

# Commentary

## Brave new world

### *Part 1: A perfect storm*

*The outlook for the global economy, and for those corporations that manage global markets and supply chains, now looks so much different from the picture just one year ago. While many businesses and governments around the world are taking stock and adjusting to the new reality, here in the Philippines, the government appears to be taking a “business as usual” approach in the hope that the worst of the storm may quickly pass.*

*Probably it will not, and although the Philippines may weather the initial chill; over the long haul, the economy is not in as good shape as some would make out. There are disturbing local factors which have so far been largely ignored but which may be exacerbated by present circumstances. Instead of denying the problem, there is a need for both a policy and a mindset shift while thinking about a roadmap for the longer term.*

*Should these factors be ignored, the combination may yet turn a “perfect storm” into a “perfect typhoon.”*



**W**e are entering a brave new world. Going into 2009, the global fundamentals—political and economic—that inform the forward-planning of corporate decision-makers are now much different from those of last year. The feared economic meltdown originating from structural problems in the United States may yet come to pass. Europe and Japan are already in recession and the United States looks to be heading that way. The world is facing the prospects of a global recession starting in 2009. The smart money is predicting that recovery will be slow and, perhaps, not until 2012 or later will real growth start to show itself once again. There are some tough times ahead of us.

### A global problem

The signs had been there for a while but most hoped that the worst case scenarios could be avoided. The US housing market—which was the catalyst for the present crisis, but not the cause—had started to come off the boil in late 2005 and by early 2006 both house prices and new starts went into sharp decline. With the faltering of the housing market came a coincident drop of growth in US

consumer spending (from a high of 3.9 percent in 2004 down to 1.9 percent in 2007). Results for this year appear even more stark than last. A US government report on July-September gross domestic product (GDP) growth showed an annualised 3.1 per cent decline in consumer spending over that quarter. This was the biggest drop since 1980 and drove Q3 US GDP into a 0.2 per cent contraction, confirming predictions that the world's biggest economy was sliding towards recession. With the real financial storm not biting until the end of the quarter, many analysts now fear that recession is unavoidable. The Q4 data to be released in January 2009 will show the full picture.



*Driving the US economy*

Problems at the consumer level are mirrored at the macro level in the US structural deficits. These are the government's budget deficit and the borrowings that have financed national expenditure. The US current account deficit is now back at more than US\$800 billion after falling slightly in 2007. This level of deficit has long been recognized as unsustainable. It amounts to almost seven percent of US GDP and, to service its debt requirements, the United States must import around \$1 trillion of foreign capital every year.

There is no easy solution to the deficit problem. Proposed remedies have focused on reduced government spending, stimulation of trade in major economies outside the United States, and a gradual but substantial realignment of exchange rates. All of these are now made that much harder to achieve by recent events. Much will depend on whether China and other countries allow the dollar to fall substantially against their own currencies.

Despite the recent weakening of the dollar—it has declined by more than 20 percent against major US trading partners since 2002—and the expectation that this would lead to some improvement in US exports, the improved export position has neither created new jobs nor has it managed to save existing ones: employment in manufacturing and in services continues to decline. Personal debt relative to income is at a record high, inflation has led to fresh wage pressures and these in turn have resulted in more cautious hiring policies by US firms anxious to protect their bottom line. In October alone the US economy shed 240,000 jobs for a total job loss of 1.2 million over the first 10 months of 2008.

With the weakening of the dollar, import growth naturally fell in tandem. This was bad news for Asia since the US accounts for some 30 percent of personal consumption expenditure (PCE) globally. Demand for Asia's export products has therefore been weakening as a result and with the Philippines over-reliant on a single export category—electronics—the vulnerability is acute.

The US may still have weathered the crisis with minimal fallout had the third leg of the stool supporting the US economy—Wall Street—not collapsed under the burden of unsound financial instruments and practices; and dare we say “greed?” Last month, the system did break down and

the stage was set for what has been described by others as a “perfect storm.” That storm has now spread beyond the US and is heading our way.

## Local reactions

On the local scene, official pronouncements from Malacañang and from the Bangko Sentral ng Pilipinas have suggested that this country is largely isolated from the global economy and therefore from the worst impact of the present crisis. The government has sought to calm a nervous business sector. Such statements are true in part, but only because despite the claimed record growth of recent years, the Philippines has not really embraced globalization. The country has remained highly protectionist, notwithstanding claims to the contrary. Much of this protection is in the form of non-tariff barriers. Because of it, the Philippine economy is locked in a pre-industrialization time warp.

