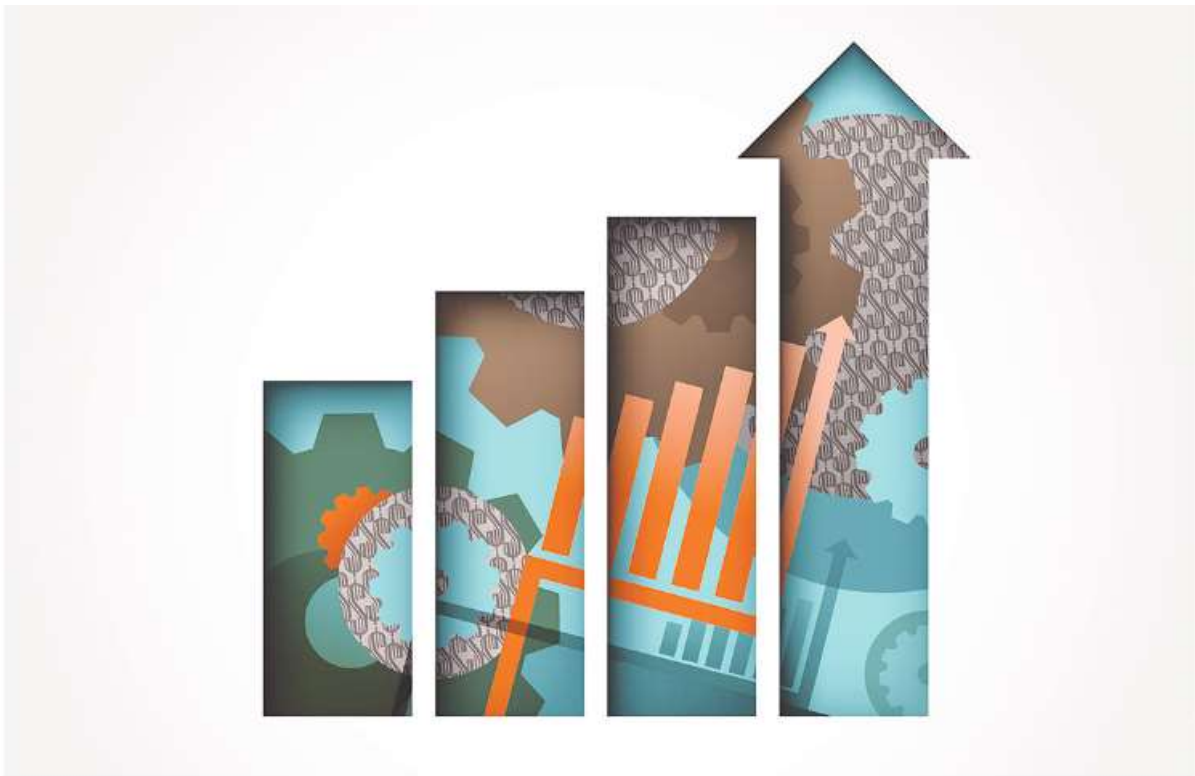


Annual growth of 6.5-8% until 2028: How?

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THE KEY outcomes of President Bongbong Marcos' Philippine Development Plan 2023-2028 — to increase income per capita, reduce poverty, and create employment — rest on a necessary condition: to attain a 6.5-8% annual growth rate through 2023 to 2028. If achieved, the Philippines would resemble its East Asian neighbors, which attained

similarly high growth rates decades ago. This is much needed given the still low wages and per capita income of the country. Yet, this "target" poses several questions.

First, it is not clear where the government's 6.5-8% target comes from: whether it is a wish, or a figure derived from an economic model. If it is the former, then it is simply the growth needed (under some assumptions and back-of-the-envelope calculations) to attain the outcomes. In the latter case, it would be a statement of what the Administration believes will happen, based on its understanding of how the economy functions (a model).

Secondly, what would be remarkable about the Philippines' growth performance, if this target is attained, is that the age of growth miracles came to an end years ago. We know that abnormally rapid growth is rarely persistent. The lack of persistence in country growth rates implies that current growth is not a good predictor of future growth. It also means that rapidly growing countries cannot post unusually high growth, or much higher than the world's historical average of 2% plus 2% standard deviation, for extended periods. The Philippines' GDP grew fast in 2022, but this was partly the effect of leaving behind the pandemic, and of fully reopening the economy. Many experts question that growth will reach 6% in 2023.

Thirdly, growth miracles, particularly in Asia, have almost always been driven by labor-intensive manufacturing, and export-led growth. The Philippines skipped these. The conditions to generate such a growth process are harder to meet in the new global economy, due to changes in manufacturing technologies and the global context. Skill-biased technological progress has reduced job creation in manufacturing, resulting in an increasing share of employment in less-productive service activities. Moreover, globalization and the associated rise in competition in world markets (e.g., the rise of China as a manufacturing power) have made industrialization much more difficult for newcomers to achieve fast growth via exports.

