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Paths to shared prosperity for the Philippine economy

The good news from a recent McKinsey Global Institute (MGI) report, Southeast Asia at the crossroads: Three paths to prosperity, is that three major trends offer the Philippines and other ASEAN member countries new avenues to transform productivity performance and build a future of shared prosperity.

Historically growing more slowly than its large Southeast Asian neighbors, the Philippines is starting to reap the benefits of improved governance and economic fundamentals. While other ASEAN member states are feeling the effects of volatile capital flows, falling commodity prices, and slowing growth in China, the Philippines continues to experience relatively robust economic growth.

To sustain this momentum and continue to improve the quality of living of its people, the Philippines will have to address a problem that plagues much of Southeast Asia: low productivity. Three-quarters of the Philippines' recent GDP growth was fueled by a shift from agriculture to urban employment as well as rising numbers of young people entering the workforce. As these factors diminish, productivity growth will need to pick up the slack. In fact, the Philippines will need to increase its historical pace of productivity gains by almost 60 percent just to maintain its historical pace of economic growth.

The good news from a recent McKinsey Global Institute (MGI) report, Southeast Asia at the crossroads: Three paths to prosperity, is that three major trends offer the Philippines and other ASEAN member countries new avenues to transform productivity performance and build a future of shared prosperity.

1. Capturing a greater share of global trade and production

The Philippines and its fellow ASEAN member states face critical choices regarding how they will trade and compete in a more interconnected global economy. In 2012, flows of goods, services, and capital across the world's borders reached $26 trillion, or 36 percent of global GDP. Southeast Asia can benefit from this global phenomenon by pushing ahead with the measures necessary to make the ASEAN Economic Community (AEC) integration plan a working reality. The AEC, which is premised on the freer movement of goods, services, capital, and skilled labor across the region's borders, aims to create an open market of 600 million consumers. MGI analysis finds that greater integration could create efficiencies that lower costs by up to 20 percent in many sectors. The Philippines has an opportunity to capture even greater benefit from global flows. The country currently ranks 45th on MGI's connectivity index, which measures the inflows and outflows of goods, services, finance, people, and data and communication relative to the size of the economy. This is far lower than some other ASEAN member states such as Singapore (which ranks 4th), Malaysia (18th) and Thailand (36th).

While full integration appears highly unlikely by the target date of 2015, there has been real progress, including the near elimination of tariffs in many ASEAN countries. But other types of barriers—such as foreign ownership restrictions, varying product standards between countries, and inefficient customs procedures—are falling more slowly. Integration is proceeding faster for traded goods (particularly automotive, textiles, and wood) than for services (such as finance and health care). Additionally, many local firms lack a sense of urgency about entering new markets and expanding their regional presence.

The Philippines has much to gain from streamlining administrative red tape and harmonizing regulations. Beyond the potential for increased trade in goods, the country can also benefit from tradable services and the freer movement of skilled labor where its proficiency in English gives it a crucial advantage over many ASEAN member states.

2. Riding the urbanization wave

ASEAN's second major opportunity lies in its booming cities, which already account for two-thirds of the region's GDP. By 2030, more than 90 million additional people are expected to move to urban areas, a shift that if well managed will support the continued rise of a middle class with newfound spending power. The Philippines will need a step up in long-term urban planning to avoid the mistakes of the past (e.g., the Asia Competitiveness Institute's Global Liveability Index ranks Manila 63rd out of 64 large global cities on quality of life). Supporting this growth will require an estimated $900 billion in infrastructure and real estate investment in the Philippines between 2014 and 2030.

3. Adopting disruptive technologies

Technology (e.g., cloud, big data, automation of knowledge work, the Internet of Things) represents a third major catalyst for growth. The Philippines could be fertile ground for these innovations; Filipinos are avid social media users and tend to be early adopters of new technologies (e.g., mobile payments). Our studies in emerging economies show that broad Internet adoption drives GDP across the economy, helping large companies (e.g., banks, retail players) expand their services to new segments at radically different price points while also driving productivity gains for small businesses that dramatically improves their competitiveness. The biggest near-term challenges for the Philippines will be building out the necessary broadband infrastructure (which in most countries has required government intervention and support) at a faster pace than ASEAN peers, and cultivating a high-tech workforce.

Technology is likely to cause some disruption in the labor market as supply chains and assembly lines are automated, e-commerce supplants traditional brick-and-mortar stores, and next-generation construction methods are adopted. In all, 6 to 8 percent of ASEAN's total non-farm labor force in 2030—or 12 million to 17 million workers in non-farm jobs—could be displaced by technology. Governments will have to ensure that these workers have access to support and retraining. The business processing outsourcing (BPO) sector is one area that could be at risk from technologies that enable automation of knowledge work.

