Why a new industrial policy for the Philippines is critical

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Around the world, growth patterns and sources of competitiveness are changing dramatically. Emerging economies are becoming key players as the United States, European Union, and Japan continue to face slower growth. In the context of these rapidly changing global conditions, the Philippines is now seen as a new growth market especially as investors look for alternative areas after the Japan quake and Thai flooding that disrupted many supply chains, and given the rising yen and the increasing labor costs in China. Moreover, many see the impressive 6.6 percent growth in gross domestic product for 2012 as a sign of increasing economic momentum that is necessary to drive the country toward a higher growth path in the succeeding years.

Given the opportunities and challenges that the Philippines is now facing, both the government and private sector must formulate strategies to adapt to changing global market trends. The government needs an inclusive growth model where the industrial sector plays a key role in generating investment, employment, and innovation. For growth to be sustainable, it should increasingly be broad-based across sectors and inclusive of the large part of the country’s labor force (World Bank 2009). While the services sector has provided a major source of value added and employment, manufacturing needs to be revived to attain more inclusive and sustained growth. As Yap (2012) argued, there are more high-productivity, high-paying, quality, and stable jobs in

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manufacturing. Though the country’s growth posted improvements in the recent past, its impact on employment creation has been minimal and has been characterized as jobless growth. On the average, unemployment rate was around 7.6 percent from the mid-2000s while underemployment remained high at 20.14 percent during the same period.

**Current state of Philippine manufacturing and need for structural transformation**

To lead the country’s sustained and high growth level, a strong and modern industrial sector is needed. However, the overall performance of the manufacturing industry in the past two decades has been weak in terms of its contribution to employment, investment, and productivity growth. From the 1980s up to the early 2000s, manufacturing growth was slow with an average of 0.9 percent in the 1980s and 2.5 percent in the 1990s. Modest growth was posted in the 2000s averaging 4.1 percent. The share of manufacturing to total industrial output remained unchanged during the same periods, accounting for 28 percent of total output in the 1970s, 26 percent in the 1980s, and 24 percent in the 1990s and 2000s. In terms of employment generation, the manufacturing industry failed in creating enough employment to absorb new entrants into the labor force as its share to total employment dropped from 11 percent in the mid-1970s to 9 percent in the 2000s.

There has been no structural transformation of the economy from agriculture to manufacturing and no rapid industrial growth. Instead, as Fabella and Fabella (2012) highlighted, a case of development progeria (premature ageing) characterizes the Philippine economy. This is manifested by the rise in the share of services and a fall in the share of industry and manufacturing sectors. While our neighboring countries registered substantial increases in the share of industry, the share of industry declined and remained stagnant in the Philippines in the past two decades.

The manufacturing export base has become less diversified as the country’s exports are largely concentrated in three product groups: electronics and other electronics, garments and textile, and machinery and transport equipment. Within these major product groups, exports are highly concentrated in low value-added and labor-intensive product sectors. These goods are considerably dependent on imported inputs and have weak backward and/or upward linkages with the rest of the manufacturing sectors (Box 1).

The industrial structure has remained hollow or missing in the middle, and medium enterprises have never seriously challenged the large entrenched incumbents. The linkages between small and medium enterprises (SMEs) and large enterprises have also remained weak. SMEs have
Box 1. Broken linkages and supply chain gaps

Broken supply linkages characterize many of our industries. The lack of materials processing has severely affected the competitiveness of the Philippine parts and supplies industries and hampered the ability of high-technology industries to move up the value chain. Due to weak backward linkages within the manufacturing industry, automotive and electronics have continued to rely on imported parts and remained at the assembly stage of the supply chain.

In the iron and steel industry, which is critical for the manufacture of parts and equipment, competitiveness issues have remained due to the high costs of power, raw materials, and logistics; unabated smuggling; and limited government capacity to monitor product standards. With the shutdown of Global Steel, local production of hot-rolled coil/sheet, cold-rolled coil sheet, tin plates and wire rods were completely displaced by imports.

In terms of forward linkages, the local tool and die industry has to compete heavily against imported dies and molds while its backward linkages are weak due to the unavailability of most raw materials, equipment, and software. Special steels and castings, general and specialized metal machining equipment, and software are all imported. Labor is the only component of the value chain that is locally sourced. Though the country has natural resources that would provide important metals like iron and copper, there are no processing plants (capital-intensive blast furnace, steel-making facility) that would produce the form of metal that the industry requires. There is no reliable aluminum casting facility for molds used in molding large plastic components like refrigerator liners. In the export-oriented copper industry, firms have hardly any linkage with the domestic economy (Icamina 2012). Copper ores are all exported and although the country has a copper smelting facility, it imports 100 percent of its copper ore requirements and exports 100 percent of its output due to the absence of a copper rod facility. Manufacturers of wiring harness, a major export product and user of copper rods, import all of their copper rod requirements.

continued to face competitiveness problems and are continuously beset by difficulties in financing as well as technology and market access.

