

**Navigating the Uncertain Global Environment and Building Inclusive Growth
in the Philippines**
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Outlook and Risks

The global outlook has become increasingly uncertain, and the recovery is more sluggish than we envisaged just a few months ago as the handover from public stimulus to private demand has stalled in the United States and euro area financial turbulence has intensified. While the outlook for advanced economies is for a continuing, although weak, expansion for the remainder of 2011 and 2012, the risk of a renewed slowdown is greater now than six months ago, especially if structural fragilities remain unresolved.

After a strong start in the first quarter of 2011, economic activity in Asia has also moderated, mainly as a result of weakening external demand. Domestic demand has been generally resilient as employment gains and real wage growth supported private consumption, high capacity utilization boosted private investment, and financial conditions have remained accommodative. In our latest Asia-Pacific *Economic Outlook* that we presented in Manila on October 17 we expect that in Asia, mirroring the rest of the world, growth in 2011 and 2012 is expected to be slightly lower than we previously envisaged. But at 6¼ percent on average this year and 6¾ percent next year, Asia's growth would still be robust while inflation should recede modestly after peaking in 2011.

In the Philippines, growth has slowed down in recent quarters amid global headwinds, supply-side disruptions from the twin disasters in Japan, and weak public spending in the first half of 2011. Like in several other Asian countries, the GDP growth forecast was revised down modestly, to 4.7 percent this year and 4.9 percent next year. The outlook is supported by a rise in government investment towards budget targets, a dissipation of supply-chain disruptions, and implementation of the government's private public partnership (PPP) agenda.

Despite this generally benign picture, risks for the Asia and Pacific region are decidedly tilted to the downside. On the external front, an escalation of euro area financial turbulence and a renewed slowdown in the United States could have severe macroeconomic and financial spillovers to Asia in general, through both trade and financial channels. On the domestic side, overheating pressures remain elevated in a number of economies, with credit growth still robust and inflation momentum generally high. Over the medium term, a key risk for the region derives from the potential for a gradual build up of balance sheet imbalances after a protracted period of easy financial conditions as corporate sector leverage is increasing more rapidly compared to previous recoveries, particularly in already highly indebted sectors that are experiencing excess capacity, such as construction.

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Policy challenges

The downside risks to growth amid persistent overheating pressures present Asian policy makers with a delicate balancing act, as they need to guard against risks to growth but also limit the adverse impact of prolonged easy financial conditions on inflation and balance sheet vulnerabilities. In economies where overheating pressures are more elevated and monetary conditions still accommodative, the return to more neutral monetary stances should continue, through both higher interest rates and more flexible exchange rates. However, in economies where expected inflation is within central banks' target ranges and the exposure to severe external shocks is greater, a pause in monetary tightening may be warranted until the global uncertainties have lessened.

This policy dilemma is relatively less pronounced in the Philippines for three reasons. First, despite the recent uptick, credit growth in the Philippines has been relatively modest and asset-price bubbles are absent. Second, price pressures are subsiding and inflation expectations have declined and are consistent with the BSP's target range after successive rounds of policy rate and reserve requirement hikes and subsiding commodity pressures. And third, the economy is neither experiencing overheating, nor significant slack as growth is broadly in line with potential. Nevertheless, policymakers need to remain vigilant regarding balance sheet vulnerabilities particularly in an environment of elevated concentration risk, as maintaining accommodative financial conditions for an extended period could fuel further credit expansion and corporate leverage and result in lower asset quality down the road.

At the same time, the weakness in global demand only confirms that Asia would greatly benefit from further progress in rebalancing growth towards domestic sources of demand. In addition to structural reforms, this would require a reprioritization of fiscal spending, in order to create fiscal space for critical infrastructure investment and social priority expenditure. Deepening regional financial integration would also help with rebalancing, by improving access to finance and strengthening domestic demand, without necessarily opening the door to greater contagion risks. These measures would help increase domestic demand over time, as well as make the region more resilient to external shocks, and they would also help to make growth in Asia more "inclusive."

Indeed, inclusive growth has been elusive and despite progress in poverty reduction, income inequality in Asia has increased over the last decade. This quest is also well recognized in the Philippine Development Plan (PDP). The conditional cash transfer program in the Philippines sets an example in Asia in terms of redirecting resources toward socially desirable programs in a well targeted way. The PDP also recognizes the need for higher spending on health and education and greater public investment to achieve higher per-capita income growth that usually tends to reduce poverty incidence. This will require more fiscal space by increasing government revenue, an area where the IMF is actively supporting the Administration to improve tax administration and to implement a meaningful sin-tax and fiscal incentives reform.