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Macro Management Sector: Abridged Version by: Joseph Lim

I. Introduction

The Philippines has performed poorly against the major economies of East Asia and Latin America. (Table 1) It had the lowest average annual growth rate in the last half century, next only to Argentina, for two reasons. First, even during growth periods (1960-80, 1993-97 and 2003-2005) the Philippines did not grow as fast as the more successful countries so that its best years equal only those of Mexico and Brazil in the dismal decade of the 1980s. Second, it suffered major recessions due to balance of payments and financial crises, yielding negative average annual growth in the periods 1980-1991 and 1997-99.

Table 1: Annual Growth Rate of GDP per Capita of Selected Countries for Various Growth Periods Based on GDP per Capita at Constant 2000 US Dollars

Average Growth Rate*	1960-2005	1960-1980	1980-1991	1991-1993	1993-1997	1997-1999	1999-2002	2002-2005
Argentina	0.96	1.83	-1.76	7.41	2.78	-0.96	-6.42	7.97
Brazil	2.23	4.57	-0.50	0.60	2.47	-1.04	1.06	1.17
Chile	2.55	1.54	2.42	7.62	5.88	-0.11	2.12	4.34
China**	6.00	2.89	7.71	12.75	9.63	6.68	7.84	9.42
India	2.71	1.19	3.14	3.14	4.86	4.75	2.65	7.11
Indonesia	3.55	3.58	4.68	5.53	5.55	-7.68	3.00	3.71
Korea, Rep.	5.66	5.47	7.54	5.05	6.20	0.27	5.66	3.44
Malaysia	3.93	4.38	3.57	6.52	6.30	-3.20	2.18	4.07
Mexico	1.98	3.53	-0.06	0.92	0.74	2.94	1.20	1.78
Philippines	1.38	2.43	-0.92	-1.06	2.78	-0.64	2.06	3.49
Thailand	4.55	4.56	6.17	6.73	4.38	-4.29	3.10	4.97
Vietnam**	4.86	n.a	2.46	6.23	7.07	3.86	5.62	6.64

* Annual growth rate is estimated by $F(T) = F(0) (1+r)^T$ where $F(T)$ is the final value, $F(0)$ is the initial value, r is the annual growth rate and T is the number of years. This leads to $r = [F(T)/F(0)]^{1/T} - 1$

** Data for China starts in 1975 and data for Vietnam starts only in 1984

Source: Calculated from Data of *World Development Indicators* of World Bank

This puts the country in the league of the major Latin American economies, Argentina, Mexico and Brazil, which suffered recessions or stagnation (almost zero GDP per capita growth) in the 1980s and 1990s. In recent years, however, Argentina has been doing very well (next only to China) and the Philippines has not been doing too badly either. The latter has been growing at a pace much better than Brazil and Mexico, and at par with South Korea. In 2007, the growth rate of the Philippines in the first semester was 7.3%.

2. The Importance of Macroeconomic Stability for Growth and Investments

The importance of macroeconomic stability for growth and investments is obvious. To provide a good business environment there should be:

- a) continuous periods of growth and high business confidence free from financial, balance of payments or debt crises;
- b) absence of high current account deficits (same as large gaps between investments and savings) and high fiscal deficits;
- c) absence of heavy government and external debt burden or debt service that cause instability in the financing of government expenditures and foreign exchange financing of import needs for development;
- d) price stability so that businesses can predict input and output prices reasonably to encourage production and investments;
- e) absence of strong contractionary policies such as high interest rates, damaging speculative attacks on the currency (massive and sudden devaluation) and fiscal cutbacks in public spending and public infrastructure

It is clear that the absence of any of the above will discourage firms to expand production and undertake long-term investments for the economy.

3. Macro Stability and Growth: Historical Trends

The modern post-war economic history of the Philippines has been marked by frequent economic and political crises that led to periodic economic downturns and stagnation. From 1946 until the early 1980s, there was a steady increase in GNP per capita, except for three years—1958, 1960 and 1970—all of which saw balance of payments crises. (Fig. 2) Since the 1980s, the Philippine economy had been highly volatile, hitting four recessions and stagnation in two decades, in 1983-85, 1991-93, 1998 and 2001. These periods, except in 2001, were marked by balance of payments difficulties, the 1984-1985 crises, which involved an external debt crisis and financial crisis, being the deepest in the country's modern history.

Like most industrializing countries, the share of agriculture fell steadily through the decades, recovering briefly in the late 1960s and early 1970s, then declining more rapidly beginning in the mid-1970s. By 2006, this was down to 14% from 37% in 1947. By contrast, industry's share grew steadily from the late 1940s to the early 1980s, peaking at close to 40% in 1980-1983. Driving industrial growth was manufacturing, whose share of GDP reached a plateau in the 1970s, staying at 25% of GDP until the early 1990s.

The service sector initially expanded with industry from the late 1940s until the second half of the 1960s, but fell thereafter until the mid-1970s as industry share grew rapidly. After the economic collapse of 1984-85, the service sector became the lead sector of the economy, increasing its share sharply then stabilizing at around 53% to 54% in recent years. Meanwhile, the shares of industry and manufacturing continued gradually fell through the 1980s and 1990s. There was a brief recovery in the share of manufacturing and industry after the Asian crisis, but these have stagnated at around 32% and 23% of GDP, respectively.

On the demand side, the economy posted respectable rates of gross capital formation or investments, which were especially high during the post-war reconstruction period (1946-48)

and the Marcos era 1970s to the early 1980s. The share of investment to GDP collapsed during the 1984-85 recession to 14% in 1985 from 30% in 1983. A moderate recovery was evident in the second half of the 1980s thanks to government pump-priming activities, and again in the mid-1990s as optimism fed by foreign capital inflows triggered a real estate boom. In those two periods, however, investment spending did not come close to the rates posted in the 1970s.

The post Asian crisis period has seen investment fall steadily to a record low of 15% in 2006 (at par with the level recorded in 1985).

The share of private consumption to output has moved opposite to investment: it fell in the 1950s to the mid-1970s, as the share of investment reached new heights. Consumption shot up to 70% in the mid-1980s, as growth collapsed and the investment share fell, and has hovered at that level in the last three decades. The late 1980s and 1990s saw strong external trade activity as a result of trade liberalization and the emergence of the electronics export production. From a share of 20% of GDP in the mid-1980s: exports and imports zoomed to 50% of GDP in the mid-1990s. The Asian crisis disrupted the growth in exports and imports as both have dipped below 50% of GDP. Except in recession years, imports have mostly exceeded exports, resulting in perennial trade deficits.

A Short Economic History

The first half of the 1950s saw the best growth performance in Philippine history as import-substitute industries flourished. The country was widely seen as the front-runner to achieve successful development in East Asia. The process of industrialization was launched with the share of manufacturing rising quickly to 25% by the end of the 1950s from only 7% in 1946. This marked the start of the sustained decline in the share of the agricultural sector.

The promise of an economic 'take-off,' however, failed to materialize. Industrialization did not develop backward linkages, hampered by a small domestic market characterized by high income inequality, a lack of cohesive industrial strategy, and corrupt practices in the issuance of import licensing with alternating administration using state power to expand their rent-seeking activities. A key weakness of import-substituting strategy was the inability to outgrow its initial dependence on imported raw materials, intermediate inputs and capital equipments. With policymakers preferring an overvalued peso, trade and current account deficits became the rule. International reserves shrank (in terms of import cover) throughout the 1950s, culminating in the intense balance of payment crisis from 1957-61. Pressures to devalue the peso became difficult to stave off.

1962-1970: Trade and Foreign Exchange Liberalization, Entry of IMF and BOP Crisis

A regime defending the import-substitution strategy was replaced in 1962 by a new administration that won the elections on the platform of trade and foreign exchange liberalization. The peso was devalued and IMF help sought, which marked the beginning of the IMF's deep (and disastrous?) involvement in economic policymaking and management.

