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Financial Crisis and Asian Developing Countries

The Impact of the Global Financial and Economic Turmoil on the Philippines: National Responses and Recommendations to Address the Crisis

JOSEPH ANTHONY LIM

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Third World Network

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NOTE

This paper was prepared as part of a Third World Network research project on financial policies in Asia directed by Yilmaz Akyüz. An earlier version was presented at the Conference on the Effects of the Global Financial Crisis on Asian Developing Countries and Policy Responses and Lessons, held in Penang, Malaysia on 18-20 August 2009 and organized by the Third World Network and Consumers Association of Penang.

Chapter 1

THE GROWTH PATTERN BEFORE THE GLOBAL FINANCIAL CRASH

Philippine Vulnerability to Global Crisis and External Shocks

SINCE the Philippines started its trade and financial liberalization processes in the 1980s – unilaterally opening up more than its Asian neighbours – it had suffered with every global and regional financial and economic crisis. This is shown clearly in Figure 1. One can see the Philippines' vulnerability in the sharp economic collapse in 1984-85 – due in part to the Latin American debt crisis, and in part to the political crisis and 'people power' revolution in the country. This vulnerability surfaced again in 1991 (world slowdown, oil crisis with Iraq-Kuwait war), in 1998 (Asian crisis) and in 2001 (dot-com and September 11 recession).

The current global crisis is again causing the economy to weaken considerably and is creating financial and foreign exchange volatilities and vulnerabilities.

Growth Before 2008: Spurred by Overseas Workers' Remittances, Consumption and Net Exports; Anaemic Investment

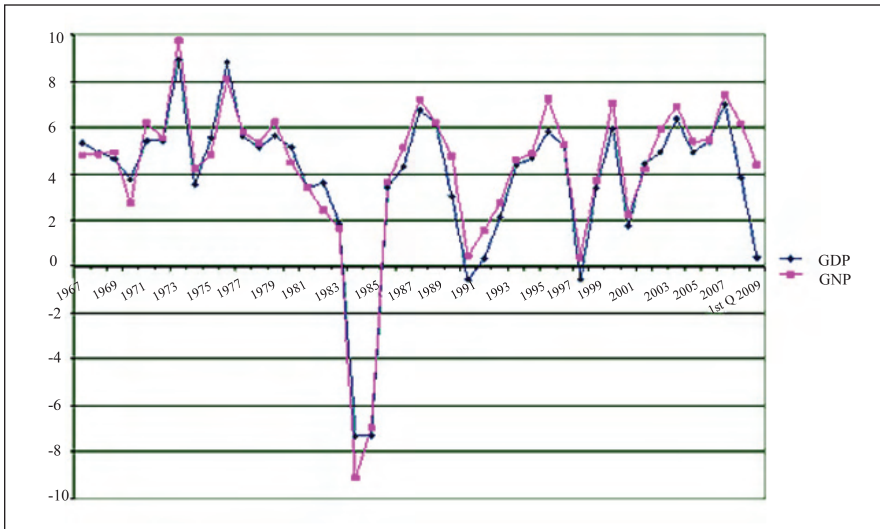
Tables 1a and 1b show us the growth rates of the demand and supply (economic sectors) components of GDP, respectively, from 1997 to the second quarter of 2009. Tables 2a and 2b give us the contribution to the GDP growth rate of the demand components and the economic sectors.[1] One can see

[1] The contribution to the growth of GDP is the product of the share of the component in GDP and the growth rate of that component.

from Tables 1a and 2a that private consumption contributed significantly to growth from 1997 to 2007. Investment grew anaemically except in 1997, 2000 and 2007. From Table 2a, it can be seen that in the latest growth period of 2004 to 2007 (except for 2005), net exports became a significant source of growth from the demand side.[2] Thus, right before the sharp world trade and economic contraction the Philippines became dependent on net export growth for its high growth.

Tables 1a and 2a and Figure 2 show that income sent by overseas workers (overseas remittances) – comprising almost all of net factor income from abroad (NFIA) – significantly boosts the gross national product (GNP).

Figure 1. Philippine GDP and GNP Growth Rates: 1967 to 1st Quarter of 2009



Source: National Statistics Coordination Board

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2 It must be pointed out that net exports were still negative during most of the years 2004 to 2007, but the reduction of the trade deficit contributed significantly to the growth in GDP. It is also most obvious from Table 2a that statistical discrepancy explains a large proportion of the growth rate of GDP in most years. This reveals large statistical errors between the supply-side national accounts and the demand-side accounts. This is perhaps aggravated by the fact that the base year is 1985 wherein relative prices of sectors were very different from the more current periods.

The big injections from overseas workers partly explain why private consumption is the main contributor to growth in GDP, as overseas remittances are used by the families to expand their consumption. Without much government pump-priming (to be explained later), the main injection to growth is the high overseas remittances. Secondarily in 2004 to 2007, net exports contributed to the growth of the economy.

Tables 1a, 2a and Figure 2 also show that overseas remittances cushioned the impact of recessions and economic slowdown, in the Asian crisis year of 1998 and the recent economic slowdown in 2008 and, especially, the first two quarters of 2009 (see Figure 2).