In terms of the product space, the Philippines is also characterized as hollow as most of its manufactured products are in the periphery and very few are in the core area (Usui 2012). Core products such as machinery, chemicals, and metal products are closely linked with each other while periphery products are those that are only weakly linked, like natural resources and primary and agricultural products. For a country that specializes in peripheral products, structural transformation is much more challenging.

Most binding constraints to firm growth
To lay the foundation of becoming a major growth driver, technology upgrading and transformation of the manufacturing industry are required. Given the country’s relatively open economy and narrow industrial base, the structural transformation and product diversification process would entail many coordination and information externalities that the government should
address. The lack of infrastructure and weak investor confidence arising from governance issues and weaknesses in the larger regulatory environment and investment climate are the most binding constraints affecting industry growth and entry of new firms.

At the micro level, firms continue to face major constraints such as poor infrastructure and logistics; lack of domestic raw material suppliers, parts and components; bureaucracy, red tape, policy inconsistency; and lack of highly skilled workers. Domestic manufacturers have continued to suffer from the unabated entry of smuggled and substandard products as well as high power and logistics costs. Competitiveness has also been negatively affected by the underdevelopment of parts and components industries and high cost of raw materials (Box 1). In the face of increasing competition from imports, the lack of adjustment measures like temporary industry support measures and training and job search assistance for displaced workers has led to the inability of firms to cope with the new operating environment.

Good infrastructure and efficient institutions are necessary to support industry growth and generate supply-side responses. The role of the government is crucial as it needs to coordinate policy support measures that will address the obstacles to the entry, exit, and growth of domestic firms, particularly SMEs. To achieve this, well-functioning institutions and regulatory agencies are necessary. To boost the country’s competitiveness, policies should be geared toward improving the business environment, including investment in human capital and infrastructure as well as the quality of governance in the country.

**Industrial policy to facilitate upgrading, generate gobs, and catalyze growth**

A new industrial policy is crucial to help the government determine measures to strengthen industries and the business environment in which they operate. Industrial policies are needed to enhance firm productivity, deepen linkages of domestic firms and SMEs with large domestic and multinational companies, and aggressively court more investment. Policies will also be necessary to boost the survival of new entrants and provide assistance for the growth and development of SMEs. To enable firms to move up the technology scale, programs should be formulated to improve technological and human resource capabilities as well as to strengthen supply chains.
In the short run, the policy focus should be on strengthening and rebuilding existing capacity of industries especially those with strong potentials to generate employment, address missing gaps, and create linkages and spill-over effects...During this initial stage, policies and programs should aim at exploiting economies of scale and learning by doing. In the medium term and as domestic capacities are reached, efforts in the initial stage should lead to expansion and new investments especially in the upstream or core sectors...In the long run, a globally competitive manufacturing industry with strong forward and backward linkages is envisioned.

In the short run, the policy focus should be on strengthening and rebuilding existing capacity of industries especially those with strong potentials to generate employment, address missing gaps, and create linkages and spill-over effects such as automotive, electronics, motorcycle, shipbuilding, chemicals, and allied or support industries. During this initial stage, policies and programs should aim at exploiting economies of scale and learning by doing. In the medium term and as domestic capacities are reached, efforts in the initial stage should lead to expansion and new investments especially in the upstream or core sectors such as iron and steel and other metals as well as in parts and components industries. In the long run, a globally competitive manufacturing industry with strong forward and backward linkages is envisioned.

Making domestic firms internationally competitive is a major challenge that would require government support and close coordination among local and national government agencies and the private sector. To jumpstart the upgrading process, the Department of Trade and Industry, Board of Investments, and the Philippine Institute for Development Studies are formulating a Comprehensive Manufacturing Industry Roadmap to enable manufacturing firms to upgrade, thrive, and become catalysts and engines for sustained and inclusive growth. In consultation with the private sector, the Roadmap Team is currently in the process of identifying the different industrial activities where the Philippines may have potential opportunities for sustained growth and employment generation and also planning on how to focus infrastructure support to encourage these activities. Box 2 presents the roadmap for the automotive industry.