The Philippines under Marcos entered another BOP crisis in 1969-70 as foreign debt began to bunch up and as trade deficits continued. In 1970, the Philippines entered another IMF-sponsored structural adjustment program that called for drastic devaluation, and pushed for an outward oriented economic strategy.

1971-1981: Authoritarian Rule and Martial Law

The declaration of martial law in 1972 was followed by a decade of high growth. Massive borrowings from multilateral institutions and foreign banks rolling in petrodollars financed a spending spree in public infrastructure that lasted till the late 1970s. The period was also marked by an inconsistent implementation of an outward looking strategy combining export promotion with the protection of economic sectors dominated by close Marcos allies.

The “debt driven” growth of this era survived the first oil price shock in 1973-74, but not the Latin American crisis of 1982 which took its toll on the country as access to long and medium term debt was virtually cut off and short-term debt instruments were obtained at exceedingly high interest rates. The peso devaluation in July 1983, followed by the assassination of Marcos's political rival touched off a domestic political crisis, set the stage for the worst BOP crisis in the country's history. A moratorium on external debt payments amidst sharp depreciation of the currency was declared in the third quarter of 1983, two years after the start of the world recession and about a year after Mexico's and Brazil's foreign debt crises erupted.

Policymakers followed the monetarist policy prescribed by the IMF. Liquidity and credit were contracted in 1984-1986 to stem capital outflows and control inflation which resulted from the sharp currency devaluations. The credit contraction deepened the recession. Financial conditions rapidly deteriorated, much like it did in the hard-hit countries in the Asian crisis a decade later. Firm closures and work stoppages hit in key industries. The Central Bank and state-owned banks ended up holding non-performing assets of the private sector. It took a long while to dispose of these assets, rehabilitate the financial sector, especially hard-hit government financial institutions, and re-establish the Central Bank free of crippling debt burden.

As investment share fell, the share of consumption rose. The other side to rising consumption is falling gross domestic savings. Data on poverty and income distribution also show that poverty rates and income distribution worsened during this period.

On the supply side, industry and manufacturing suffered the most. The economic collapse precipitated the premature decline in the share of industry, unlike in the more successful countries where industry, after reaching maturity, retreats to give way to services. The recession was accompanied by high inflation which reached 50% in 1984 and more than 20% in 1985. As the economy hit rock bottom in 1986, inflation fell to zero and (briefly) negative levels and external balance was restored as imports contracted.

In all, GNP per capita shrunk by almost 20% from 1983 to 1985, setting back the economy a full decade as the country lost its chance to become part of the East Asian success story. The resulting depression was perhaps worse than the Indonesian experience in 1998.

1986 – 1993: Recovery, Recession and Power Shortages

The resolution of the crisis with the new Aquino government offered a golden opportunity for reformers in government to institute structural adjustments with the backing of the multilaterals. The disastrous Marcosian interventions were seen as proof that market liberalization, deregulation and privatization would spur growth. Import restrictions were lifted, large-scale privatization of state-owned enterprises pursued, and tax reforms implemented (Lim and Montes, 2000).

The economy slowly recovered as the decade came to a close, not without IMF assistance and government pump-priming efforts. The resulting fiscal and external deficits proved unsustainable in 1989 and 1990, especially since the public and external sectors continued to suffer from debt overhang after the government had to assume a substantial amount of private debts.

The government, under IMF supervision, responded to the external and fiscal deficits and double-digit inflation rates with tight monetary policy, a reduction in fiscal spending, and higher indirect taxes. Interest rates jumped to over 20% in 1990-1991; fiscal spending was slashed (partly to allow the servicing of accumulated debts). On the political front, a series of military challenges against the Aquino government sapped business confidence which has been showing signs of revival. With the first Gulf War, the external environment turned against the country: oil prices rose in the global market and the peso came under pressure. The stage was set for the 1991 recession. Economic recovery was delayed by widespread power shortages, a result of lack of sustained cutbacks in public investments in the previous decade.

1993 – 1998: Liberalization, Surge and Contagion

A new administration under Fidel Ramos which took office in 1992 pursued liberalization in earnest. It reduced tariff rates (most import restrictions had been eliminated by the early nineties) and locked the country into international agreements to open up the economy to international trade and investment flows: the ASEAN Free Trade Area (AFTA), World Trade Organization (WTO) and the Asia-Pacific Economic Cooperation (APEC). Throughout all of the 1990s, the Philippines unilaterally reduced tariff rates on many items way below the bound rates it had set for itself in the agreements. Not surprisingly, export and import shares grew at an unprecedented pace during the opening up (globalization) period, starting in the late 1980s up to the Asian crisis, with their share exceeding 50% right before the Asian crisis.

A key reform in the period was capital account liberalization initiated in 1991 and completed in the last quarter of 1993. The move opened up the country to volatile private capital flows reviving a moribund asset and financial markets. Positive developments in the domestic front—the fast-track construction of power plants (which later would lead to higher electricity costs), the success of the Brady Plan in reducing foreign debt payments, the creation of the new debt-free Central Bank and the economic recovery in the first four years of the Ramos administration—seemed to justify the ‘irrational exuberance’ and ‘over-optimism’ in financial markets. During this period, economic growth was spurred by rapid credit expansion, lower interest rates, and improving fiscal position. The switch to positive fiscal balances, falling inflation rates and continuing foreign capital inflows fuelled even more optimism for the Ramos growth strategy. The peso appreciated as capital inflows intensified until the second quarter of 1997.

Not all indicators were looking bright. The external sector continued to register sizeable current account deficits and the investment-savings gap widened during this period. As is well known, the foreign inflows that came in were largely in the form of short-term debts and portfolio investments (‘hot money’). Unhedged dollar borrowings (used to finance real estate, construction, speculative and manufacturing activities) and ‘hot money’ fueled a bubble in asset and equity markets, paving the way for the country’s participation in the Asian crisis. The financial crisis, in addition to the El Niño weather phenomenon that had detrimental effects on agriculture, halted growth and the economy contracted in 1998.

The Philippines initially reacted to the financial turmoil by defending the currency by using international reserves, raising Central Bank repurchase rates and liquidity reserve ratios in a bid stem the currency depreciation. These moves merely hastened the loss of confidence and the deterioration in the quality of loan portfolios. In addition to monetary tightening, the IMF program required the economy to attain a fiscal surplus at the height of the crisis, which obviously could not be complied with, further eroding confidence. These policy responses, much like in other affected countries, weakened the financial and real sectors and ushered in the last recession in 1998.

1999 – Present: Post Asian Crisis

Political volatilities during the Estrada administration ensured that the recovery from 1999 to 2001 would be lackluster, with GDP growth rates averaging less than 4% for these three years.

2001 was a low-growth year as the Estrada government was rocked by a scandal involving illegal gambling that reached the President himself, who was forced out of office by another people revolt finally backed by the military forces. He was replaced by the Vice-President, Gloria Macapagal-Arroyo. The Arroyo government in turn has been rocked by coup rumours and political scandals. This was also accompanied by global recession, led by the US.

The low confidence in the Philippine economy is shown by the developments in balance of payments and exchange rate movements. There were net capital outflows and currency depreciation in the period 2001 to 2005, as the Arroyo administration was rocked with coup threats and corruption scandals, the most serious one being the rigging of the presidential election in 2004, which Pres. Arroyo won. The lack of confidence was further aggravated by a fiscal crisis where continuing declines of the tax effort and losses from the government-owned National Power Corporation (NPC) led to high fiscal deficits and a high public burden. When the fiscal crisis subsided with the imposition of the R-VAT (and better performance of NPC) and once it was clear that coups and attempts to impeach the President were unsuccessful, portfolio inflows started to pour in lifting the stock and sovereign bond markets of the country in 2006 to first half of 2007. But the external shock of the subprime crisis in the US starting July 2007 quickly reversed this in a matter of weeks. Now it's a see-saw between increases in portfolio inflows and outflows with the outflows spurred by the US subprime crisis and political instabilities besetting the Arroyo government.