Figure 3a shows us the share in GDP of the demand components over the years, including the first two quarters of 2009. One can see that consumption dominates the demand components, making up 70% or more of GDP. The share of exports and imports went up to more than 50% in the early 2000s but started declining during the high-growth period of 2004 to 2007. The negative net exports were also reduced during this period, contributing to the growth in GDP. Investment, which had been on a long-run downward trend since the economic collapse of the mid-1980s, declined alarmingly after the Asian crisis up to the current period.

On the supply side, Tables 1b and 2b clearly show that the service sector was the main contributor to growth in the past decade. This is clearly supported by Figure 3b, which shows the share of services in GDP going up over the last three decades. In the growth years 2004 to 2007, the service sector was the lead contributor to growth while industry was just secondary. Figure 3b also shows the share in GDP of industry and manufacturing (the biggest component of industry) going slowly down over the years. This is mainly due to the much higher contribution to GDP of services compared to industry and manufacturing. The low performance of manufacturing mirrors that of investment, as services dominate GDP growth. Furthermore, manufacturing is hurt every time there is a recession or economic slowdown (much more so than services). Finally, the falling share of manufacturing over the long run may also reflect the lack of competitiveness of Philippine products compared to foreign products.

Table 1a: Growth Rate of GDP by Expenditure Items: 1997 to 2nd Quarter of 2009

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	1st Q 2009	2nd Q 2009
Personal Consumption Expenditure	4.99	3.45	2.64	3.51	3.58	4.08	5.28	5.88	4.83	5.51	5.85	4.67	0.81	2.25
Government Consumption	4.63	-1.95	6.73	6.15	-5.32	-3.83	2.61	1.39	2.31	10.38	6.58	3.23	3.78	9.08
Capital Formation	11.70	-16.28	-1.98	23.93	-7.29	-4.30	2.99	7.17	-8.80	4.98	12.46	1.68	-16.49	-9.84
1. Fixed Capital	11.47	-11.17	-2.27	19.92	-13.03	2.15	3.76	1.31	-6.62	3.81	10.95	2.90	-5.67	-1.94
a. Construction	14.58	-5.34	-0.26	27.17	-22.60	-0.70	-1.23	-0.79	-7.31	5.49	21.79	4.56	9.91	11.75
b. Durable Equipment	9.17	-18.05	-4.97	13.58	-3.20	4.84	9.22	3.18	-7.11	-1.76	7.70	1.91	-17.91	-18.85
c. Breeding Stock & Orchard Dev't	7.91	0.29	1.21	8.76	1.48	3.29	-0.47	0.94	1.07	29.90	-19.84	-1.55	1.17	-4.86
2. Changes in Stocks	24.46	280.04	-9.41	-86.23	-1380.8	-109.3	141.73	-444.2	-58.1	64.08	60.46	-25.3	-186.9	-194.2
Exports	17.15	-21.03	3.62	17.05	-3.44	4.03	4.88	15.00	4.78	13.40	5.38	-1.89	-18.18	-15.99
Less: Imports	13.49	-14.70	-2.80	4.27	3.52	5.61	10.82	5.77	2.37	1.89	-4.19	2.39	-19.15	-2.67
Statistical Discrepancy	-79.26	572.35	-54.44	488.46	-84.26	-432.0	131.24	-53.04	71.71	-134.5	363.08	-28.9	-81.30	-63.50
GDP	5.19	-0.58	3.40	5.97	1.76	4.45	4.93	6.38	4.95	5.40	7.02	3.84	0.45	1.45
Net Factor Income from Abroad	6.84	23.92	10.10	26.82	9.78	0.50	20.61	13.52	10.72	6.07	12.13	30.79	40.80	29.67
GNP	5.25	0.41	3.73	7.07	2.26	4.18	5.95	6.91	5.40	5.45	7.44	6.17	4.44	4.42

Source: National Statistics Coordination Board

Table 1b: Growth Rate of GDP by Economic Sectors: 1997 to 2nd Quarter of 2009

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	1st Q 2009	2nd Q 2009
Agriculture, Fishery, Forestry	3.09	-6.38	6.52	4.31	3.71	3.95	3.76	5.18	2.00	3.70	4.93	3.22	2.15	0.33
Industry	6.14	-2.12	0.90	8.95	-2.48	3.87	4.00	5.21	3.78	4.81	6.51	4.95	-2.12	-0.33
of which: Manufacturing	4.22	-1.13	1.60	5.59	2.87	3.47	4.24	5.84	5.28	4.60	2.89	4.31	-7.32	-7.19
Construction	16.18	-9.65	-1.53	26.23	-23.13	-4.02	-0.81	3.41	-5.88	9.63	21.15	7.84	16.74	16.94
Services	5.42	3.47	4.02	4.42	4.25	5.09	6.12	7.73	7.00	6.47	8.16	3.34	1.41	3.06