In fact there is no such thing as a single Filipino economy: there is a duopoly—the formal and the informal economies—that coexist within the same geographic area. It is this low-level informal economic activity that provides the buffer between good times and bad.

In the short term, the present crisis may actually benefit some local corporations. As foreign investors divest of their Asian assets to shore up their head office balance sheets, cash rich local banks and firms have the opportunity to acquire strategic assets at a fraction of their true worth. Canny local investors will also look for opportunity further afield; if not in the American or European markets then possibly in Australia or New Zealand.

While the worst effects of the crisis on the Philippines may not be immediate, the longer-term effects of any protracted economic downturn may be severe indeed. In the remainder of this essay we will look at some of the pointers that bear watching in coming months.

Export growth, never particularly robust, is showing signs of a slowdown as a result of reduced demand. There has already been a flight of capital from local stocks. Some \$312 million left the country in September alone. This is just the first phase. Much needed foreign investment, already scarce, may become even more so, especially from the more traditional sources. China, of course, will have a field day. This may change the face of Asia permanently. That can wait until another essay for comment.

### Brave new world

#### An essay series in five parts



#### Part 1 | A perfect storm

As the Philippines faces a new period of uncertainty, how robust is the domestic economy and what can be done to build future resilience?

#### Part 2 | The future of globalization

Is globalization in retreat as a result of the present crisis or will it be redefined by the process? How will the Philippines respond?

#### Part 3 | A new strategic paradigm

Strategic thinking in the post-globalization era; redrawing the map of Asia for the 21<sup>st</sup> century.

#### Part 4 | Batten down the hatches

Expectations for 2009 and how the corporate world can deal with an uncertain environment.

#### Part 5 | Truth and consequences

How will the Philippines cope with the brave new world that is upon us? What opportunities are there to be pro-active now in redefining the political and economic fundamentals of the country?

Remittances need to be watched closely. For much of the Arroyo term it has been remittance income that has kept the economy afloat. Remittances support both the value of the peso, especially against the US dollar as well as domestic consumption. PCE accounts for as much of 70 percent of domestic demand but has started to contract in recent times as remittance growth has started to slow and consumers become more nervous. The ability of government to pump-prime growth is limited.

Inflation too has played a role in undermining local consumer confidence. Now at its highest level since 1991, consumer prices peaked in August at a 17-year high of 12.5 percent before easing back to 11.8 percent in September and 11.2 percent in October. While the worst may be over for a while, the effects of the recent inflationary round will be long-lasting especially on those who survive at the margins.

Fortunately the banking sector appears to be in reasonable shape. By the end of the third quarter, non-performing assets of the financial sector were down to around 4 percent of total loans. In March the NPL ratio stood at 6.2 percent of the total loan portfolio of domestic banks and shrank further to 5.7 percent in Q2. This is one number that has been moving in the right direction although recently questions have been raised as to the accuracy of the numbers; in some cases bad debt may have simply been removed from the balance sheets. The December figure will bear watching.

But, as a number of commentators have pointed out recently, an eye has to be kept on a range of off-balance-sheet items and any flow-on from problems of the insurance sector. These two sectors are closely intertwined. To this we would add credit card debt. Here the situation may become worrisome and a further sign that consumer spending is in trouble close to home. Total credit card receivables in June stood at P122 billion. This represented 5.24 percent of the total loan portfolio of the domestic banks and down from 5.40 percent in Q1. Even more of a concern is the rise in non-performing credit card receipts. Going from 10.2 percent of total credit card debt in March to 11.6 percent in June, this represented an increase of 20.2 percent. This was before the storm struck. We will need to see the figures for the second half year before drawing any conclusions but the figures for 1H 2008 are not encouraging. They provide further evidence that even middle class consumers are already feeling the strain.

Many are asking whether the Philippines is sufficiently robust to ride out the approaching storm—or should we say ‘typhoon?’ We would suggest that the very nature of the local economy means that, in the early phase at least, the worst effects of the storm may be hidden from many. The Philippines remains at heart a pre-industrial agrarian society with many Filipinos labouring in subsistence conditions that are far removed from the sight of those who live or work in the major business districts of Metro Manila. The net worth of the business and political elite, measured in share or property values, may suffer for a while, but their lives will be little changed by it all. It is the working people—those who sell their labour for wages or other forms of income—who will likely bear the brunt of any prolonged downturn. Knowledge workers will fare better than most, and the rural poor will be less affected than the urban poor.