Despite the problems, GDP annual growth rates quickened in 2002 and 2006 to between 4% and 6%. The GDP growth rates in the first two quarters of 2007 were reported to be the highest ever in many decades – 6.9% and 7.5%, respectively.

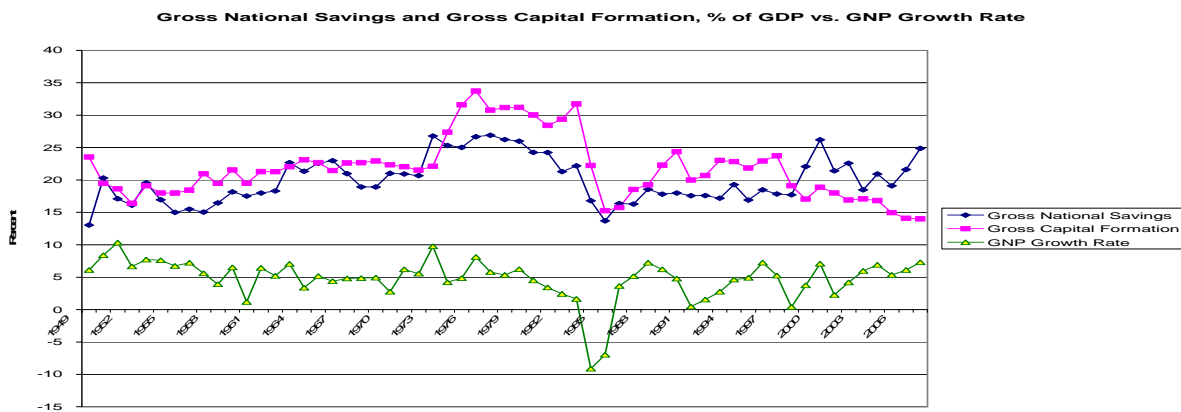
4. Macroeconomic Instability As Constraint to Growth

4.1 The External Position: Foreign Exchange Constraints and Crises

The two-gap theories had pointed to investment-savings gap and foreign exchange constraints as limiting growth of developing countries. This had been true for the Philippines before 2003. Foreign exchange constraints as exhibited by large current account deficits and large gaps between investments and savings expose the Philippines to high risks of balance of payment crises that lead to economic collapse, recession or financial debacle. This becomes more likely if the high current account deficits are accompanied by high short term debts, high

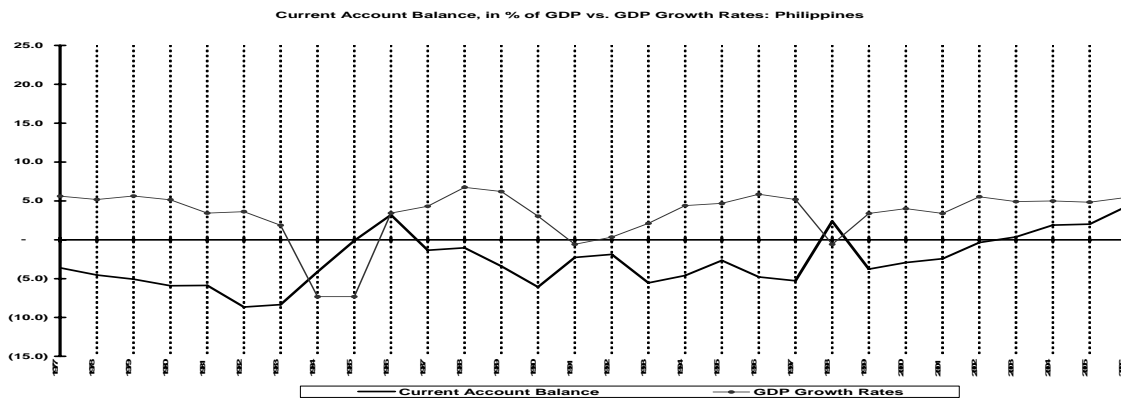
credit vis-à-vis international reserves, low international reserves, high debt burden, and high lending rates (severe monetary contraction). Figures 1 and 2 show that there were large gaps between gross capital formation and savings, and that there were high current account deficits preceding substantial slowdowns or recessions in 1960, 1970, 1983-85, 1991 and 1998. The economic collapse in 1984-85 was so deep as to retard Philippine growth for a decade. The longer paper shows that the Philippines share this crisis vulnerability with Latin American countries in especially in the 1980s. Korea, Malaysia, Thailand and Indonesia all had significant current account deficits, fiscal deficits and exposure to short-term debt in the 1970s and early 1980s, but did not suffer the economic collapse of the Philippines and the Latin American countries because of their 'tiger' status of high export growth and macroeconomic and political stability.

Fig. 1:



Source: National Statistics Coordination Board (NSCB)

Fig. 2



Source: IMF, International Financial Statistics

Appendix A shows a logit regression analysis with a binary dependent variable with a value of 1 during crisis years (1983-1985, 1991 and 1998). Note that the most significant explanatory variables in the logit regressions of Appendix A are: 1) lagged ratio of domestic credit ratio to international reserves; 2) lagged short-term debt ratio to international reserves; 3) lending rate; 4) lagged international reserves expressed in number of months of imports; 5)

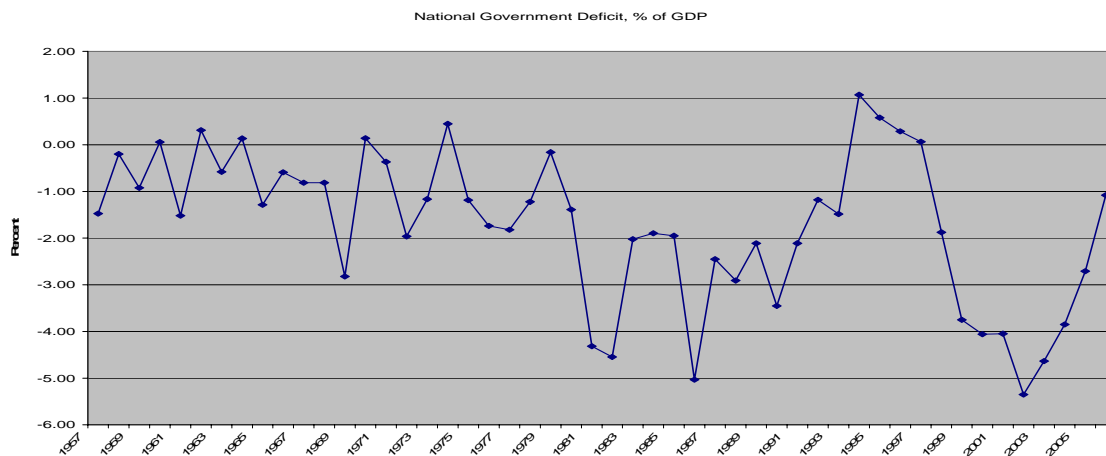
lagged current account deficit as percent of GDP. Unfortunately, the variables above are quite collinear with one another so that if any two variables are used in a logit regression, their z-values become insignificant even if their likelihood-ratio chi-square statistic is significant at better than 1%. The picture that emerges is that the economy becomes vulnerable to crisis when there is high domestic overborrowing while international reserves are dwindling. This leads to high probability of debt defaults when currency attacks occur and when interest rates are increased to fight these attacks and to reduce the inflationary pressures. Crises are also likely when short-term debts are used to finance current account deficits and are large with respect to international reserves, and when currency speculation and losses of confidence trigger responses of monetary contraction and high interest rates.