Source: National Statistics Coordination Board

Table 2a: Contribution to GDP Growth of Demand Components (Expenditure Items)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	1st Q 2009	2nd Q 2009
Personal Consumption Expenditure	3.83	2.64	2.10	2.78	2.77	3.21	4.14	4.63	3.79	4.31	4.58	3.61	0.62	1.73
Government Consumption	0.37	-0.16	0.53	0.50	-0.44	-0.29	0.18	0.10	0.15	0.66	0.44	0.21	0.26	0.68
Capital Formation	2.90	-4.28	-0.44	5.03	-1.79	-0.96	0.61	1.44	-1.78	0.88	2.19	0.31	-3.27	-1.99
Exports	8.02	-10.96	1.50	7.07	-1.58	1.75	2.11	6.49	2.23	6.26	2.70	-0.93	-7.93	-8.39
Less: Imports	7.95	-9.34	-1.53	2.19	1.78	2.88	5.62	3.16	1.29	1.01	-2.15	1.10	-8.35	-1.18
Net Exports	0.08	-1.62	3.03	4.88	-3.35	-1.13	-3.50	3.33	0.94	5.25	4.85	-2.03	0.42	-7.21
Statistical Discrepancy	-1.99	2.84	-1.83	-7.22	4.57	3.62	3.50	-3.11	1.86	-5.70	-5.04	1.73	2.42	8.24
GDP	5.19	-0.58	3.40	5.97	1.76	4.45	4.93	6.38	4.95	5.40	7.02	3.84	0.45	1.45
Contribution to GNP Growth														
GDP	4.98	-0.55	3.23	5.65	1.65	4.15	4.61	5.91	4.56	4.96	6.44	3.51	0.40	1.30
Net Factor Income from Abroad	0.27	0.96	0.50	1.42	0.61	0.03	1.33	1.00	0.84	0.50	1.00	2.66	4.04	3.12
GNP	5.25	0.41	3.73	7.07	2.26	4.18	5.95	6.91	5.40	5.45	7.44	6.17	4.44	4.42

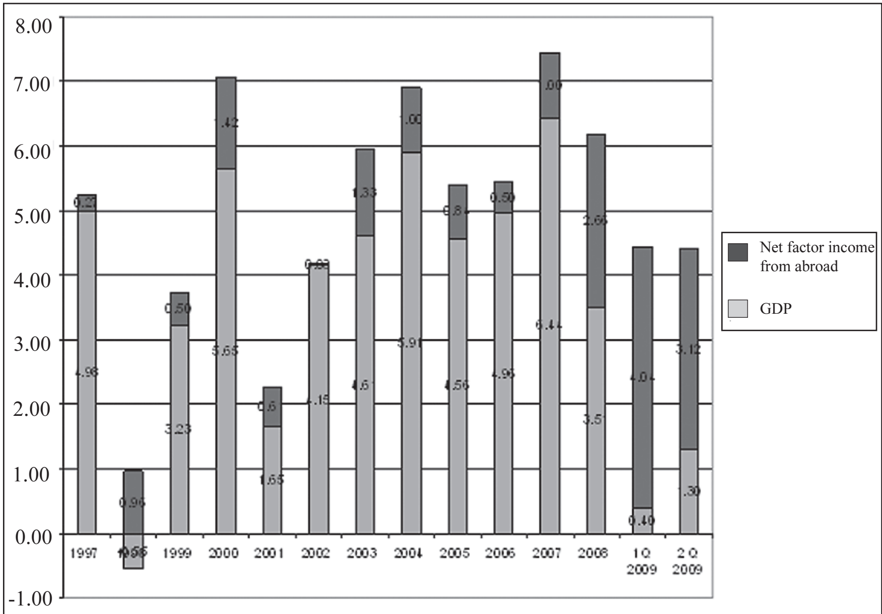
Source: Calculations of data from National Statistics Coordination Board

Table 2b: Contribution to GDP Growth of Economic Sectors

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	1st Q 2009	2nd Q 2009
Agriculture	0.65	-1.32	1.27	0.87	0.73	0.80	0.75	1.03	0.39	0.71	0.93	0.59	0.42	0.06
Industry	2.19	-0.76	0.32	3.09	-0.88	1.32	1.35	1.74	1.25	1.58	2.12	1.61	-0.66	-0.10
of which: Manufacturing	1.07	-0.28	0.40	1.37	0.70	0.86	1.03	1.42	1.27	1.11	0.69	1.00	-1.64	-1.49
Construction	0.94	-0.62	-0.09	1.46	-1.53	-0.20	-0.04	0.15	-0.25	0.36	0.83	0.35	0.63	0.74
Services	2.35	1.51	1.82	2.01	1.90	2.34	2.82	3.61	3.31	3.12	3.97	1.64	0.70	1.52

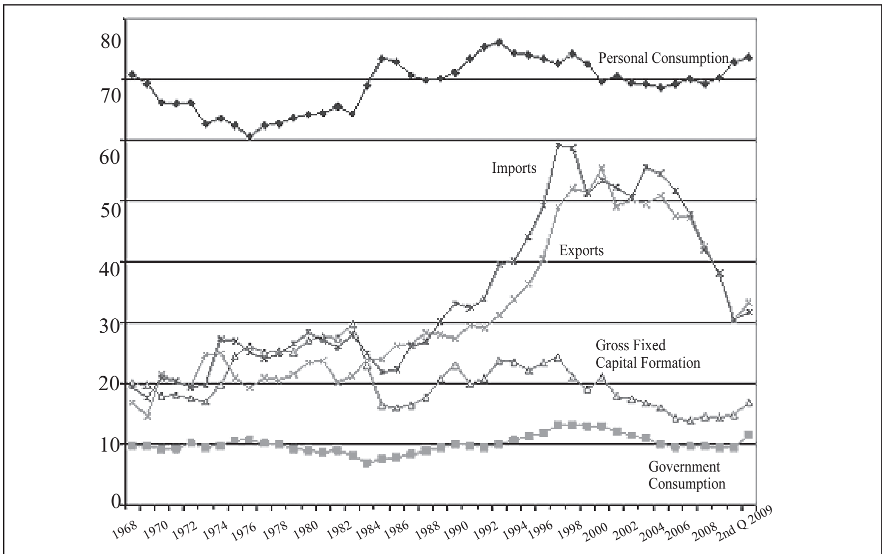
Source: Calculations of data from National Statistics Coordination Board

