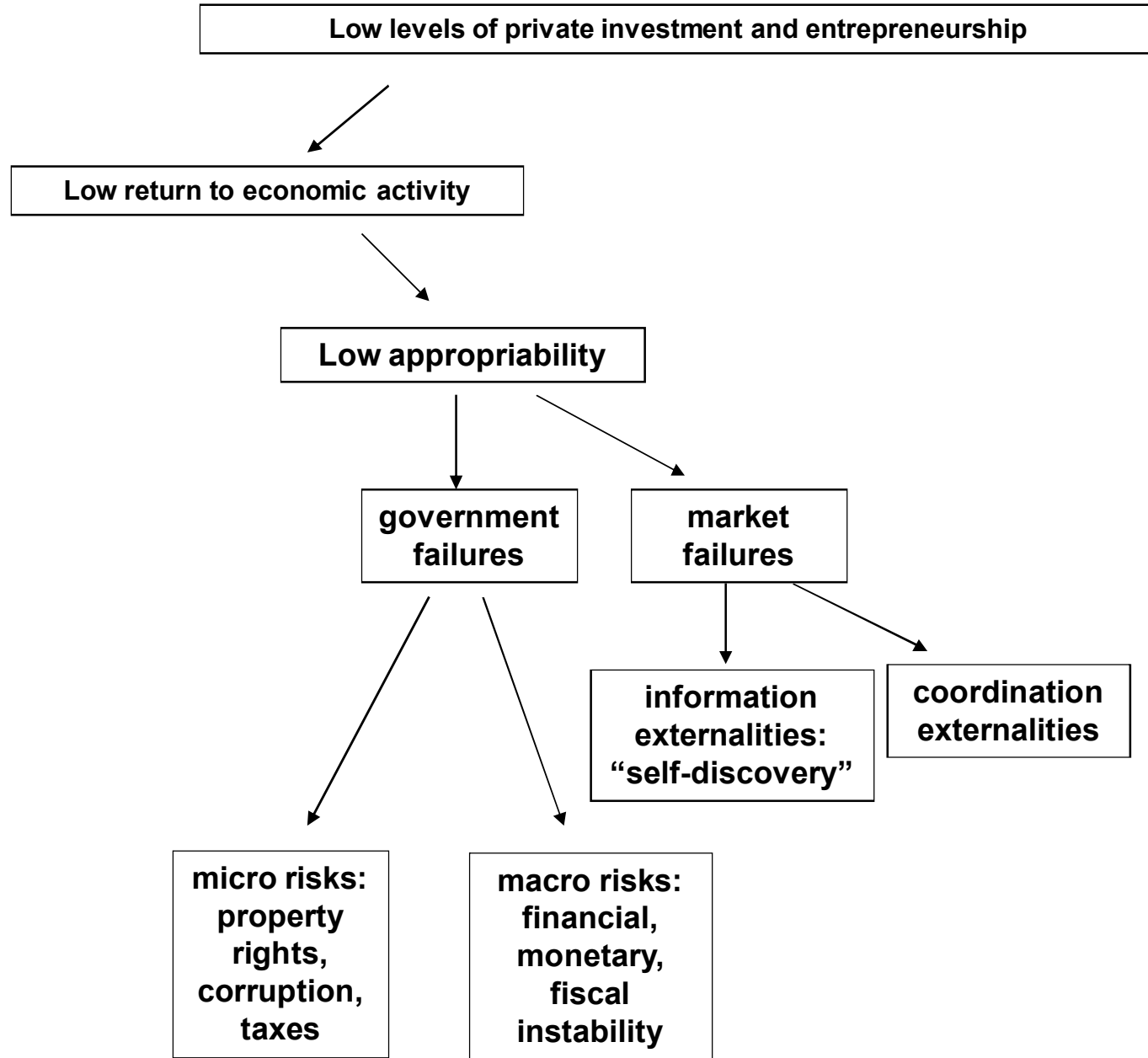
In transport infrastructure: per capita paved road length for the Philippines is roughly one sixth that of Thailand and one fourth of Malaysia.



# Low levels of investment and poor conditions of infrastructure have increased the cost of doing business in the Philippines

- Investment Climate Survey indicated that inadequacies in the transport network and disruption in the cost of electric supply are major constraints to doing business in the Philippines.
- Vehicle operating costs and intercity freights are 50% higher compared to Indonesia and Thailand.
- The costs of exporting a 20-foot container from the Philippines is 16-51% higher than from PRC, Singapore or Thailand.
- Power tariffs for business in Manila are 20-80% higher than major Southeast Asian cities.

