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The Philippine Economy After the Global Financial Crisis: Lessons Leart Challenges

by

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The Philippine Economy After the Global Financial Crisis: Lessons Learned and Current Challenges

By Dante B. Canlas*

1. Introduction

This paper looks at lessons for the Philippine economy that enabled it to escape recession after the 2008 global financial crisis, spells out current challenges that the economy faces, and discusses policies that minimize the risks of a recurrence of the unwanted business fluctuations while supporting long-run economic growth. Events in the international financial market are central to the global financial crisis while national policy responses, particularly, monetary and financial, affected to a great extent the aggregate output and price performance of the Philippine economy during and shortly after the crisis.

The Philippines narrowly escaped recession in the aftermath of the 2008 global financial crisis that emerged from the collapse of the sub-prime housing loan market in the US. Output growth slowed down in 2008 and 2009, but recovered in 2009 and 2010.

Real gross domestic product (GDP) grew 7.1 percent in 2007 and slowed down to 3.8 percent in 2008. In 2009, the slowdown continued with real GDP growth decelerating to 1.1 percent. In 2010, the economy recovered with real GDP growing 7.3 percent. All figures, unless otherwise stated, are taken from the *National Accounts of the Philippines* published by the National Statistical Coordination Board (June release).

Meanwhile, the inflation rate based on the consumer price index (CPI) surged to 9.3 percent in 2008 from a modest 2.8 percent in 2007. It slowed down in 2009 to 3.4 percent and rose slightly to 3.8 percent in 2010.

Table 1: Growth Rate of Real Gross Domestic Product and Inflation Rate

Year	Real GDP Growth Rate[1] (%)	Inflation Rate[2] (CPI, in (%)
2007	7.1	2.8
2008	3.8	9.3
2009	1.1	3.4
2010	7.3	3.8

Source: 1. National Statistical Coordination Board (NSCB), *National Income*

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Accounts (June release)
2. National Statistics Office (NSO)

Evidently, the 2008 global international crisis triggered unwanted business fluctuations, namely, a slowdown in output growth. These proved short-lived, though. The Philippine showed sufficient resiliency by recovering strongly in 2010, with real GDP growing 7.3 percent.

2. Lessons Learned from the Crisis

A small open economy that is integrated with the rest of the world economy through trade in commodities, securities, and national monies is vulnerable to external financial shocks that have real output effects not only in the country where the financial shocks originated but also in other countries that trade with it.

Since the second half of the 1980s, the Philippines has been ushering in an economic policy reform program aimed at increasing its economy's integration with the rest of the world (see chapter 2 in D.B. Canlas, M.E. Khan, and J. Zhuang 2009) This has involved, for instance, liberalization of the trade and the capital accounts in the balance of payments.

Trade liberalization is anchored on import liberalization and tariff reduction. Ever since the Philippines acceded to the World Trade Organization (WTO) in 1993, it has observed the most-favored nation (MFN) principle. It has progressively lifted quantitative import restrictions, replacing them with border tariffs.

In addition to joining the WTO, the Philippines has also joined regional preferential trading arrangements (PTAs), such as, the ASEAN Free Trade Area - Comprehensive Effective Preferential Tariffs (AFTA-CEPT), while complying with the MFN principle.

Trade liberalization has enabled the Philippines to gain from international outsourcing and subcontracting. Trade in intermediate goods has become the fastest growing segment of foreign trade in recent years. Manufacturers in developed countries relocate production, for example, of microchips, spare parts and components in developing countries provided they can reduce production costs and maintain price competitiveness.

Moreover, the Philippines has pursued a monetary and financial market development program aimed at establishing an independent central bank, liberalizing the commercial banking system, and strengthening the country's equity and bond markets. In 1993, a law was enacted that made the BSP independent (see Tetangco, 2003; Tuano-Amador, 2003)

Most local commercial banks are engaged in universal banking, with authority to invest in financial markets abroad. Meanwhile, ten foreign banks were initially allowed to operate branches in the Philippines in 1994 (see T.B. Marcelo, 2003) There are, however, other modes of entry by foreign banks, such

as owning up to 60 percent of the voting stock of an existing bank or of a new bank subsidiary.

Meanwhile, the monetary authority—*Bangko Sentral ng Pilipinas* (BSP)—has long adopted a market-determined exchange-rate system, although it continues to reserve its right to intervene in foreign-exchange markets to smoothen sharp fluctuations in the nominal exchange rate. The BSP also allows international capital mobility along with a market-determined exchange rate.