Figure 2: Contribution to Growth of GNP by GDP and NFIA



Source: National Statistics Coordination Board

Figure 3a: Share in GDP of Demand Components



Source: National Statistics Coordination Board

Gross National Savings and Gross Capital Formation

Figure 4 gives us the gross national savings and gross capital formation, both as a percentage of GNP. One can see the boom-bust cycles here as characterized by initial high savings-investment (or current account) deficits preceding the crisis years (1984-85, 1991, 1998). The 1984-85 crisis was catastrophic as it brought both gross national savings and gross capital formation down sharply, and gross capital formation, or gross investment, has never attained the heights of the 1970s since. But a dramatic change occurred in the 2000s. The massive overseas remittance inflows (despite trade deficits) led to a rise in gross national savings as a percentage of GNP. At the same time, the aftermath of the Asian crisis saw investment (or gross capital formation) declining ever lower as a percentage of GNP until the present. The gap between gross national savings and gross investment led to a growing current account surplus, especially in recent years (2006 to present). The current crisis due to the global financial meltdown is the only crisis when the Philippines is not suffering from large current account and balance-of-payments deficits. The fact that growing gross national savings are not being used to finance gross investment – for an economy with very low investment – reveals a growth pattern that is not conducive to long-term growth in production and productive capacity.

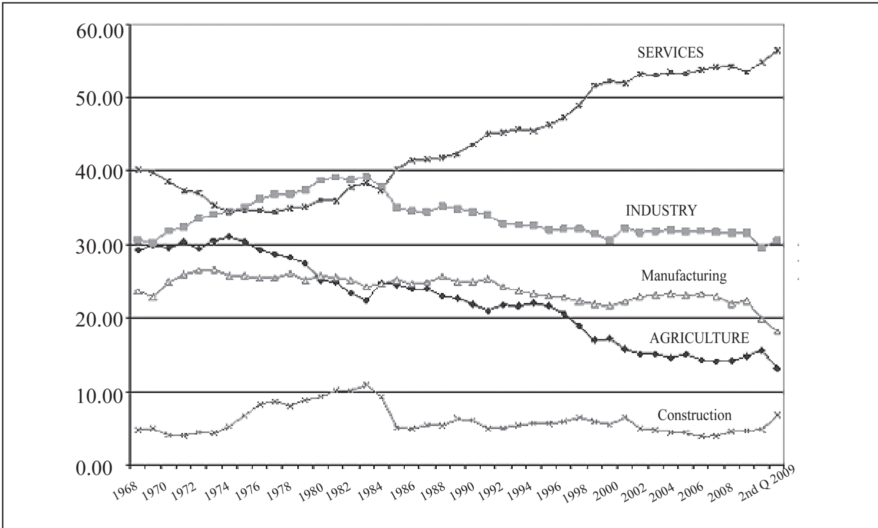
The low investment rate, even in the high-growth years of 2004-07, can be explained by the following:

a) The latest growth period in 2004-07 was spurred mainly by high overseas remittances (channelled to consumption) and secondarily by net exports. The pump-priming of the economy was externally generated, and not due to high domestic confidence.

b) Political instabilities and the fiscal crisis (to be explained below) may have deterred investors from investing long-term in the Philippines.

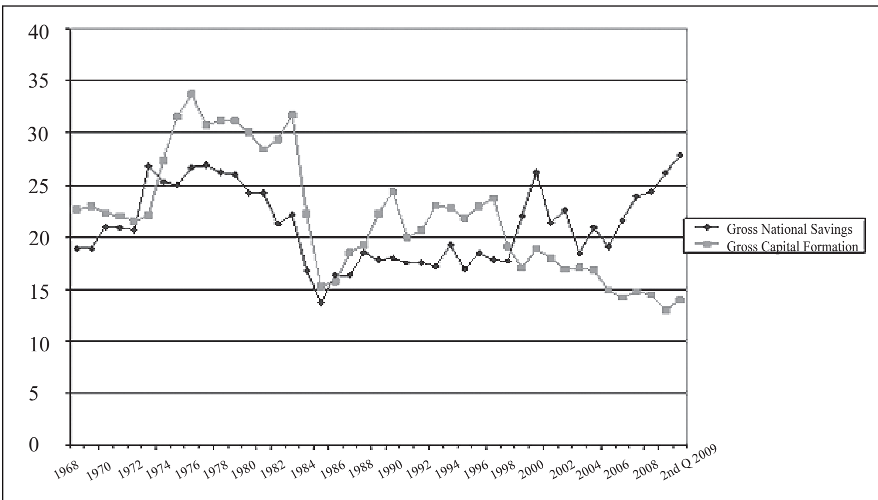
c) The low domestic-credit-to-GDP ratio (to be shown later) meant both banks and firms were conservative in using credit to expand investments, due perhaps to more stringent financial regulation in the post-Asian-crisis period, the experience of default problems during the Asian crisis, and lack of confidence due to political instabilities and the fiscal crisis.