**Hence, infrastructure *is* a critical constraint.**



## 2. Binding Constraints to Growth

### C. Appropriability of Returns to Investments

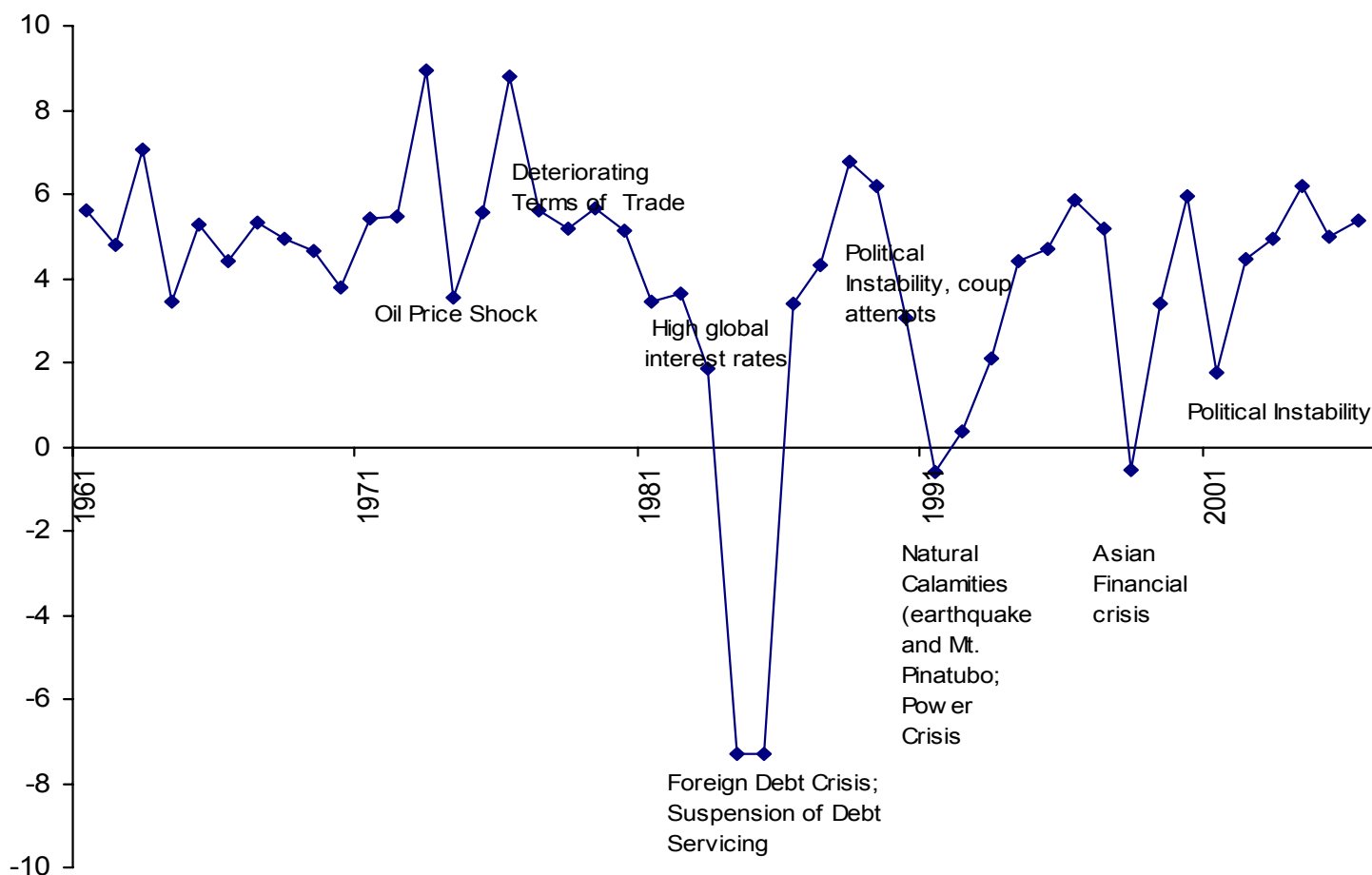
#### 1) Macroeconomic Risks

- Historically the Philippines has had periodic macroeconomic [instabilities](#) and despite some improvement in recent years, macroeconomic stability has remained a key investor concern
- [Persistent fiscal deficits](#) have been a key source of macroeconomic instabilities and remained a critical constraint to growth