4.2 The Fiscal Deficit and Public Debt

Figure 3 shows the Philippine national government deficit as percentage of GDP. There were three periods of extremely high fiscal deficits, the early 1980s, the second half of the 1980s, and especially the period 2002-2004. The first two preceded output recessions. The national government posted rare surpluses in 1994-97. High fiscal deficits in the Philippines can be traced to three factors: low tax effort, high public debt service, and losses of government corporations. Value-added taxation was instituted in the late 1980s. High growth in the 1994 to 1997 period helped raise the tax effort as it peaked at 17% in 1997.

Large and rising fiscal deficits in 2002-2004 have raised concerns from all corners. The most disturbing thing is the decline in the tax effort in the post-Asian crisis years of 1999 to 2005, despite economic recovery and growth. The reasons for this decline can be traced to reduced tariffs due to import liberalization, the effects of the Comprehensive Tax Reform Law of 1997 which allowed significant exemptions to big corporations and high-income individuals, and deteriorating tax administration. Figures 4a to 4c show that the Philippines' recent tax effort pales in comparison with key East Asian economies and is inferior to some Latin American countries. Only India does worse than the Philippines, but this is because the Indian figures refer to central government revenues and do not include the significant revenue collection of the large states of India.

Fig. 3



Sources: Department of Finance, Department of Budget and Management

Fig 4a

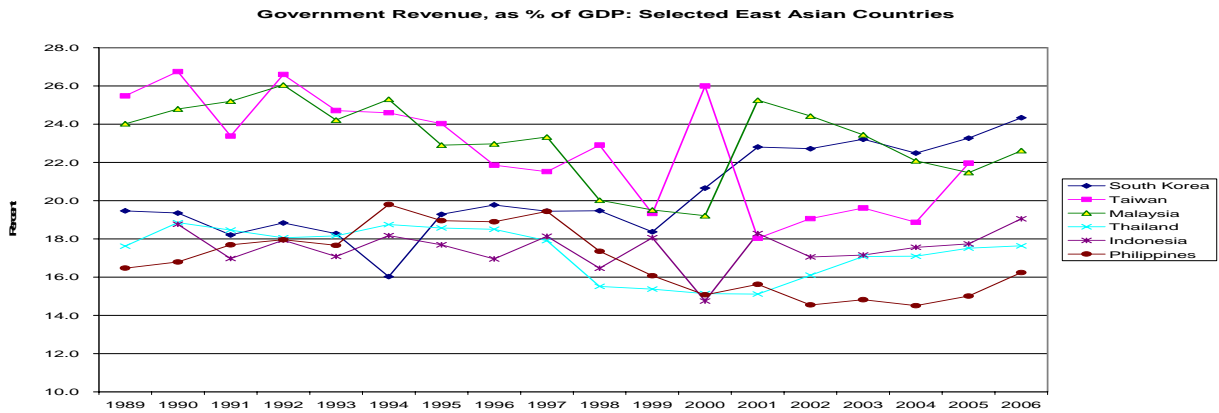


Fig. 4b

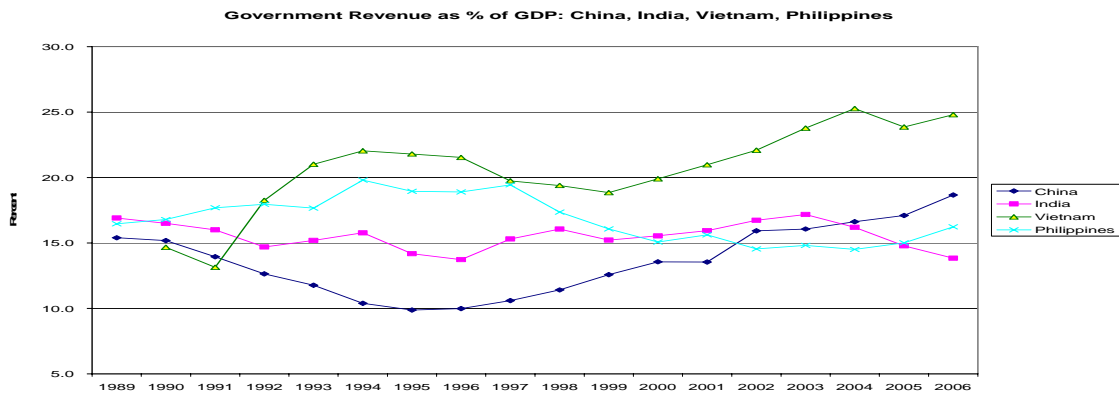
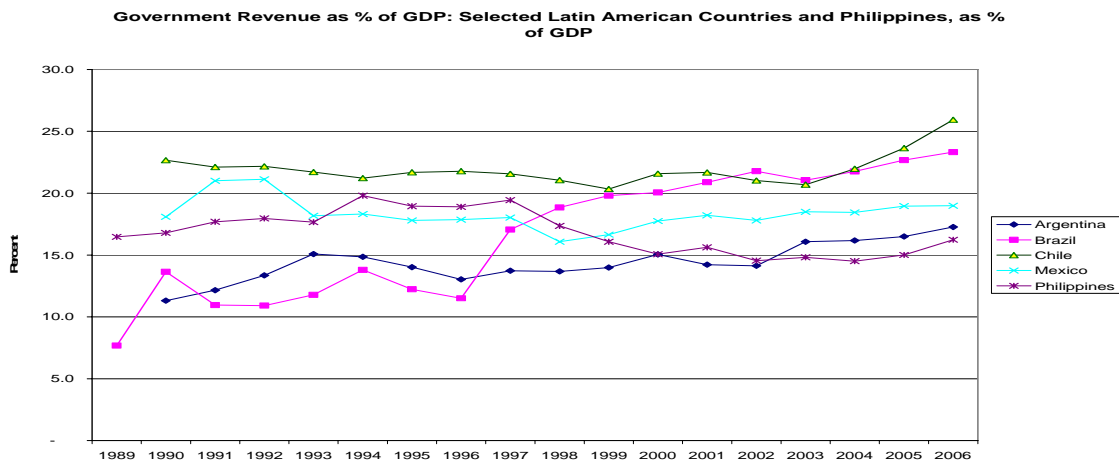
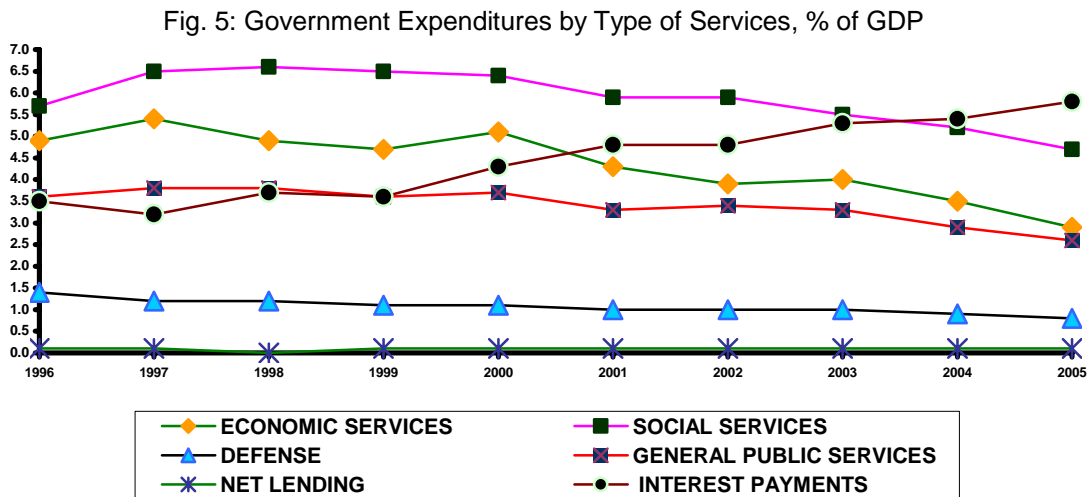