Figure 3b: Share in GDP of Agriculture, Industry and Services; and the Subsectors of Manufacturing and Construction



Source: National Statistics Coordination Board

Figure 4: Gross National Savings and Gross Capital Formation: % of GNP



Source: National Statistics Coordination Board

Difficult Growth Period from 2002 to 2007

The growth period between the Asian crisis and the current global economic and financial crash was quite rocky and difficult.

Political Instabilities

First there were political instabilities from 2001 to 2005, with continuing corruption charges and strong and widespread opposition to the government that have persisted until the present day. In 2001, the Joseph Estrada government was overthrown by a people's revolt. His successor, President Gloria Macapagal Arroyo, is also being hounded by serious charges of corruption, election fraud, shady deals and high spending. This has brought about several unsuccessful revolts by junior officers in the military backed by some civilian forces.

Fiscal Crisis

Equally serious was a fiscal crisis that emerged and intensified from 2002 to 2005 when the fiscal deficits as well as public and external debts ballooned beyond what international finance capital allowed.

Table 3 shows this. Fiscal surpluses had been achieved by the Fidel Ramos administration in 1996-97 before the Asian crisis. The Asian crisis, however, brought back fiscal deficits. Table 3 shows the fiscal deficits worsening after the crisis, with the national government deficit reaching more than 5% of GDP in 2002. These deficits in the early 2000s were actually underestimated because they did not include the losses of government corporations, especially the National Power Corporation, during this period.

The main reason for the fiscal problem is that the post-Asian-crisis economic recovery from 1999 to 2005 had surprisingly failed to improve tax effort, but instead worsened it. The tax effort peaked at around 17% of GDP in 1996 and 1997, after which it consistently fell and bottomed out at 12.4% in 2004 (Table 3). The falling tax effort despite significant GDP growth may be attributed to poor tax administration and a tax law passed in 1997 that

gave significant exemptions and loopholes to corporate and individual income tax payers. The high fiscal deficits and increasing debt burden (with sovereign credit rating downgrades by the international rating agencies), especially warnings of an Argentinian-style debt default, forced the government to undertake substantial tax increases. The tax effort improved to around 14.3% in 2006 mainly due to the expanded coverage and higher value-added tax rate (raised from 10% to 12% and expanded to include coverage of services). But the tax effort deteriorated again in 2007 to the present.

The falling tax effort and rising public debt burden after the Asian crisis brought about a serious situation wherein the public debt burden and public debt service, including the external debt burden, increased significantly in the mid-2000s.

Tables 4 and 5 show the pictures of the national government debt burden and external debt burden, respectively. The tables show that because of high fiscal deficits, public debt and external debt (driven mainly by public foreign debt) as a percentage of GDP went up to more than 70% in the first half of the 2000s. These debt ratios were reduced substantially from 2005 mainly because of strong constriction of expenditures. But the debt burdens continue to be high compared to the other emerging countries in East Asia – surpassing Indonesia. The low tax capability of the economy as well as the higher debt burden (compared to other emerging economies in East Asia) are restricting the government's ability to undertake fiscal stimuli, as international capital wields the threat of a sovereign credit downgrade as public and external debts increase (as a response to the global downturn) and as currency depreciation occurs as international capital escapes from emerging economies.

Current Account Surplus and Growing International Reserves Since 2005

Now we look at the economy's balance of payments (BOP) before the global financial recession. The Philippines, despite the Asian crisis and severe crises in Turkey and Argentina in the early 2000s caused by capital account openness, expanded and deepened its capital account liberalization by increasing the maximum allowable purchases or outflows of foreign exchange

made by residents. The central bank also eased documentation requirements for cross-border financial flows. This was justified on the grounds that:

- More foreign exchange funds will be available (this argument is still being used now amid the global recession).
- During the 'good' times of currency appreciation, allowing more capital outflows from residents will tame the appreciation.

Table 6 gives us the current and financial account items of the BOP from 1996 to 2008. One can see that, unlike in previous periods, the current account turned consistently positive starting 2003 as a result of the high inflows of net income and current transfers due to overseas workers' remittances. The continuing trade deficits were outpaced by the remittances, taking the current account into surplus territory. With regard to the financial account, capital and financial inflows in the 2000s were not as high as in the pre-Asian-crisis period. But net portfolio inflows became moderately significant in the period from 2005 to 2007.

The BOP was flat in 2002-04 because:

- Trade deficits were large and were just offset by the overseas remittances
- There were not much foreign investments coming in because of the fiscal crisis and political instabilities.

The BOP improved substantially in 2005-07 because:

- Trade deficits were reduced
- Overseas remittances grew even further
- More foreign direct and portfolio investments came in as the fiscal and political crises waned.