Significantly, the safety valve that has long prevented the boiling over of social discontent may be tightened. The number of workers seeking overseas employment has increased dramatically over the past decade but that number may start to contract in many markets. Not only will there be a decline in absolute demand (a decline that is already becoming evident) but the Philippines will face

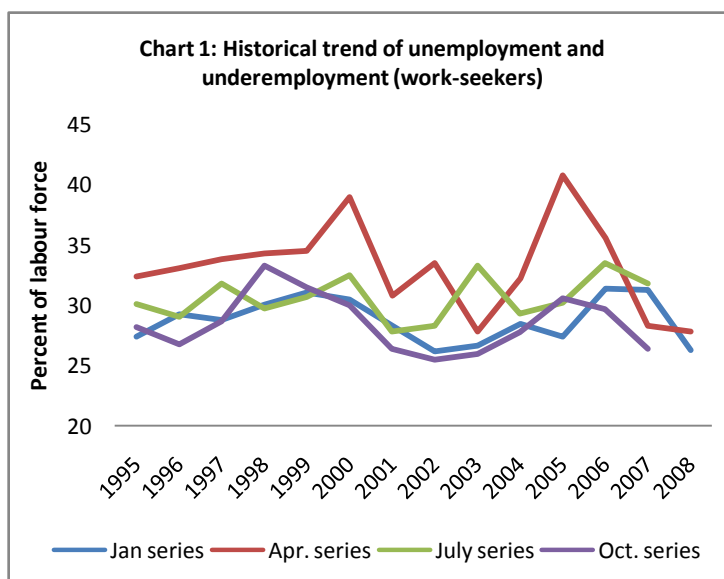
increased competition from other labour exporting countries. Yes, labour migration has now been globalized as well.

This leads us in the second part of this essay into a discussion of local factors that could actually amplify the effects of the global crisis on the Philippines. And our theme is as follows: the domestic economy is already failing to produce sufficient jobs for those who would enter the labour force; the situation may be more serious than the official numbers suggest; increased globalization of the labour market, especially in a time of global stress, may bring the situation to a head. But before we draw any firm conclusion, we have to make a detour and look at the recent labour force data.

## Hidden people

Chart 1 shows historical rates of unemployment and underemployment in the Philippines as a percentage of the available workforce and as measured by the quarterly Labor Force Surveys conducted by the Department of Labour and Employment. The numbers show a strong seasonality factor with the April surveys (boosted by the influx of new entrants at the end of the school year) generally showing the highest levels of work-seekers<sup>1</sup> and the October figures (prior to the Christmas season) showing the lowest.

By combining all data, we see that the average number of work-seekers for the period 1995–2000 amounted to 31 percent of the workforce and 29 percent of the workforce for the period 2001–2007. At first blush this suggests a small, but valuable, decline in the proportion of those seeking domestic work. But there is a catch: in 2006 the government redefined the concept of workforce

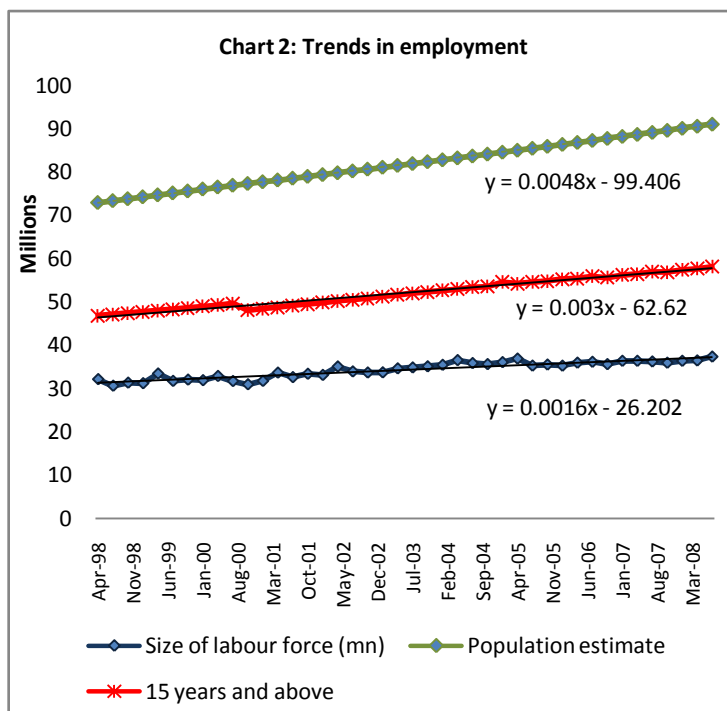


by including only those who were “actively looking for work.” This had the immediate and long-term effect of hiding at least two percent of those who would wish to be employed simply by removing them from the definition. If these people are folded back into the equation then the number of work-seekers climbs to an average of 29.8 percent for the period 2001-2007 and if only the data for the past three years is averaged (since the new definition), then the number returns to 31.4 percent of the workforce—even higher than that for the pre-Arroyo period.