Fig 4c



Sources for Figs. 4a to 4c: IMF, International Financial Statistics

Significant improvements in lowering the fiscal deficits of the Philippines have been achieved from 2003 to 2006, but at very high costs. For one, lower deficits have been achieved mainly through deep cuts in social and economic services (see Fig. 5) as interest payments went up (making up around 30% of the total budget in 2006). Total budget expenditure shrank to 12.2% of GDP in 2005 and 2006 and improved only in the first half of 2007. The expansion of the coverage of the value-added tax and improved financial condition of the state-owned National Power Corporation (whose losses aggravated public deficits in 2002 to 2005) have helped tax revenues in 2006. But tax collection may have faltered again in 2007 as fiscal targets in the first nine months have been missed and as government is again spending below its targets in order to achieve its fiscal targets. Furthermore, to make up for the missed tax revenue targets, the government is selling government-owned shares of stocks in private corporations derived from the sequestration of the Marcos assets. Even with these problems, the government is still aiming for a balanced budget (zero national government deficit) by 2008, two years ahead of the original target date.



With national government debt representing 64% of GDP in 2006, debt service (interest and principal) payments have been taking up more than 80% of government revenues. (Table 2) Interest payment was a high 5.5% of GDP and 31.1% of the budget in 2006. This has gone down to around one-quarter of the budget in the first seven months of 2007. All these figures show a deterioration from the 1998 (Asian crisis) situation. The longer paper shows how the Philippines' fiscal debt burden and fiscal debt service burden is much worse now than its East Asian and even some Latin American counterparts. In particular, Indonesia, which suffered a major debt and financial turmoil during the Asian crisis has now better debt service and debt ratios than the Philippines.

Appendix B provides a regression analysis to show tax effort from 1998 to present is a period with inferior tax effort. 'dumtax' is turned on (equals 1) during the years 1981 to 1985, 1988, and 1998 to 2006. The years 1981 to 1985 was when opposition to the Marcos government became very strong, tax boycotts were called, and economic collapse happened in 1984-85. 1988 was the first year VAT taxation was implemented and there were start-up problems with administering and collecting the VAT taxes. 1998 to 2006 is the current period – the Asian crisis and post-Asian crisis years and the years following the Comprehensive Tax Reform Law. It is clear that when 'dumtax' is turned on, tax revenue collection is lower than

what it should have been. This includes the recent period of 1998 to 2006. This justifies the initiatives to strongly improve tax administration and revenue collection.

Table 2: Public Debt Service and Public Debt Burden

As % of Gov't Revenues	1998	1999	2000	2001	2002	2003	2004	2005	2006	Jan-July*
NG Debt Service Payments	35.6	42.9	44.3	48.4	61.9	73.5	85.1	83.2	87.2	
Interest	21.6	22.2	27.4	30.8	32.1	35.4	36.9	36.7	31.7	
Principal	14.0	20.7	16.9	17.6	29.8	38.1	48.2	46.5	55.6	
As % of GDP										
Total National Gov't Debt	56.1	59.6	64.6	65.7	71.0	77.7	78.2	71.5	63.8	
Domestic	31.9	32.9	31.8	34.4	37.1	39.5	41.1	39.8	35.7	
Foreign	24.2	26.8	32.7	31.3	33.9	38.3	37.2	31.7	28.1	
As % of GDP										
Total Public Sector Debt	94.6	101.4	109.3	106.0	110.2	117.5	108.7	92.6	73.9	
Domestic	35.2	32.8	32.5	32.7	34.4	35.5	35.1	32.1	28.7	
Foreign	59.5	68.6	76.8	73.3	75.9	82.1	73.7	60.5	45.2	
As % of GDP										
Total Expenditure less Interest Payment	16.4	15.9	16.1	14.8	15.2	14.2	13.0	12.2	12.2	13.5
Interest Payment	3.7	3.6	4.2	4.8	4.7	5.2	5.4	5.5	5.1	4.4
Total Expenditure	20.2	19.5	20.3	19.6	19.9	19.5	18.3	17.7	17.3	17.9
Interest Payment As % of Budget	18.6	18.3	20.6	24.5	23.5	27.0	29.2	31.1	29.7	24.4

*GDP was estimated as 7/6 times the GDP of the first semester of 2007

Source: Bangko Sentral ng Pilipinas, Bureau of Treasury, Department of Budget Management

Appendix C below shows very clearly that the fiscal bind, which is restricting infrastructure and public construction and other vital economic and social spending, is reducing the investment rate and jeopardizing growth. The regression in Appendix C shows that the investment rate is positively affected by public construction. Fig. 6 shows that public construction had been drastically cut in the period 1998 to 2006 due to the fiscal bind. This regression shows that this is the main cause of the decline in the investment rate in the recent period since lending rates in the current period are low. Thus one main cause of the low investment rate in recent periods is the low public construction which fell from the 2000 position.

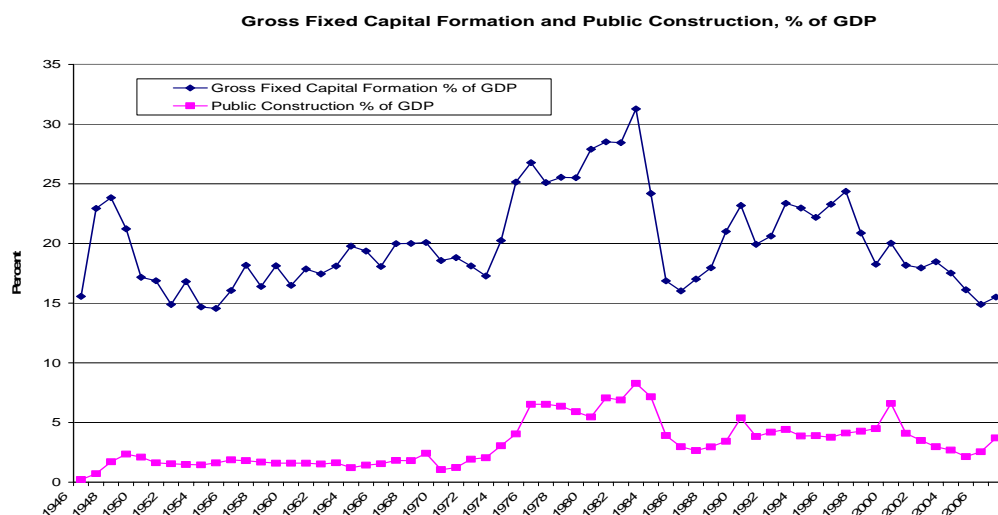
4.3 Inflation, High Interest Rates and Monetary Contraction

Inflation trends

The Philippines has had to grapple with high inflation from the 1970s to the 1990s with profound consequences on its growth performance. Inflation began to become a major (double-digit) problem in the early and mid-1970s owing to a major devaluation and high oil prices. It remained high in the late 1970s and early 1980s with the second oil price shock. The sharp currency depreciation in 1984-85, accompanied by deep economic and political instability,

brought about record inflation rates. Inflation remained high in the late 1980s prompting the government to institute austerity measures that eventually led to the 1991 recession. In the 1990s inflation came down to below 10%, with a temporary uptick during the Asian crisis year of 1998. High world oil prices raised inflation in 2004 and 2005, but subsided in 2006 to as below 3% in recent months. It remains to be seen whether this will be sustainable as world oil prices continue to set new record highs.