Table 3: National Government Cash Budget: Revenues, Expenditure and National Government Balance

Item	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
as % of GDP													
Revenues	18.90	19.44	17.35	16.07	15.34	15.63	14.59	14.82	14.51	14.99	16.24	17.07	16.04
of which: Tax Revenues	16.94	16.98	15.63	14.50	13.71	13.59	12.81	12.75	12.42	12.96	14.25	14.01	13.99
Expenditures	18.61	19.38	19.23	19.82	19.35	19.68	19.91	19.45	18.35	17.69	17.31	17.26	16.95
of which: Interest Payments	3.52	3.21	3.74	3.57	4.20	5.00	4.69	5.25	5.36	5.51	5.14	4.02	3.63
Surplus	0.29	0.06	-1.88	-3.75	-4.00	-4.05	-5.32	-4.63	-3.84	-2.70	-1.07	-0.19	-0.91

Source: Bureau of the Treasury

Table 4: National Government (NG) Outstanding Debt

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Total (in billion pesos)	1155.2	1350.6	1496.2	1775.4	2166.7	2384.9	2815.5	3355.1	3812.0	3888.2	3851.5	3712.5	4220.9
As % of GDP:													
Total	53.19	55.65	56.14	59.64	64.59	65.67	71.03	77.73	78.25	71.42	63.84	55.77	56.30
Domestic Debt	34.17	30.89	31.93	32.87	31.84	34.36	37.12	39.47	41.08	39.76	35.71	33.07	32.20
NG Direct	33.12	29.67	31.02	32.18	31.27	33.98	36.91	39.42	41.03	39.71	35.67	33.03	32.17
of which Gov't Securities	32.44	29.06	29.56	30.85	30.81	33.55	36.51	39.06	40.45	39.20	35.33	32.73	31.99
Assumed	1.05	1.22	0.91	0.68	0.57	0.38	0.21	0.05	0.05	0.04	0.04	0.03	0.03
Foreign Debt	19.02	24.76	24.21	26.77	32.75	31.32	33.91	38.26	37.17	31.67	28.14	22.70	24.09
NG Direct	14.31	18.70	18.21	18.19	19.30	17.26	17.80	18.90	17.27	12.92	11.18	9.22	10.58
Assumed	0.72	0.75	0.57	0.44	0.40	0.32	0.25	0.18	0.12	0.06	0.02	0.00	0.00
Foreign Denom. Securities	3.99	5.31	5.43	8.14	13.04	13.73	15.87	19.17	19.79	18.68	16.94	13.48	13.51

Source: Bureau of Treasury

Table 5: External Debt and External Debt Burden

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Total External Debt (in million US dollars)	46,146	50,997	51,206	51,900	53,645	57,395	54,846	54,186	53,367	54,938	53,856
As % of GDP:											
By Type of Debt	67.6	69.1	76.3	73.5	71.9	73.9	63.3	52.8	43.5	34.2	34.1
Medium- and Long-Term	59.0	62.4	68.1	65.0	64.4	65.9	57.5	46.6	39.4	29.8	29.7
Short-Term	8.6	6.7	8.2	8.5	7.4	8.0	5.8	6.2	4.1	4.4	4.4
Trade	1.7	1.4	1.7	1.7	1.4	1.7	1.9	2.1	1.7	1.5	1.2
Non-Trade	6.8	5.3	6.5	6.8	6.1	6.3	3.9	4.1	2.4	2.9	3.2
By Borrower	67.6	69.1	76.3	73.5	71.9	73.9	63.3	52.8	43.5	34.2	34.1
Banking System	17.6	15.4	16.8	16.4	14.7	14.5	11.1	10.8	8.0	6.4	5.1
Bangko Sentral (central bank)	7.0	6.3	7.2	8.1	6.2	5.7	3.1	1.8	0.4	0.2	1.1
Banks	10.5	9.1	9.6	8.3	8.5	8.8	8.0	9.0	7.7	6.2	4.0
Government Banks	3.5	3.7	4.5	3.8	3.9	3.9	3.7	3.0	2.4	1.7	1.9
Private Banks	7.1	5.4	5.1	4.5	4.5	4.9	4.3	6.0	5.2	4.6	2.1
Foreign Banks	0.9	0.7	0.6	1.3	0.9	0.9	1.1	2.8	3.4	3.0	0.9
Domestic Banks	6.1	4.7	4.5	3.2	3.6	4.0	3.1	3.2	1.8	1.5	1.2
Non-Banking System	50.1	53.6	59.6	57.0	57.2	59.4	52.2	42.0	35.4	27.7	29.0
Public	33.4	36.5	39.2	35.4	37.4	41.3	36.9	30.8	27.4	21.6	22.5
National Government and Others	32.4	35.8	38.5	34.9	37.1	41.0	36.8	30.7	27.4	21.5	22.4
Central Bank Board of Liquidators	1.0	0.7	0.7	0.4	0.4	0.2	0.1	0.1	0.0	0.0	0.0