Five possible implications for growth in the Philippines

The Philippines has several strengths to take advantage of these economic trends, including a foreigner-friendly orientation, strong skills in selected industries (e.g., healthcare, seafaring), and a large English-speaking population. Our research highlights five possible themes for private and public sector players to explore in the Philippines.

A. Improving private sector productivity

The goal of creating a more seamless environment for trade has taken on urgency, as rising wages in China have led some multinationals to look for new production locations. However, the Philippines' wage cost advantage is seriously undermined by low productivity, particularly in manufacturing (the average annual output for manufacturing workers in 2012 was 28 percent higher in Thailand and 101percent higher in Malaysia) and agriculture (yield per hectare in 2012 was 50 percent higher for rice and 122 percent higher for coconut in Vietnam). The triple pressures of value-conscious Filipino consumers rapid growth in new towns and barangays, and greater competition from the coming AEC will only increase the importance of Filipino companies' improving productivity levels.

The Philippines will need to further focus on improving productivity in firms, both large and small. Beyond tackling gaps in skills (which we discuss later), we believe that disruptive technologies will play a central role in re-engineering cost positions and overcoming skill-gaps. The Philippines could consider developing similar support structures for technology adoption among firms that have proven successful in other countries, such as Singapore's SPRING agency and Germany's Fraunhofer Institute.

B. Expanding external orientation

The Philippines currently exports less than its ASEAN neighbors (ranking 8th out of the 10 ASEAN nations on the export-to-GDP ratio). The complexity of its exports has remained low (ranked 74th globally) and the country has only a small number of domestically-headquartered multinational companies.

A substantial amount of investment will be needed to shift this economic orientation. The country may well need to prioritize a few sectors, and devise economic policies suited to attracting more foreign investment in those sectors. Increasing AEC awareness among small and medium enterprises, and encouraging their ASEAN expansion plans, could also allow Filipino companies to develop the required 'muscle' ahead of integration.

C. Ramping up infrastructure investment

Historically a relatively low 3.2 percent of the Philippines' GDP has been spent on infrastructure. That needs to grow to more than 5 percent of GDP through 2030 to support economic growth, to provide the population access to basic needs, and to protect against climate change.

Particular gaps in infrastructure investment have been observed in shipping and broadband. In shipping, the Philippines' logistics costs are some of the highest in ASEAN. For example, the average port and terminal handling cost of $213 per unit is ASEAN's second-highest. Broadband infrastructure is a basic enabler for disruptive innovation and unleashing entrepreneurial energy, but the Philippines is falling behind in its provision. In 2014, mobile broadband speeds of 4mbps trailed Korea (27 mbps), China (22 mbps), and the United States (12 mbps).

The country will need to think about how to best optimize its current infrastructure, strengthen capabilities to make informed infrastructure investment decisions, and better harness recent technological advancements in the delivery of its infrastructure projects. The government has already begun a major infrastructure push (aiming to take infrastructure spending to 5 percent of GDP by 2016) that includes bringing in private investors, but it will take a sustained commitment to address the most serious gaps.

D. Improving local skills

Literacy rates are no longer a differentiator within ASEAN (only Cambodia and Laos have a literacy rate of less than 90 percent), with the focus shifting to talent competitiveness, where the Philippines does not rank as highly. Talent competitiveness has been significantly hindered due to factors such as the lack of skills-focused education, high drop-out rates among males, and gaps in teacher training and quality.

The Philippines should consider some global practices in developing talent competitiveness, such as getting the best people into teaching (e.g., Singapore), developing a strong vocational education system (e.g., Germany), and improving skills-matching between schools and industry (e.g., the Netherlands, which has a business sector advisory board to influence curriculum design in universities).

E. Building on the Philippines' strength in services

The Philippines has some unique skills. For example, Filipinos make up one in five seafarers globally; the country is amongst the largest exporters of healthcare workers to the OECD; and there are large numbers of Filipinos in the oil and gas, engineering, and airline industries. The Philippines may have an opportunity, leveraging its historical advantages in the services industry (as witnessed by the growth of its BPO industry), to drive process disruptions globally in some of these sectors (similar to India's role in IT in the 1990s).

Harnessing this opportunity would require a strong private-public commitment around a clear vision and prioritized set of initiatives, creating the required skill-building capability while building the business and infrastructure ecosystem.

Despite the Philippines' status as one of the fastest-growing economies in the world, approximately a quarter of its citizens still live in poverty. Through improving private sector productivity, expanding the external orientation of its economy, ramping up infrastructure investment, improving local talent, and building on its service sector strengths, the Philippines could harness the three major trends we have identified, and build an era of shared prosperity for all.

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