All this has increased the integration of the Philippines not only with commodity markets abroad, but also with securities and foreign-exchange markets. The benefits are many, including, expanded markets for commodity exports and access to least-cost capital goods and intermediate goods (spare parts and components, for example) from abroad, increase flow of foreign direct investments and access to foreign savings, and diversification of currency risks. But the risks from globalization are likewise prodigious.

Joseph Stiglitz (2008) said in the context of the 2008 global financial crisis:

> "It should come as no surprise in a world of globalization that it's not just the good things that move more easily across borders, but the bad things as well. Now, America has exported its downturn to the world."

Product innovations in international financial markets progress rapidly but regulation of new financial products and understanding of the risks attached to them even in developed countries tend to lag behind

Integration of domestic financial markets with international financial markets is bound to continue given the gains from global financial intermediation. There are many private savers without investment opportunities in the developed countries, while there are market agents in the developing countries with investment opportunities, but who are short of funds. Universal banks mediate between these savers and investors.

Big domestic corporations, facing savings-investment gaps, aside from being able to tap foreign bank loans, are also able to float their commercial papers in financial markets abroad. These domestic corporations that tap funds abroad operate in a variety of sectors, including, food manufacturing, property development, wholesale and retail trade, and telecommunications.

In addition, governments engaged in deficit spending can borrow funds from abroad by floating their Treasury bills and bonds in international financial markets. In doing so they are able to put a lid on domestic interest rates since governments, which are big borrowers in the domestic financial market, but small in international markets, can cause nominal domestic interest rates to jump, given their large borrowings.

The global financial crisis was triggered by the collapse of the sub-prime housing loan market in the US. But it was propagated by US banks with global

reach through new financial instruments, such as, collateralized debt obligations (CDOs) and credit default swaps (CDSs). These financial instruments were marketable and so banks holding them that faced short-run liquidity problems were of the belief that they could easily convert them anytime into cash. But the newfound marketability had it seems led to excessive risk taking. Major banks and insurance companies in the US failed as a result.

Meanwhile, it was revealed later that there was hardly any government regulation of the new financial instruments like CDOs and CDS. The banks and insurance companies, later on, found themselves holding unbacked financial assets. Furthermore, even ratings agencies, it seems, failed to properly assess the risks attached to CDOs and CDSs.

There is consensus about the need to improve bank regulation. For example, Edmund Phelps (2008), a Nobel Prize winner in economics said:

> "Finally, the banks were their own worst enemies. The level of their loans and their borrowings to make those loans reached so high a level in relation to their capital, or equity, that any serious disturbance to asset prices -- a default shock or a shock to liquidity premia -- could have devastating effects on the equity of any bank and thus on its ability to function and to survive. At some banks, measured leverage was not extraordinarily high but the opacity of the assets and the resulting uncertainty over their future returns was very high.
>
> That the banks chose to take on ever-greater levels of risk, with no end in sight until the collapse, was an effect of employee compensation: Fortunes could be made for each additional day that the bank could operate. There was no claw-back provision that would pay bonuses only for performance over the long term.
>
> Is regulation required here? Undoubtedly some new regulations are required here and there."

Robert Lucas, Jr. (2008), another Nobel Prize winner in economics is of the same opinion about the need for new bank regulation:

> "The regulatory structure that permitted these events to occur will have to be redesigned, but this is not a job that needs to be done this week nor can it be done well in time to affect the current crisis.
>
> The regulatory problem that needs to be solved is roughly this: The public needs a conveniently provided medium of exchange that is free of default risk or "bank runs." The best way to achieve this would be to have a competitive banking system with government-insured deposits.
>
> But this can only work if the assets held by these banks are tightly regulated. If such an equilibrium could be reached, it would still be possible for an institution outside this regulated system to offer deposits that are only slightly more risky but that also pay a higher return than deposits at the regulated banks. Some consumers and firms will find this

attractive and switch their deposits. But if everyone does, the regulations will no longer protect anyone. The regulatory structure designed in the 1930s seemed to solve this problem for 60 years, but something else will be needed for the next 60."

After banks got saddled with large non-performing loans, they had to put up loan-loss reserves, which in the aggregate impeded financial intermediation. Even borrowers with good investment opportunities found it hard to get project financing through bank loans as a result. Meanwhile, the US insurance firms also got entangled in the financial mess through their underwriting activities, thereby impeding risk diversification. Production suffered with recessionary impacts in the aggregate. The problems of the US banks spilt over to banks in Japan and Europe, with similar adverse effects on output.