Private	16.7	17.1	20.3	21.7	19.7	18.1	15.3	11.2	8.0	6.2	6.5
of which: Red Clause/Export Advances	0.5	0.6	0.3	0.2	0.1	0.1	0.2	0.2	0.2	0.1	0.1
By Institutional Creditor	67.6	69.1	76.3	73.5	71.9	73.9	63.3	52.8	43.5	34.2	34.1
Banks and Other Financial Institutions	11.7	12.4	15.5	16.4	15.8	13.8	12.9	12.6	8.7	6.5	5.7
Suppliers	2.3	2.3	2.4	2.7	2.8	4.2	2.4	1.8	2.3	2.3	1.6
Multilateral	14.7	13.9	14.4	13.5	12.0	11.6	9.7	7.2	5.8	4.8	5.6
of which:											
International Bank for Reconstruction and Development	6.3	5.5	5.4	4.6	4.4	4.4	3.8	2.8	2.2	1.7	1.6
International Monetary Fund	2.3	2.5	3.0	2.8	2.2	1.5	0.9	0.4	0.0	0.0	0.0
Asian Development Bank	5.1	4.8	5.0	4.5	4.4	4.8	4.3	3.4	3.2	2.6	3.0
Bilateral	21.9	22.2	22.9	20.6	20.9	21.8	19.4	13.9	10.9	8.5	9.8
Export Credit Agencies	7.8	2.8	2.9	3.4	3.3	2.9	2.3	1.6	1.1	0.8	0.7
Others	14.1	19.4	20.0	17.2	17.6	18.8	17.1	12.3	9.8	7.8	9.0
Bondholders/Noteholders	16.4	17.5	19.9	19.4	19.8	22.0	18.3	16.8	15.2	11.5	11.0
Others	0.6	0.8	1.3	1.1	0.6	0.6	0.6	0.6	0.5	0.5	0.4

Source: Bangko Sentral ng Pilipinas (Philippine central bank)

Table 6: Balance of Payments (% of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Current Account, n.i.e.	-4.8	-7.2	2.3	-3.9	-3.3	-2.5	-0.4	0.4	1.9	1.9	4.4	4.4	2.7
Trade Balance	-13.7	-18.3	0.0	-8.1	-8.9	-8.9	-7.4	-7.5	-6.6	-7.6	-5.5	-5.2	-8.0
Goods: Exports f.o.b.	24.9	41.6	43.2	46.4	55.7	44.3	46.1	45.5	44.8	39.2	37.9	30.8	30.5
Goods: Imports f.o.b.	-38.6	-59.9	-43.3	-54.5	-64.6	-53.2	-53.5	-53.0	-51.4	-46.8	-43.4	-36.1	-38.5
Balance on Goods and Services	-9.5	-16.7	-3.9	-10.3	-11.7	-12.1	-10.1	-10.1	-8.6	-8.9	-5.4	-3.8	-7.1
Services: Credit	15.7	24.9	11.0	4.7	5.0	4.3	4.6	4.4	4.7	4.4	5.2	6.1	6.5
Services: Debit	-11.4	-23.3	-14.8	-6.9	-7.8	-7.6	-7.3	-6.9	-6.7	-5.7	-5.1	-4.7	-5.5
Net Income and Current Transfers	4.7	9.5	6.2	6.4	8.4	9.6	9.7	10.4	10.5	10.8	9.7	8.3	9.7
Financial Account, n.i.e.	13.6	10.7	0.7	5.7	4.8	0.5	0.5	0.6	-1.9	1.4	1.1	2.3	-2.9
Net Foreign Direct Investment	1.6	1.8	3.1	1.5	3.2	0.5	2.0	0.2	0.1	1.6	2.3	-0.4	0.8
Direct Investment in Philippines by Non-Residents	1.8	2.0	3.4	1.7	3.3	0.3	2.1	0.6	0.8	1.8	2.4	1.8	1.0
Direct Investment Abroad by Residents	-0.2	-0.2	-0.2	-0.2	-0.2	0.2	-0.1	-0.4	-0.7	-0.2	-0.1	-2.2	-0.2
Net Portfolio Investments	6.4	1.0	-1.4	5.0	-0.8	0.1	1.0	0.7	-0.7	3.2	3.7	3.0	-1.6
Net Equity Securities	2.6	-0.6	0.1	0.6	-0.4	0.2	0.3	0.6	0.6	1.4	2.1	1.9	-0.8
Net Debt Securities	3.9	1.6	-1.5	4.4	-0.5	-0.2	0.7	0.1	-1.2	1.8	1.7	1.0	-0.8
Net Financial Derivatives	0.0	0.0	0.0	0.0	0.1	0.0	0.0	-0.1	0.0	0.0	-0.1	-0.2	-0.1
Net Other Investments	5.6	7.9	-1.0	-0.8	2.4	0.0	-2.4	-0.3	-1.4	-3.4	-4.8	-0.1	-2.0
Other Investment from Non-Residents	7.7	7.2	-2.2	0.6	-1.2	-1.1	-2.1	-1.2	-0.3	1.3	-1.9	2.9	-4.4
Other Investment Abroad by Residents	-2.1	0.7	1.2	-1.4	3.7	1.1	-0.3	1.0	-1.0	-4.7	-2.9	-3.0	2.4
Net Errors and Omissions	-3.6	-8.6	-1.1	3.1	-2.4	0.9	0.0	-1.2	-0.3	-1.8	-1.3	-1.3	-1.4
Overall Balance	5.3	-5.1	1.9	5.1	-0.7	-1.0	0.2	-0.1	-0.3	1.6	4.3	5.4	-1.6

Source: IMF, International Financial Statistics

But all in all, the increase in international reserves from 2005 to the current period came mainly from current account surpluses driven by overseas remittances, and only secondarily, and that too just from 2005 to 2007, from financial and capital inflows. The magnitude of capital inflows is much smaller than in other emerging countries in Southeast Asia (such as Singapore, Malaysia, Thailand and Indonesia). Net foreign direct investments, particularly, were small compared to those in other countries in the region. This is of course related to the lack of dynamism in the export sector, the continuing political instabilities and the still relatively weak fiscal sector.