**Hence, macroeconomic risks are a critical constraint.**



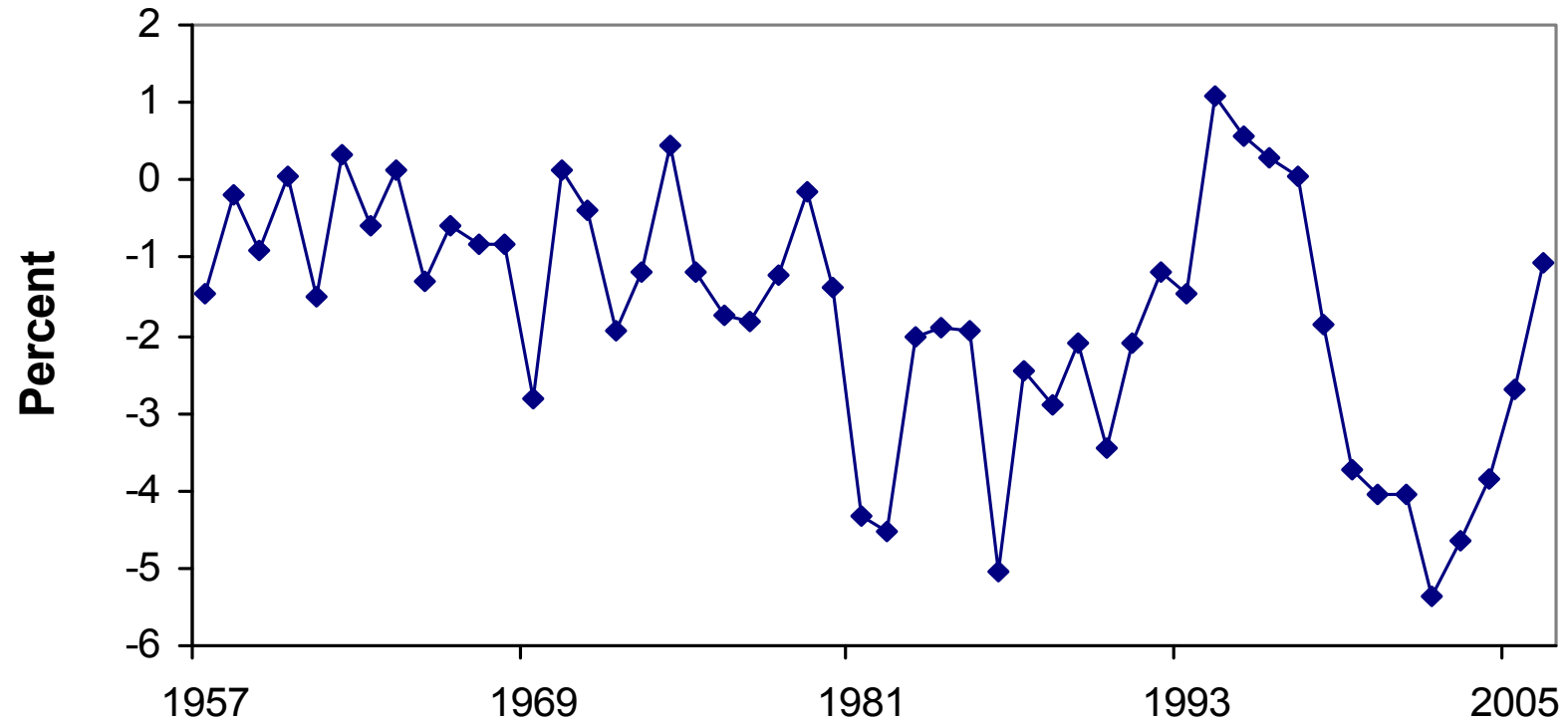
# GDP Growth in % and External and Internal Shocks



Source: National Income Accounts, NSCB and Vos and Yap 1996



# National Government Deficit % of GDP



Source: Data from IMF (2007)



## 2. Binding Constraints to Growth

### C. Appropriability of Returns to Investments

#### 2) Microeconomic Risks

- Poor governance is a credible threat to appropriability and a critical constraint to investment and growth

Governance indicators show that the Philippines has scored among lowest for countries with similar income level on controlling corruption and maintaining political stability.