Fig. 6



To a large extent, episodes of high inflation (10% and above) in the Philippine can be explained by just two factors: currency devaluations and oil price shocks. (Fig. 7) In the 1970s, inflation can be traced to the 1970 devaluation and the first oil price shock in 1973-74. In the 1980s, high inflation rates were caused initially by the second oil price shock and worldwide inflation in 1979-81, followed by the significant devaluations in 1983 and 1984. In the 1990s, the moderate devaluation in 1990-91, plus oil price shock due to the first Gulf War crisis cause a rise in inflation in those years. The significant devaluation during the Asian crisis in 1998 brought a slight uptick in inflation, but nowhere near the high inflation that occurred in previous devaluations. Thus, by just using two types of supply-side shocks – currency depreciation and oil price shock – one can explain practically all the above-10% inflation in modern Philippine history.

In general, the Philippines had higher inflation than the other Asian countries over the years. (Fig. 8) This could explain partly the weaker confidence investors have in the Philippines in the 1970s through the 1990s. But the picture is not as simple. Philippine inflation has not been much worse than Indonesia's (except in the mid-1980s and late 80s to early 90s), yet the latter has outperformed the Philippines during this period decades, except during the Asian crisis (see longer paper). This is mainly because high inflation in the Philippines occurred following balance of payment crises (with inflation being spurred by currency devaluations) and was met by monetary contraction. In the case of Indonesia, inflation before the Asian crisis was not accompanied by balance of payment crises, and authorities did not undertake monetary contraction to economic activity.

In the early 1980s, quarterly monetary targeting became the norm in fighting inflation. This policy had its basis in the monetarist school of thought which prescribes monetary austerity to combat inflation and which the IMF subscribed to in earnest. Monetary targets were tightened every time the balance of payments deteriorated and inflation increased. These targets were achieved through: a) high required reserve ratio; b) high policy rates of the Central Bank; and c) open market sale of Central Bank bills and government securities in order to reduce the monetary base. The open market operations of the Central Bank have proved particularly effective in reducing money supply by siphoning off liquidity and credit in the financial sector. The overly strict monetarist response to inflation has been blamed for the economic recessions since the 1980s.

Fig. 7: CPI Inflation vs. Growth of Exchange Rate

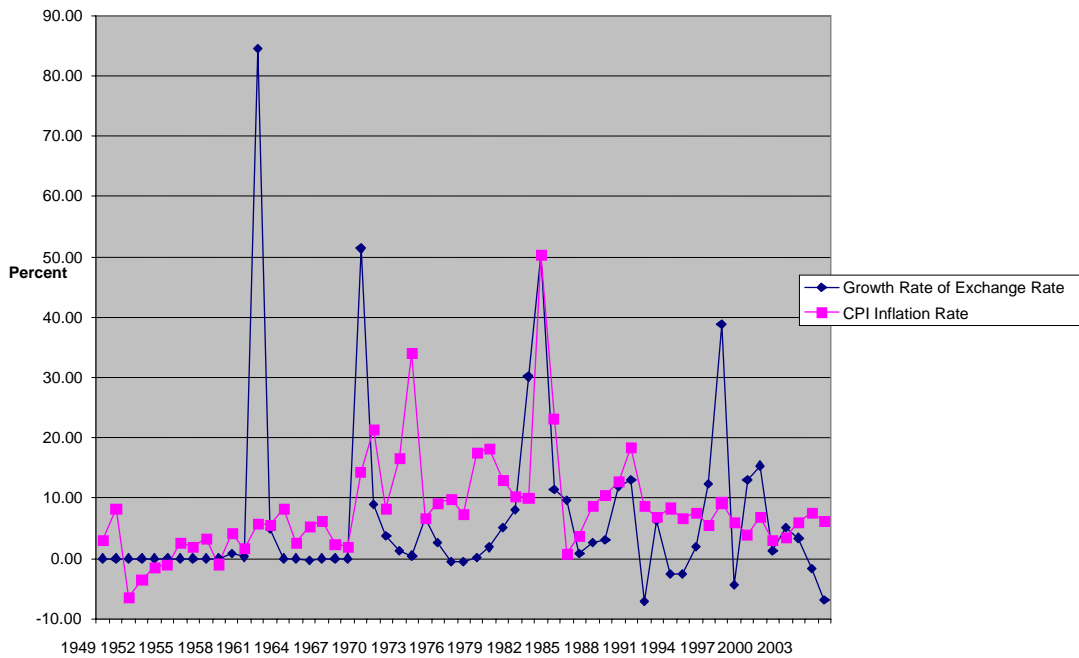


Fig. 8

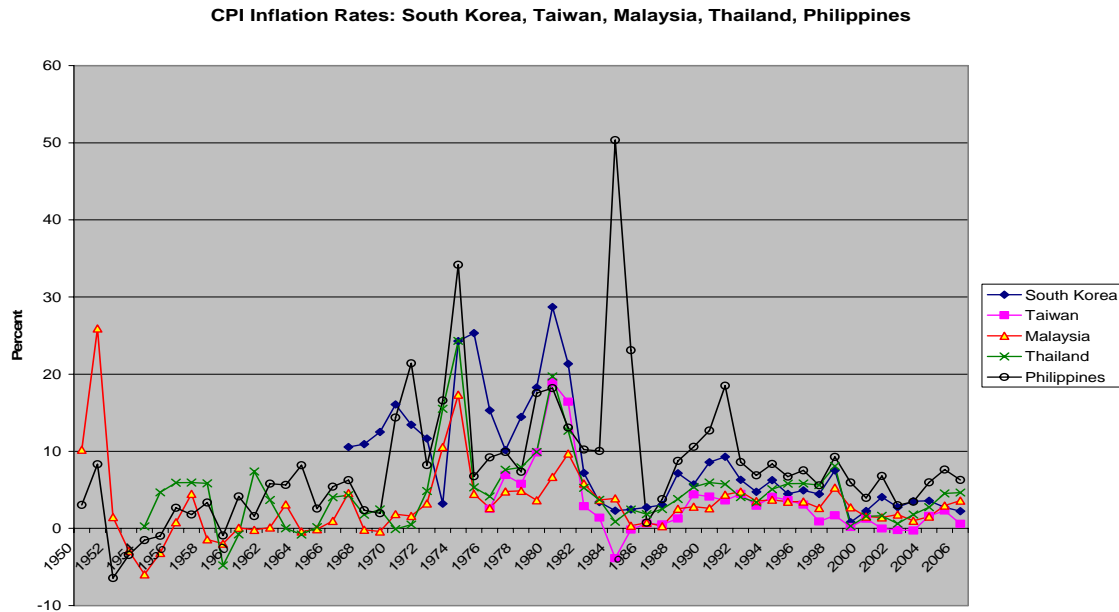


Figure 9 graphs real money supply (deflated by GDP price deflator) with real GDP. It shows a strong positive relationship between real GDP and real money supply. Real monetary contraction in 1984-85, in 1991 and in 1998 was accompanied by real output contraction. A similar story is given if we graph lending rates and growth rate of per capita GDP (Fig. 10).

In the longer paper, comparing the Philippine experience with monetary growth with that of other countries reveals two things: One, the high growth countries -- Taipei, China, PRC, India, Vietnam, South Korea, Malaysia, Thailand and Indonesia – show sustained growth in real money supply (no monetary and credit contraction as in the Philippines) until the Asian crisis. The Asian crisis prompted Indonesia, Malaysia and Thailand to contract real money supply temporarily only in 1998. South Korea, however, did not engage in monetary contraction until 2004 in the wake of a consumer debt crisis. This (along with the debt workout arrangement the Korean government promptly undertook) partly explains the quick recovery of the South Korean economy compared to the other countries.