An effective shield against external financial shocks is a well-run and well-regulated domestic banking system

The role of banks is to match savers and borrowers. In this regard, banks assess the probability of default by potential borrowers. If they err in a big way on this function, the situation can lead to bank runs and bank failures. In addition to a proper assessment of credit risks, banks operating in a globalized environment also must develop the capacity to assess market risks, both locally and internationally.

The Philippine banking emerged largely unscathed from the 2008 global financial crisis. The reforms undertaken in the banking system in the aftermath of the 1997 Asian financial crisis led to a profound reduction of non-performing loans and increased capitalization in line with Basil II requirements on risk-adjusted minimum capitalization. When the 2008 global financial crisis broke out, domestic banks were better positioned to weather the crisis. Moreover, local banks were quite successful in assessing the risks of new financial products; none of the local banks failed as a result of holding unbacked CDOs and CDSs.

The BSP also successfully steered local banks towards mergers and acquisitions that enhanced capitalization. In reaction to the 1997 Asian financial crisis, the BSP as a matter of policy geared the banking industry towards higher capitalization and loan-loss provisioning, while encouraging mergers (see Navarro Reyes, 2003). The entry of foreign banks sharpened competition, which provided additional incentive to local banks to behave prudently, with the ability to manage both credit and market risks.

The banking system in the Philippines, however, is not only composed of commercial banks. There are rural banks, savings and loans associations, and small private development banks. The ratio of their non-performing loans as a proportion of their capital was bigger than those of commercial banks. In general, they have limited capacity to assess the risk of default by potential borrowers, much less market risks.

Sound macroeconomic policies is vital to minimizing the probability of sharp economic downturns

The Philippine government, under a succession of political administrations since 1986, has adopted macroeconomic policy reforms geared to sustained growth of income and employment, stable prices, and sound balance-of-payments position. Fiscal policy has been geared to a reduction of the budget deficit of the national government, although the fiscal position of the government continues to pose a major challenge even at this point, in view largely of observed weaknesses in tax administration.

Meanwhile, monetary policy has been geared to maintaining stable prices to preserve the signals provided by a decentralized price system in a market-oriented economy and minimize the likelihood of price signals being drowned by inflation noise. In line with this goal, a law was enacted in 1993 that established an independent BSP, an institutional reform that ushered in inflation targeting as the preferred monetary-policy rule in January 2002 (see Tuano-Amador 2003).

The exchange-rate system in place is market-determined in a spot foreign-exchange market operated by the Bankers Association of the Philippines. Under this system, international mobility of capital is permitted.

Under this macroeconomic policy setting, the Philippine economy has had an economic recovery that lasted from 2001 to 2008 until real GDP growth was flattened in 2009, mainly as a result of the negative spillover effects of the 2008 global financial crisis. However, the long-running positive economic recovery was also marred by some output-growth fluctuations stemming from shocks like 9/11, retreat of the information technology sector in 2002, and outbreak of SARS in East Asia in 2003.

Weak macroeconomic fundamentals triggering and propagating a business downturn recession, in contrast, could be seen from the recession of 1984-1985, a two-year period wherein real GDP declined 11 percent, with adverse consequences to human welfare.

The downturn in 1983 was triggered by the countercyclical fiscal and monetary policies aimed at warding off the expected recessionary impacts of the oil-price shocks of the 1970s. The government resorted to deficit spending that led to inflationary monetary policies under a managed-float exchange-rate system. Such conduct of macroeconomic policies persisted into the 1980s. When interest rates increased worldwide at the start of the 1980s following the disinflationary policies pursued by the US Federal Reserve, the Philippines found debt servicing quite burdensome; eventually, it defaulted on debt servicing in 1983 along with a balance-of-payments crisis (see Canlas 1990, 1992, 2002).

To address its liquidity problems, the government turned to the International Monetary Fund (IMF) for the needed Special Drawing Rights (SDRs) under a standby loan agreement. The Philippines submitted a letter-of-intent spelling out its commitment to IMF policy conditionalities. In short, the

government committed to a tightening of fiscal and monetary policies. Performance indicator targets were written down. The SDR drawdowns were contingent on meeting the performance targets.

The economy did not react neutrally to the tightening of macroeconomic policies. Real GDP contracted 7 percent in 1984 and another 4 percent in 1985. In the political front, the recession helped set the stage for the overthrow of then President Marcos, ending martial-law rule and replacing it with democratic political elections in 1986. With democracy restored, profound structural policy reforms began to be pursued by the new government.