<b>Governance Indicator</b>	<b>1996</b>	<b>1998</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>
Voice and Accountability		+	+	+	+	+	+
Political Stability	-	-	-	-	-	-	-
Government Effectiveness	+					+	+
Regulatory Quality	+	+	+	+		+	+
Rule of Law	+	+	-	-	-	-	-
Control of Corruption	-	-	-	-	-	-	-

Legend: + or – denotes a governance score for the Philippines that is significantly better (+) or worse (–) at the 5% level or less, compared to countries with similar gross domestic product per capita for the period.

Sources: Author's computations using data from Kaufmann, Kraay, and Mastruzzi 2006.

## 2. Binding Constraints to Growth

### C. Appropriability of Returns to Investments

... High tax rates and poor tax administration are critical constraints and cumbersome business procedure and over regulation\* are constraints which have affected FDI inflows

\* According to the Global Competitiveness Report 2003/04 it took 59 days to register a business compared with 8 days for Singapore and the country ranked 98<sup>th</sup> out of 102 countries in terms of extent of regulatory burden)



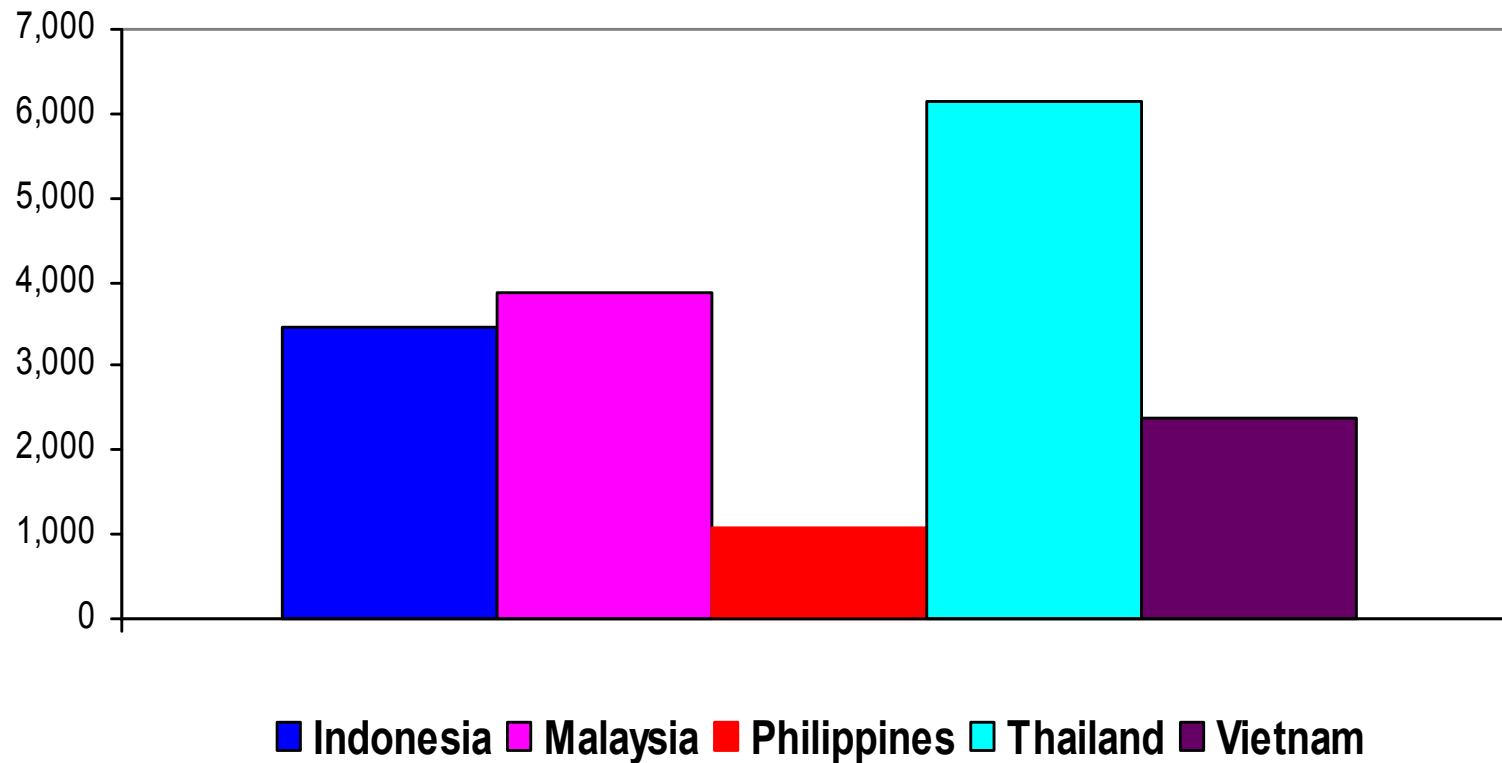
## Corporate Income Tax and VAT in Selected Economies (%)