For a government that has put so much emphasis on generating employment such numbers provide no comfort at all. Were it not for the BPO sector, the situation would be much worse. This is the condition entering the storm but it is not the entire story. Looking at the numbers another way shows an even more serious problem developing. A second cold front may be forming.

<sup>1</sup> We use the term “work-seekers” as distinct from “job seekers” since many of these people are already in some form of employment but seek additional work within the context of their existing job.

Chart 2 graphs the trend of (i) gross population, (ii) population aged 15 years and above (i.e. those of working age) and finally (iii) the size of the labour force over the past ten years. Population estimates are obtained from interpolation using the 1995, 2000 and 2007 census results as fixed points while the other data is obtained from the Labor Force Surveys. The time period analyzed (10 years) is sufficiently small as to allow a linear curve of best fit to be applied to the three data sets. The slope of each trend line suggests that gross population over the period has been growing faster than that proportion that is 15 years and above. This is not what would be expected from a slowing population growth rate. The most likely explanation for this is that the OFW component depresses this factor although this has not been examined in detail. However, what is significant is that, of the three sets of data, the lowest growth is recorded when measuring increase in the size of the labour force. This means that an increasing number of people of working age are hidden from the data. Where do they go? What do they do?



### Tip of the iceberg

The raw unemployment and underemployment numbers are therefore only the tip of the iceberg. If the data is accurate then the number of those hidden from the official statistics appears to be growing in the Philippines. If the present global uncertainty continues for any length of time, the impact on external labour demand will start to make itself felt.

According to the *2006 Survey on Overseas Filipinos*, the number of overseas Filipino workers (OFWs) who worked abroad at anytime during the period April to September 2006 reached 1.52 million. This was up from 893,000 in 2002 and 654,000 in 1995.

The 2006 estimate represented an increase of 14.3 percent over the 1.33 million OFWs estimated for the period April to September 2005. Overseas Contract Workers (OCWs)—those with existing work-contracts abroad—accounted for 91.4 percent (1.38 million) of the total OFWs during this period. This number is 14.0 percent more than the 1.21 million OCWs for the same months in 2005. According to the Survey, The most vulnerable component representing those who worked as unskilled workers (domestic helpers, cleaners and manufacturing labourers) comprised 35.1 percent of total OFWs. Those who were trade workers or trade-related workers made up 14.7 percent, while those who were service workers and shop and market sales workers accounted for 13.8 percent. We would suggest that these are all vulnerable since their replacement by others is relatively easy in present circumstances.