Fig. 9

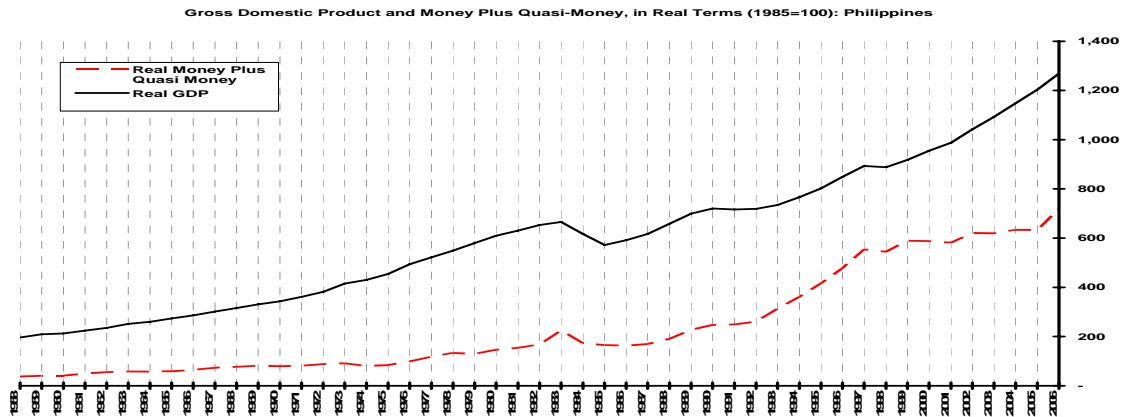
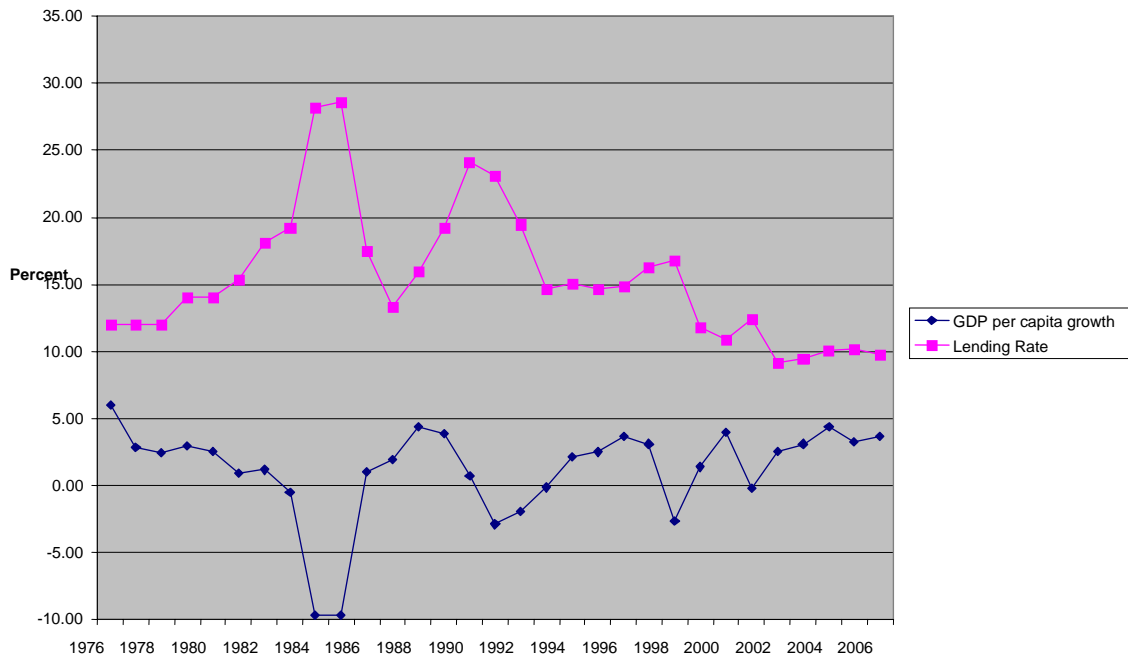


Fig. 10: GDP per Capita Growth vs Lending Rate



Two, the Latin American countries, like the Philippines, saw many instances of monetary contraction during their crises. Declines in money supply in Argentina, Mexico, Brazil and Chile were accompanied by recessions, stagnation or low growth. These are the mid- 1970s, early 1980s to mid-1980s, late 1980s, 1994, 2001 to 2002 for Argentina; mid-1970s and early 1980s for Chile; early 1980s, 1988 and 1994-95 for Mexico; 1980 to 1983 and the volatile monetary movements in the hyperinflation period 1989 to 1992 period in Brazil. These are shown in the longer paper.

The investments growth rate regression in Appendix C showed lending rate figuring prominently in constraining investment growth. Appendix D shows that in a regression of real GDP (see longer paper for the theoretical basis of the regression) both the lending rate and

investment rate contribute significantly to GDP growth. Thus credit and monetary contraction during the crisis years had deepened the economic recession and slowdown.

The current inflation targeting regime (as opposed to the monetary targeting regime) that started in 2002 had been much more benign and had correctly avoided overly contractionary monetary policies (see financial paper for more details).

5. Policy Implications

5.1 The External Sector

The paper suggests that, to avoid external crises, the following policies be followed:

- a) Avoid high current account deficits: The trade and investment paper shows conclusively that exports decrease and imports increase if the peso is overvalued. Thus one should try to tame current trends for the peso to appreciate. This can be done by laxer monetary policy to lower the interest rates and consider the possibility of a region-wide plan for taxation of short-term capital inflows ('hot money'). The trade and investment paper also proposes that our exports either be more diversified away from electronic and non-electronic machinery and apparatus and/or move towards backward linkaging in this sector so that our exports will not be import-dependent as it is now.
- b) Do not rely on short term debts and 'hot money', since these may be the cause of currency crises when exogenous or domestic shocks occur. Policies for this are discussed in the financial paper.
- c) During times of high current account deficits, high growth and dwindling international reserves, care should be taken not to expand domestic credit excessively (especially those financed with unhedged dollars) since this may lead to high defaults if crises occurs.
- d) Even if the current period is marked by current account surplus due to high remittances of overseas workers, trade deficits still continue and as the peso appreciates strongly, the specter of past crises still lingers.

5.2 The Fiscal Sector

In the current period the main macroeconomic constraint is the fiscal constraint. Low tax effort, expenditure constriction and high public debt burden (though improved since 2006) need to be reversed convincingly. This is required to bring about the necessary public investments, infrastructures, social and economic services that will spur the economy to higher and more quality growth path. It is also needed to avoid possible public debt crises and defaults due to external or domestic shocks (sharp currency depreciation, sudden high interest rates). Policies to achieve this include improving tax administration and tax collection especially by preventing under-declaration of income or receipts and over-declaration of expenses (partly due to lax exemptions). Furthermore, proper public debt management to reduce public and external debt burden and debt service should be undertaken. This includes relying more on low-interest domestic debt, retiring foreign debt faster as the peso strengthens, taking advantage of grants and beneficial concessional loans; and undertaking initiatives on debt conversions and debt rescheduling on official bilateral debts.

The Philippine government has publicly declared the need to expand its revenue generation capability beyond the value-added taxation imposed in 2006. It is proposed that the national government stick to its tax revenue targets until 2010, but we propose the national government to reconsider relaxing the fiscal deficit target to allow for a 1% to 1.5% deficit (as % to GDP) until 2010 to catch up with infrastructure and social/economic spending that had been constricted since 2003. This is crucial to sustain the high growth in the past years, and to improve the quality of growth from that of consumption-led growth to one with more investment stimulated growth that will increase future productive capacity.

5.3 Inflation and the Monetary Sector

Policies to Fight Supply-Side Inflation

In summary, high inflation, especially during balance of payment crises, had in the past been met by monetary contraction or austerity, which either aggravates recessions or reduces the growth rate. Thus, countries without much experience with high inflation and monetary austerity have fewer constraints to growth from the monetary side, compared with countries that experience high and frequent inflation rates and subsequent monetary contraction.