Country	Corporate Income Tax Rate (%)	Value Added Tax (%)
PRC	30	5-17
Hong Kong, China	17.5	-
Indonesia	10-30	10
Malaysia	28	-
Philippines	35	12
Thailand	30	10
Vietnam	28	0-10

Sources: For Philippines <http://www.bir.gov.ph>; for Indonesia [http://usasean.org/Indonesia/business\\_guide/taxation.asp](http://usasean.org/Indonesia/business_guide/taxation.asp); for Hong Kong, China <http://www.gov.hk>; for PRC <http://www.abailaw.com/english/tax>; for all other economies <http://www.aseansec.org/6524.htm>.



# Annual Average Foreign Direct Investment over 2002-2006 US \$ million



Source: Asian Development Outlook 2007, ADB



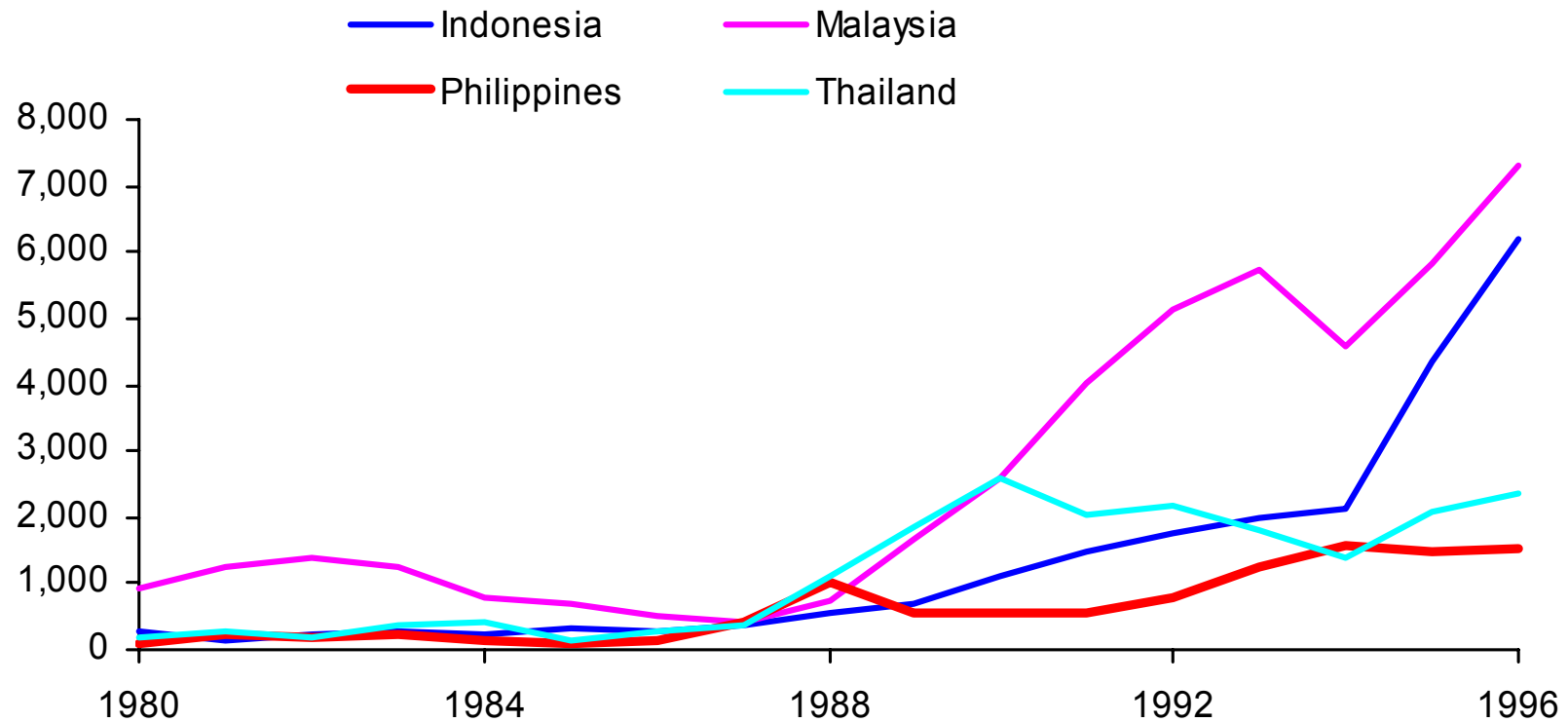
# Governance concerns affect investor confidence in the Philippines