Nomura Research (2010) indicated that the Philippines has comparative advantage in electronics subsectors like printers, multifunction peripheral, projectors, scanners, and digital cameras. The same study also identified missing linkages in the electronics supply chain such as photovoltaic cell, LEDs, rechargeable batteries for hybrid electric vehicles, electric vehicles and mobile digital devices, and next-generation energy infrastructure. In a separate study, Nomura (2012) indicated the strong potential of the Philippines in shipbuilding especially in...
Box 2. Automotive industry roadmap

The automotive industry is a highly global and technology-driven industry. It is complex with a large number of parts and components (textiles, glass, plastics, electronics, rubber, steel, and other metals) involving different production processes. Given these interlinkages, the promotion of the automotive industry can lead to an expansion of many complementary investments by automotive parts firms and help lay the foundation for broad-based industrial growth.

In the last 10 years, the Philippine automotive industry has seen intense import competition as a result of trade liberalization. Through the ASEAN Trade in Goods Agreement, tariffs were eliminated in early 2010. With increasing regional integration, domestic assemblers in the country have been shifting away from assembly or completely knocked down (CKD) operations toward completely built units imports. As its CKD operations declined from 92 percent of total sales in 2003 to 49 percent in 2009 and further to 41 percent in 2011, Ford Motors decided to close down its assembly plant in the Philippines.

The industry has been facing competitiveness issues due to the absence of economies of scale and a weak supply base. These are the fundamental issues that must be addressed in order to strengthen the industry and integrate it with regional production networks of foreign automakers. To achieve this, there is a need for strategic industrial upgrading policy and carefully designed temporary support that would target improvement of firm competitiveness as well as rebuilding the market for domestically assembled vehicles. Moreover, strong political will will be needed to address the illegal entry of new and used vehicles.

Amid these challenges, there are market opportunities that globalization brings and which the industry can take advantage of. Forecasts show that Asia will be the most dynamic market in the world especially with the steady growth of China, India, and the Southeast Asian countries. The creation of the ASEAN Economic Community in 2015 offers increased trade and investment opportunities. There are also strong growth potentials in specializing in certain core processes and alternative fuel and E-vehicles and parts. Investors will not put all their eggs in one basket especially in the light of the supply chain disruptions that occurred after the Japan quake and Thai flooding. The Philippine auto industry must be ready as investors search for alternative locations.

As the country aspires to become a regional hub like Thailand, large investments would be necessary in critical parts like body panel stampings, large injection moldings, and engines. Three major strategies are proposed to be implemented: (i) enhance the competitiveness of Filipino parts and components firms; (ii) create an incentive program to support the adjustment of the automotive industry as it transforms from CKD assembly to full manufacturing; and (iii) establish a more predictable environment for business operations. Through the effective implementation of these policy measures, the auto industry is expected to realize its potential of being one of the key drivers of manufacturing growth by 2020, producing not only for the domestic market but also for the regional and world markets.

Sources: PACCI (2012); Aldaba (2012)

view of plans by Korea and Japan to expand their overseas market.

To take advantage of the opportunities in these sectors, the Roadmap Team will identify the most binding constraints affecting their growth and development through the various consultation meetings with industry stakeholders. To address these constraints, both horizontal (general
measures like protection of property rights, improvement of business environment, and innovation strategy) and vertical measures (industry-specific policies such as tax incentives, access to raw materials, and infrastructure provision like common testing facilities to targeted industries) will be formulated. A coordination mechanism (such as industry councils) will also be designed to allow more interaction with industries in identifying obstacles, determining the most appropriate interventions, and monitoring industry programs.

Given its popularity and high trust rating, the Aquino administration is expected to continue implementing solid reforms and actions to overcome the difficult challenges in realizing the country’s potentials. With strong collaboration among national agencies, local government units, and the private sector to improve the country’s infrastructure and investment climate and implement the country’s roadmap, the Philippines is well positioned to attract new investments that would catalyze growth and development of the manufacturing industry.

While the private sector is seen as the major driver of growth, the government has an important role to play in coordinating policies and necessary support measures that will address the obstacles to the entry and growth of domestic firms. The government can promote the success of domestic firms in both the local and international markets that will lead to economic transformation by creating the proper environment and ensuring that domestic industries are not disadvantaged by international competitors. Only with the right environment can manufacturing unleash its full potentials to become an engine for sustained and inclusive growth and job creation.

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