Since much of the inflationary pressures on the Philippine economy had been and are from supply-side shocks, other means may be more productive than an immediate monetary demand-reduction response.

In many of the weather and natural calamity shocks, the government has, for practical reasons and with some success, gone into temporary price controls and constant monitoring of basic foodstuffs and imposing heavy penalties on hoarding. Importation of agricultural products is also undertaken during periods of agricultural shortages. These policies should be continued and enhanced. Improvements are especially needed in the area of equitable, transparent and efficient distribution of imported foodstuffs during periods of agricultural shortages. The inefficient distribution system and lack of transparency in many of the sales of the National Food Authority (NFA) during periods of food and agricultural shortages call for an overhaul in the system and more participation of the private sector in the distribution of temporarily imported foodstuffs during periods of shortages.

The oil price shocks are emerging as a major potential inflationary pressure. The BSP has been wise not to use this inflationary pressure to contract money supply and increase interest rate by correctly distinguishing supply-side from demand-side inflation. The current policy of lagging rate increases in public transportation (jeepneys, buses and taxis) is effective in reducing the inflationary impact of oil price shocks, but may be detrimental to the small jeepney, tricycle and taxi drivers. The government is pushing for discounted diesel fuel for jeepneys (although environmentalists may not be too happy with this). Other policies of mixing ethanol with unleaded gasoline, and offering subsidized adjustments in the vehicular structure of taxis and tricycles (so that they can depend more on this cheaper mix) may be considered to cushion the negative effects of lagged fare increases to the small tricycle and taxi drivers.

If world oil prices race towards \$100 per barrel or beyond, it is recommended that an oil price stabilization fund (used moderately successfully in the 1970s by the Marcos government) be studied carefully and explored to tackle the situation. Equally important is the need to

develop, in the medium and long run, alternative fuel sources and to reenact and implement laws that reduce the dependence on oil as fuel source.

Monetary Policy

Monetary policy should be countercyclical. During good times when trade deficits and current account deficits increase because of high growth, expansion of money supply should not be too excessive as a general policy if there is high current account deficits accompanying the growth and large exposure to foreign (especially short-term) debt. But during recessions and currency attacks, care should be undertaken that overly high interest rates and excessive credit contraction do not deepen the crisis and cause more debt defaults through deterioration of firms' and banks' balance sheets. Appendix A shows that high lending rate is itself an indicator of possible crisis.

The current policy of the BSP to be laxer with monetary policy and the series of reduction in the overnight lending and borrowing rate is going towards the right direction in tackling both the lower inflation situation and the strong appreciation of the peso.

Appendix A: Crisis Logit Regressions

dum	Coef.	Z	P> z	z	P> z	z	P> z	z	P> z	z	P> z	z	P> z	z	P> z
	-	-													
lcabpct	1.111	2.00	0.05												
lstdbt	0.003			2.54	0.01										
ldc_res	0.005					2.66	0.01								
	-							-							
lres_mos	2.290							2.09	0.04						
dbtxgs	0.013									2.08	0.04				
dbtgnp	0.085											2.08	0.04		
lendrate	0.425													2.45	0.01
Number of obs		29		29		29		29		30		30		30	
LR chi2(1)		12.10		8.36		12.63		13.71		5.25		5.38		12.85	
Prob > chi2		0.00		0.00		0.00		0.00		0.02		0.02		0.00	
Pseudo R2		0.45		0.31		0.47		0.51		0.19		0.20		0.48	
				-						-					
Log likelihood		-7.28		9.15		-7.02		-6.48		10.89		10.83		-7.09	

Variable with letter 'l' before it means lagged

cabpct=current account balance, as %
of GDP

stdbt=short term debt as % of international reserves (less gold)

dc_res=domestic credit, as % of international reserves (less gold)

res_mos=international reserves (less gold), in months of merchandise imports

dbtxgs=external debt, as % of exports of goods and services

dbtgnp=external debt, as % of

GNP

lendrate=lending

rate

Appendix B: Regression of Tax Revenue to Nominal GDP and Dummy indicating years when there were difficulties in tax collection

Intaxrev	Coef.	Std. Err.	t	P> t	[95% Conf. Interval]	
Innomgdp	1.102783	.0394928	27.92	0.000	1.021886	1.183681
dumtax	-.1059586	.0298771	-3.55	0.001	-.1671592	-.0447581
_cons	-3.429059	.5621183	-6.10	0.000	-4.580506	-2.277612
rho	.7449577					

Durbin-Watson statistic (original) 0.868314
 Durbin-Watson statistic (transformed) 2.118829

Source	SS	df	MS	Number of obs =	31
Model	2.87221044	2	1.43610522	F(2, 28) =	390.03
Residual	.103096128	28	.003682005	Prob > F =	0.0000
Total	2.97530657	30	.099176886	R-squared =	0.9653
				Adj R-squared =	0.9629
				Root MSE =	.06068

where Intaxrev=log of tax revenue in current prices
 Innomgdp=log of nominal GDP in current prices
 dumtax=dummy for years with difficulties in tax collection

Appendix C: Regression of Investment Rate to Public Construction and Lending Rate

D.lninvr85	Coef.	Std. Err.	t	P> t	[95% Conf. Interval]	
D.lninvr85(-1)	.2599368	.159525	1.63	0.115	-.0679716	.5878451
D.lnlendrate	-.2358056	.1103429	-2.14	0.042	-.4626186	-.0089926
D.lnpbcr85	.3796791	.0677979	5.60	0.000	.2403186	.5190397
_cons	.0096519	.0158808	0.61	0.549	-.0229916	.0422953

Durbin-Watson d-statistic(4, 30) = 1.397964

Source	SS	df	MS	Number of obs =	30
Model	.325411477	3	.108470492	F(3, 26) =	15.47
Residual	.182253986	26	.007009769	Prob > F =	0.0000
Total	.507665463	29	.017505706	R-squared =	0.6410
				Adj R-squared =	0.5996
				Root MSE =	.08372

where D.lninvr85=difference in the log of gross investment, real 1985 prices
 D.lnlendrate=difference in the log of lending rate
 D.lnpbcr85=difference in the log of public construction, real 1985 prices

Appendix D: Regression on First Difference of Log of Real GDP at 1985 Prices (Based on Diagram 2a)

D.Ingdpr85	Coeff	Std. Err.	T	P> t	[95% Conf. Interval]	
D.Ingdpr85 (-1)	0.3590	0.1049	3.42	0.0020	0.1419	0.5760
D.Inagrir85	0.4731	0.1139	4.16	0.0000	0.2376	0.7087
D.Inlendrate	-0.0378	0.0128	-2.07	0.0500	-0.0756	-0.0000
D.Ininvr85	0.1604	0.0255	6.30	0.0000	0.1077	0.2132
D. CABpctgdp	0.0020	0.0011	1.81	0.0830	-0.0003	0.0043
Constant	0.0058	0.0044	1.31	0.2020	-0.0034	0.0150

Durbin-Watson d-Statistic (6, 29) = 1.8184

Number of obs = 29

F (5, 23) = 36.65

Pro > F = 0.00000

R-Squared = 0.88850

Adj R-squared = 0.56430

Root MSE = 0.01295

Source	SS	df	MS
Model	0.03075	5.0000	0.00615
Residual	0.00386	23.0000	0.00017
Total	0.03461	28.0000	0.00124

where D.Ingdpr85= first difference in the log of Gross Domestic Product, real 1985 Prices

D.Inagrir85= first difference in the log of agriculture/fishery/forestry real 1985 prices

D.Inlendrate= first difference in the log of lending rate

D.Ininvr85 = first difference in the log of gross investments, real 1985 prices

D.CABpctgdp=first difference in current account balance as % of GDP