- [Political instability](#) caused the decline in foreign direct investments since the 1980s.
- Worsening corruption was found to partly explain the low investment rate
- High lending rates are result of poor governance and this discourages private investment
- Corruption and patronage problems have resulted into leakages in revenue collection and is a major reason for the weak revenue generation

**Hence, microeconomic risks are a critical constraint**



Empirical studies found a causal relationship between political instability and foreign direct investments.



Source: Data from United Nations Commission on Trade and Development (UNCTAD).  
Available: <http://www.unctad.org>.



## 2. Binding Constraints to Growth

### C. Appropriability of Returns to Investment

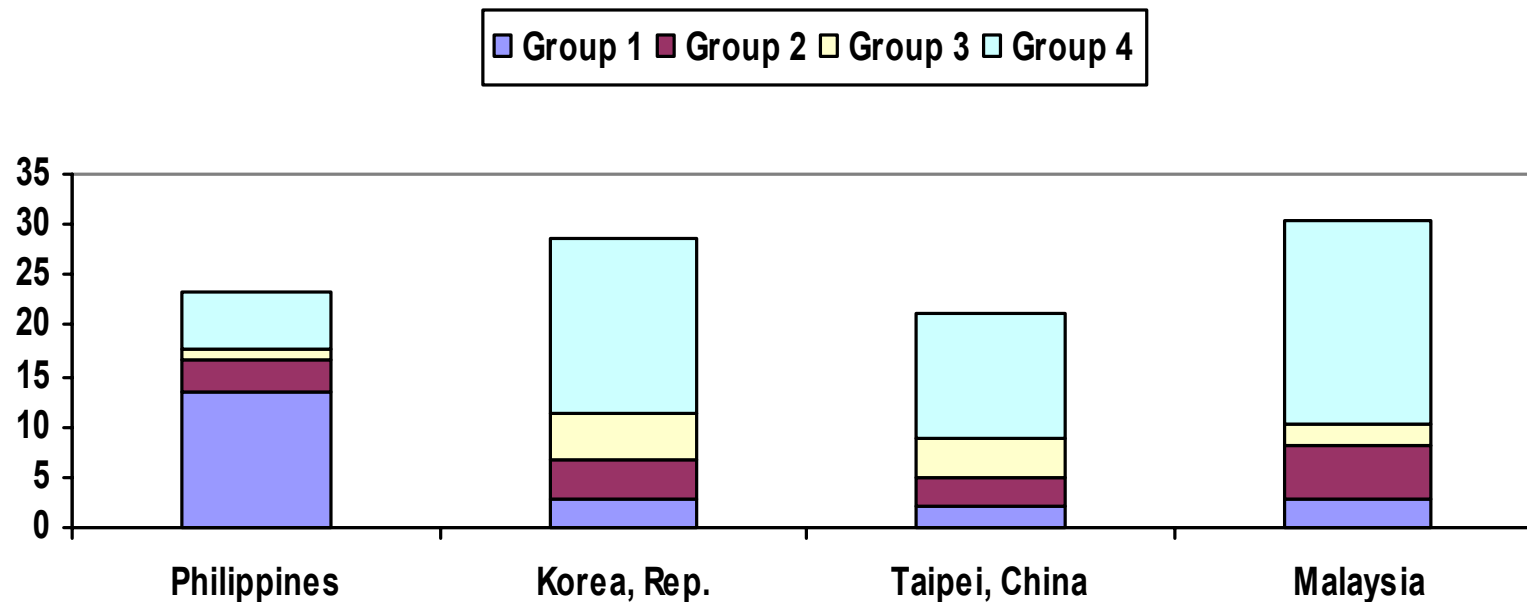
#### 3) Market failures

- Philippine manufactured exports have not diversified and have low value-added
- Domestic manufacturing focuses mostly on goods with [low productivity](#)
- Government spending on research and development is one of the lowest in a recent survey (ranked 89 out of 103 countries)
- Weak investor confidence and poor infrastructure partly explain small and narrow industrial base, but the inability to address market failures, caused by information and coordination externalities, may also be part of the reasons

**Market failures may have led to a small and narrow industrial base**



# Contribution of Manufacturing Sub-Sectors in Selected Countries by Technology Level of Production Process % of GDP



Source: National Statistics for Malaysia, Taipei, China and Philippines, ADB's CEIC for Korea, Rep.