Aside from the adjustments in fiscal and monetary policies, the government pursued trade liberalization with import liberalization and tariff reduction as pillars, privatization of big government enterprises engaged in commercial banking, oil-refinery and distribution of petroleum products, and telecommunications, to name a few, all of which increased the integration of the Philippine economy with the rest of the world economy.

3. New Challenges

This section describes selected issues that pose a challenge to long-run economic growth with stability. This goal has become more elusive with globalization in view of the variety of shocks that emanate from various sources. At this juncture, threats to the economy are many, including, Japan's contraction brought on by the tsunami and the radioactive leaks, the slowing down of the recovery in the US, the European debt crisis, and possible overheating of China.

Stabilization with Flexible Exchange Rates and Internationally Mobile Capital

Since the monetary authority adopted a regime of flexible exchange rates and internationally mobile capital, the peso has been appreciating against the US dollar. This is to be expected under a monetary rule of inflation targeting. The significant slowing down of the inflation rate as shown in Table 1 above, bar the uptick in 2008, predicts a peso appreciation granting that the purchasing power parity condition holds. Moreover, the significant increase in the dollar remittances of overseas Filipino workers has substantially increased the amount of dollars coming in.

The peso appreciation generally hurts domestic exporters whose contracts with producers in developed countries stipulate export values fixed in dollar terms, but whose domestic input costs like wages and salaries are rigid downward in peso terms. If in the next round of contracting, domestic exporters seek payments fixed in peso terms, then the dollar costs of their exports rise. As a result, domestic exporters lose their competitiveness.

These developments are inimical to long-run growth objectives. Exports generally involve some learning-by-doing. By the latter, we mean technical knowledge that exporters are able to impart to all other firms, including non-exporters. Such knowledge, which leads to increasing returns from the

introduction, say, of intermediate goods (microchips, spare parts and components) that are the products of research and development, is foregone once exporters, discouraged by an appreciating peso, start cutting back on their exporting activities.

Taxation of Capital and Labor

In the conduct of fiscal policy, the usual advice is for taxation of capital to be as low as possible. If it's taxed highly, it moves out, given its international mobility. But then this puts a relatively heavier tax burden on labor, which since the first oil-price shocks has also become more mobile internationally. The Philippine government has also not been taxing income of overseas Filipino workers.

In this situation, the tax effort or ratio of tax revenues to GDP has remained low (see Canlas, Khan, and Zhuang 2009; ADB 2007), thereby rendering the fiscal position of the government the most critical constraint to economic growth in the Philippines.

Tax reform continues to be a major policy concern in the Philippines. Additional revenues re needed to fund the unmet demand for education, health, and physical infrastructure like roads and other transport systems, all of which need upgrading to improve the investment climate. Harmonizing taxation of capital and labor towards a uniform tax burden without eroding total tax collection is thus a major challenge.

Dealing with Energy- and Food-Price Shocks

The Philippines has one of the highest electricity power rates in the world, a situation that hinders its ability to get on a sustained rapid growth path. Several factors are behind this unwanted state of affairs. The prospect for crude-oil supply worldwide is not bright. Estimates of how long the world supply of relatively cheap fuel will last suggest about 40 years. Meanwhile, geo-political shocks in the petroleum-exporting Middle Eastern countries have raised the volatility of crude oil and petroleum products on a global scale.

Energy pricing in the Philippine tends to be market based, following a series of structural reforms that privatized the electric power industry. The previous monopoly of the government over power generation--except for small-power utilities--and transmission has been removed by law.

The trend has been a secular increase in power rates. The promise of low power rates from the privatization of the industry is not being realized yet given recent trends with the prices of both crude oil, coal, and natural gas. Government policymakers have responded to these trends by enacting laws on bio- and renewable fuels, ostensibly, to reduce dependence on imported fossil fuels and to mitigate environmental problems related to climate change. At this juncture, the production costs of generating power from wind and solar, for example, are

quite high. Dispatching them into the national power grid will further raise power rates.

Clearly, reducing power rates and achieving energy security cannot be done in a day or two. The policy reforms that are indicated include developing new indigenous sources of energy, demand management conducive to energy conservation, and improved regulation of both the energy and water sector in consideration of the importance of hydropower to power generation in the Philippines.