Fourthly is the question of sustainability. Attaining a relatively high growth rate one year might be possible for a number of reasons; but maintaining it for six consecutive years is quite another: it would be the first time that the Philippines attains such a feat.

Finally, a country's long-run growth rate has a limit, a maximum. Actual growth tends to fluctuate (above or below) around this maximum. It cannot deviate from it permanently. When it does (from above or from below), there are forces that bring it back, like a pendulum. There are two such maxima in any economy. One is on the supply side, what economists call potential growth. This is the maximum growth rate that the technical conditions of production allow. It is given by the sum of the growth rates of labor productivity and of the labor force. For example, when a country's growth rate is above its potential, unemployment will decline, while wages will increase, leading to inflationary pressures, with the consequence that the central bank will increase its reference interest rate and the economy will cool, thus bringing growth down.

The other limit is on the demand side. This is based on the fact that developing countries' growth rates are constrained by the current account of the balance of payments: they need to import capital goods for their development. The problem is that imports have to be paid mostly in dollars, euros, or yen, which means that developing countries need to

earn these currencies. They can obtain them through capital flows but these are not guaranteed. Hence, they have to export and be paid in these currencies. If imports are larger than exports, they will run deficits. History teaches us that this situation is not sustainable and sooner or later a crisis will follow.

Therefore, there is a growth rate consistent with current account equilibrium, referred to as the balance-of-payments-equilibrium growth rate. In its simplest form, this is given by the product of the country's trade partners (where the country exports) growth rate times a very important variable which captures the non-price competitiveness of exports relative to that of imports. Indeed, especially important for a developing country is the set of non-price attributes of its export basket. These refer to how attractive a country's exports are in foreign markets due to quality, reliability, speed of delivery, distribution network, etc. This variable is high for countries that export machinery, cars, electronic products, or chemicals (Germany, South Korea). It is low for countries that export agricultural products and natural resources, or simple manufactures (the Philippines).

The above discussion implies that, in order to have a sensible discussion of how fast a country can grow in the medium to long-term, authorities should have an idea of what potential and balance-of-payments-equilibrium growth rates are; and also understand which one is the binding constraint on growth. My experience tells me that, for developing countries, the demand side constraint is the one that bites first. This is because before achieving its potential growth rate, an economy's actual growth performance can be curtailed by macro constraints. For emerging economies, the external constraint associated with the current account balance is particularly significant, given these countries' dependence on the availability of foreign exchange to finance their imports. Current account deficits can be sustainable and, indeed, necessary in the short run — especially when they allow for faster capital accumulation. But countries cannot finance ever-growing current account deficits in the long run, as there is a limit beyond which the deficit becomes unsustainable (or is perceived as such by financial markets) and a balance-of-payments crisis ensues. Thus, countries that find themselves in balance-of-payments problems may be forced to constrain growth while the economy still has surplus capacity and surplus labor — that is, while the actual growth rate is still below the potential growth rate.

It is very difficult to properly estimate potential and balance-of-payments-constrained growth rates for the Philippines given the severe recession in 2020. With this caveat, our estimates indicate that:

- The Philippines can grow fast by international standards but it will be difficult to maintain a growth rate above 6-6.5% during this administration's term. Both potential and balance-of-payments-equilibrium growth rates are at about 6% at best, not higher.
- Barring crises, the Philippines can still attain for a few years annual growth rates of 5-6% without forcing macroeconomic imbalances. In time, labor force growth and labor productivity growth will decline, and so too will potential growth decline.
- Labor productivity growth has been the main driver of potential growth during the last 15 years. A significant determinant of labor productivity growth is the performance of the

manufacturing sector. For a country like the Philippines, still far from the technological frontier, attaining a relatively high growth rate of labor productivity is not a chimera. Labor force growth is declining but still positive (contributing above one percentage point to potential growth).

- With a world economy (i.e., market for the Philippines' exports) predicted to grow at about 3%, it will be very difficult for the Philippines to attain a growth rate over twice this rate.

- Overseas workers' remittances contribute slightly over one percentage point to the balance-of-payments-equilibrium growth rate. This means that, even to maintain the current balance-of-payments equilibrium growth rate at about 6%, the Philippines would have to continue depending on these remittances, which is not a sign of development.

- Policy makers need to focus their attention on increasing the non-price competitiveness of the country's export basket. This requires understanding the importance of structural change, the essence of what development is about. Indeed, what all Asian fast-growing economies did during the last decades, was to increase the sophistication (non-price competitiveness) of their exports. The export structure of the Philippines has changed during the last decades, and its non-price competitiveness has increased, but it is still far from what the country needs to attain and sustain a higher growth rate. If the structure of the export basket does not change, the Philippine economy will continue being uncompetitive in world markets and will not experience a significant increase in wages and per capita income.

Summing up: 6.5-8% growth during 2023-2028? It will be very difficult unless the world economy improves significantly, or the structure of the Philippine economy shifts in the direction of exporting a more sophisticated export basket that competes in world markets not on price but on the quality of its products. The six-million-dollar question is: who will lead transformation that the Philippine economy needs? This will be the topic of a subsequent article.

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