## Summary of Critical Constraints to Private Investment and Growth in the Philippines:

- Inadequate infrastructure, particularly in electricity and transport;
- Weak investor confidence due to governance concerns, particularly, corruption and political instability; and
- Inability to address market failures leading to a small and narrow industrial base.

### **Other less critical constraints**

- Adequacy of domestic savings
- Efficiency of domestic financial intermediation
- Cost of international borrowing
- Stock of human capital

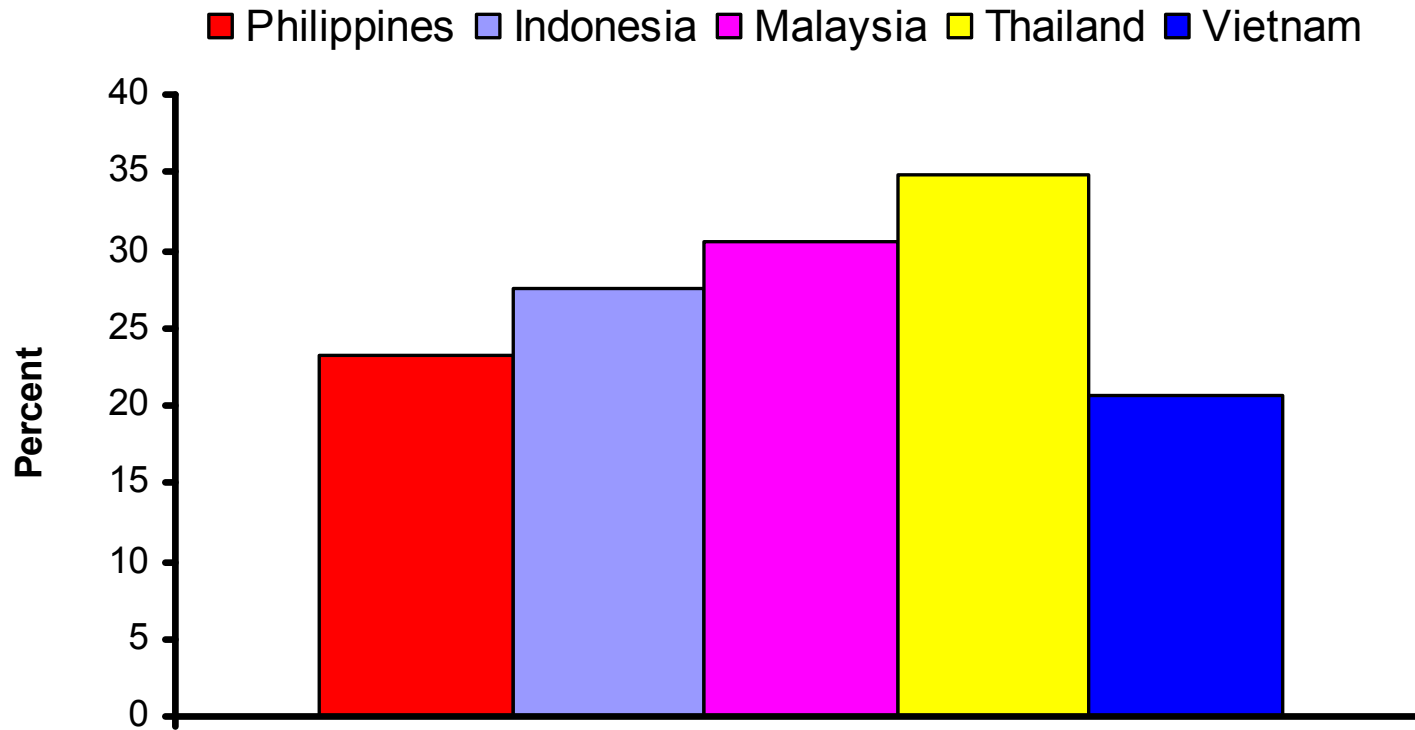
# Thank you!