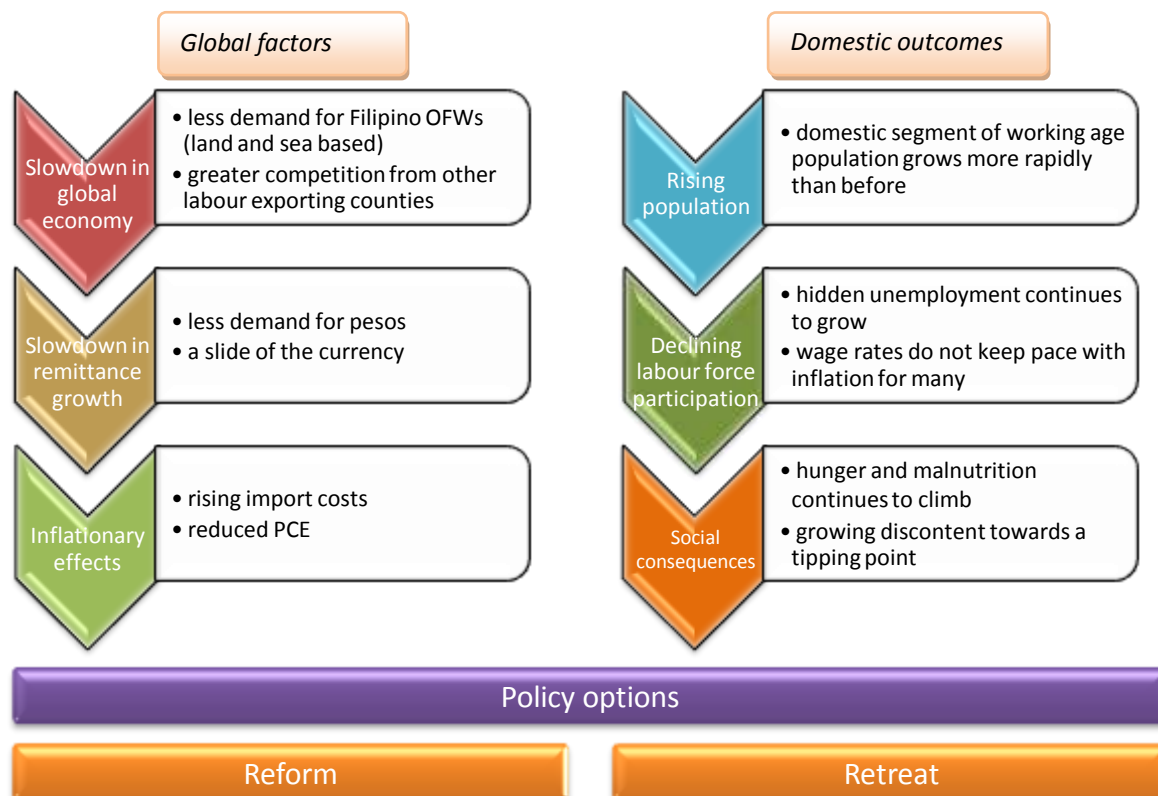
Adding the OFW numbers to the size of the domestic workforce shows that OFW contract labour accounts for around 4 percent of total employment (domestic and foreign) available to Filipinos. This of course does not include those who have taken out foreign citizenship during their overseas employment. This may have some cushioning effect on the slowdown of remittances although the extent is hard to foretell.

The key point is that to an already fragile domestic labour market, there is a real danger that present tensions will be exacerbated by a slackening demand for overseas workers from the Philippines. This will lead to a slowing of remittance income (slower in peso terms than in dollar terms); a reduced demand for pesos and, all other things being equal, a further slide of the currency that in turn will feed into inflation and a worsening of the employment situation.

Labor Secretary, Marianito Roque said recently that the “worst case” forecast of the Department of Labor and Employment (DOLE) was that the economic downturn could reduce overseas employment by around 50,000 jobs. If it can be held to this level then the Philippines will be lucky indeed. This number may turn out to be a gross underestimate. In fairness this statement from Secretary Roque came ahead of the October meltdown. Already the number is looking to be much higher.

### A wasted decade?

Complacency has been too much in evident in the policy-making of recent years. Over the past decade the safety valve provided by overseas employment has become a panacea and an excuse to avoid reforming the domestic labour market. Despite protestations to the contrary, foreign investors have been kept at arms length; especially those that have demanded a level field.



Previously and when the pie was growing, it did not appear to matter; now it may start to matter a great deal.

The key question is which road will the Philippines take when the implications of a prolonged global slowdown start to bite? Will we see a leadership that recognizes the proposition that open economies tend to fare better in hard times than closed ones or will there be continued procrastination over genuine reform and a further move to the “right” where oppression is seen as the antidote to transformation? If the latter road is taken, where will we find the ‘tipping point?’

Much talk is heard in conservative circles of the value of a high population growth rate, especially in terms of supplying an educated workforce to an expanding global economy. It is a convenient myth that avoids giving answers to hard questions. A young demographic can indeed work to the advantage of the country over the longer term but only if it leads to an employable workforce that is earning an efficiency wage within the local economy that in turn fuels robust domestic consumption as well as improving capital formation. Unless changes are made, the likely outcome will be further migration from employment for salaries and wages in the formal economy to the vagaries of self-employment in the informal one. This in turn will fuel further social discontent.

That globalization came late to the Philippines may, in the end, be no bad thing. The very fact that for the most part, the economy of the Philippines remains pre-industrial provides a new opportunity to shape the future without having to undo too many mistakes of the past. But it will mean on the economic side of the ledger, a renewed opening of the economy to broad-based foreign investment, while encouraging further domestic capital formation. Is there anyone among the polity brave enough to think outside the box? Not for the present it seems: here in Manila it continues to be “business as usual.”

*These issues will be explored further in subsequent essays.*

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