Food security is inextricably linked to energy security. For instance, with the enactment of a bio-fuel act, land previously devoted to food production gets shifted to planting bio-feedstock. Sugar for food is diverted to sugar for ethanol, jacking up sugar prices. Domestic policy reforms, no doubt, are indicated. However, regional and international cooperation in energy and food security are just as important.

Rising energy and food prices generally turn on stabilization problems. Workers burdened by rising prices of these commodities and services initiate petitions for wage increases. Once granted, the costs of production increase, causing the inflation rate to shoot up. If the monetary authority responds with a money tightening, then adverse effects on aggregate output may occur in the short run.

Income Inequality and Growth

The long-run growth experience of the Philippines shows some modest success in reducing poverty and persistence of high inequality in income distribution. About one-in-four families is still considered poor at this stage. The Gini coefficient, meanwile, continues to be high at about 45 percent.

Income inequality runs counter to long-run growth in many ways. For one, those at the bottom of the income-distribution ladder have limited purchasing power. If the income inequality persists, then there is no hope of generating additional demand from the low-income group.

For another, if the number of poor families remains high, then the political pressure to put in place redistributive tax and spending policies mount. As tax rates on capital and labor go up, the incentives to invest and work more are dampened, both of which impede growth (see Persson and Tabellinni, 1994). It is after-tax rates of returns that matter for investment and the work effort.

Meanwhile, monetary and financial policy issues open up as a result. The demand for redistribution gets manifested in the pressure to accommodate the setting up of small specialized banks to do lending to rural agricultural enterprises, as well as to micro, small and medium enterprises. Since this is banking, then proper assessment not only of credit but also of market risks is essential. Evidently, raising the capacity of these specialized banks for risk assessment and management cannot be done overnight.

4. Concluding Remarks: Way Forward

The Philippine government has made many market-friendly reforms since 1986, following the restoration of democratic political institutions. These reforms include trade liberalization, capital account liberalization, privatization of government enterprises and deregulation of industries like telecommunications. As far as short-run policies for stabilization are concerned, much progress has been achieved in the conduct of monetary policy. The establishment of the BSP as an independent monetary authority that is committed to stable prices has yielded outcomes far better than when the monetary board, the highest monetary policy-making body was dominated by ex-officio members of the Cabinet.

Fiscal policy is a work in progress, both in the area of taxation and government spending. But the announced commitment to a responsible deficit-reduction program is promising. Tax administration reforms are a good starting point, particularly, addressing the corruption problems at the Bureau of Internal Revenue (BIR) and Bureau of Customs (BOC). The fiscal program pursues spending cuts but protects core values in education, health, and infrastructure. This is vital since such a spending program goes beyond short-run stabilization; it is directed at mobilizing factors critical to long-run economic growth.

To get on a high-growth path in the long run, the government is well advised to pay attention to human-capital investments in pursuit of technological progress. The economy needs a critical mass of scientific and technical manpower that can invent, innovate, and master the new production techniques that constantly emerge under globalization.

Moreover, noting that the fastest growing segment of foreign trade is trade in intermediate products like microchips, spare parts, and components, all of which emanate from R&D, the development goal of the government in international trade is to gear its trade, industrial, and investment policies toward expanding product varieties designed for exports.

Furthermore, financial-market reforms need to continue. Broadening and deepening the financial asset markets permit shift to assets that support high-return investments. The regulatory agencies in charge, however, need to beef up their capacity to assess the risks attached to each asset, and disclose such risks properly to the saving public.

The Philippines obviously has gone some distance in carrying out economic-policy reforms. The second wave of reforms should now focus on supporting effective implementation of policies. Institutional strengthening is key. For example, after privatizing the electric- and water-utility sectors, the regulatory agencies must be capable of stopping monopolistic practices that injure consumer welfare.

Many reforms in the domestic policy front are important to undertake, but while necessary, they are not sufficient. The developed countries should likewise introduce regulatory reforms in their financial sectors to prevent a recurrence of the 2008 global financial crisis. The heavily indebted countries, meanwhile, must also pursue responsible deficit-reduction programs aimed at minimizing volatility in stock, bond, and foreign-exchange markets.

Finally, international financial institutions, such as, the Bretton Woods institutions, have for the past two decades been in some kind of a makeover. Together with domestic central banks, they continue to help provide liquidity when a country gets mired in a liquidity crisis. But since moral-hazard problems do exist, designing appropriate debt workout arrangements is crucial. The multilateral institutions must cooperate with established regional financial institutions, which maintain useable knowledge about their member-country constituents.

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