For more information, visit:

<http://www.adb.org/Projects/Country-Diagnostic-Studies/default.asp>

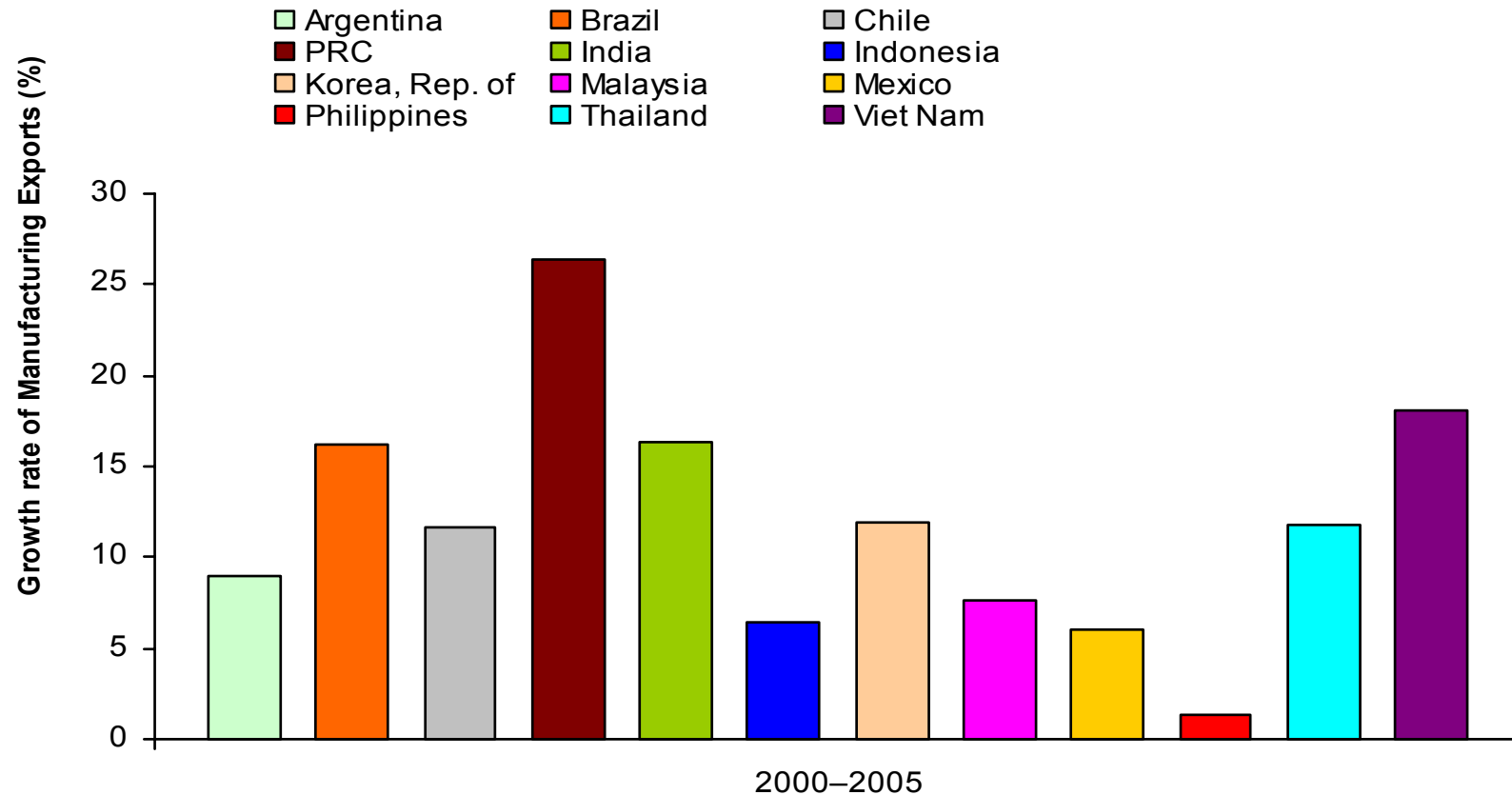
# **ANNEXES**

# Manufacturing Share to GDP of Selected ASEAN Countries 2005



Source: WDI

Philippines has a small and narrow industrial base. The manufacturing exports grew only by 1.4% per annum during 2000-05.



Source: Data from World Bank *World Development Indicators*, various issues.