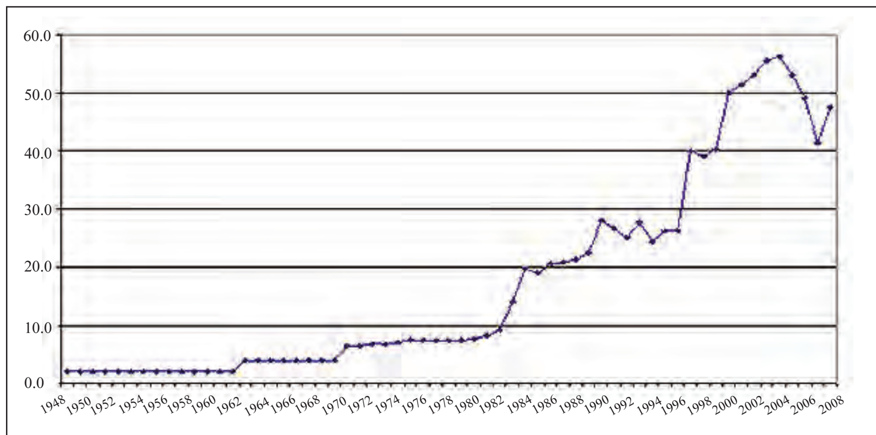
Note that due to capital account liberalization, capital outflows by residents (under the item 'other investments') were very high from 2005 to 2007, offsetting much of the portfolio inflows. This was exactly what the central bank wanted, as explained above, to tame the appreciation of the peso, and was partly a result of lifting the ceiling for financial outflows.

Depreciating Currency from 2000 to 2004, Appreciation from 2005 to 2007

Ever since the abandonment of the fixed exchange regime and the start of capital account liberalization, the exchange rate has become volatile and pro-cyclical, appreciating during 'good' times when capital inflows are high and depreciating rapidly during 'bad' times when there is a global or regional crisis and 'flight from risk'. The appreciation of the currency during the 'good' times leads to a bias against exports and increases currency risks as current account deficits grow with the currency appreciation. The depreciation of the currency during the 'bad' times aggravates the loss in confidence, increases the external debt burden and, by making essential imports more expensive, is recessionary.

Figure 5 (which illustrates the annual movement of the exchange rate based on pesos per US dollar – average of the period) shows that the peso had been in a fixed exchange regime before the 1980s. In the early 1980s, financial liberalization included moving to a flexible exchange rate regime. Especially in the 1990s and 2000s, as capital account liberalization became institutionalized and because of the low international reserves of the Philippines, the exchange rate was almost entirely floating, with intermittent

Figure 5: Exchange Rate (Pesos per US$): 1948 to 2008



Source: IMF, International Financial Statistics

weak central bank interventions except during the Asian crisis when the interventions were strong but nevertheless still failed to stop the peso's steep depreciation.

The Latin American debt crisis of the early 1980s hit the Philippines badly, leading to economic collapse and a sharp depreciation. The currency continued to weaken with debt overhang until the early 1990s. The exchange rate stabilized in the mid-1990s, but the Asian crisis which broke out after strong capital account liberalization (in the early 1990s) brought very sharp depreciations in 1997 and early 1998. Just as in the previous decade, the depreciation continued from 2000 to 2004, due to the political instabilities which led to the overthrow of President Estrada in 2001, and then the political instabilities under the Arroyo government, and severe fiscal crisis and talk of debt default described earlier.

The first time the Philippines experienced a sustained period of nominal appreciation of the currency was from 2005 to early 2008. During this time, the waning of the fiscal crisis and the decreased chances of an overthrow of the Arroyo government brought capital inflows into the economy simultaneous with the high growth in the Philippines and globally.

It is not clear whether the strong appreciation of the peso in 2005 to 2007 hurt exports. As a share of GDP, certainly the export ratio fell, as shown in Figure 3a and Table 6. But looking at Table 1a, the growth rate of exports in the 2005-07 period (when the peso was appreciating) was no different from that in the 2002-04 period (when the peso was depreciating).

Most likely, the Philippines is not doing very well in the export sector compared to its neighbours because:

- Its exports are concentrated on assembly of low-end electronic products, which is dependent on imported inputs and circuits, and has low value-added.
- The Philippines has comparatively high labour costs and very high electricity and transportation costs (one of the highest in Asia) and poorer infrastructure than its neighbours.
- The Philippines does not have a strong industrial policy of establishing backward and forward linkages with the processing of its export products.

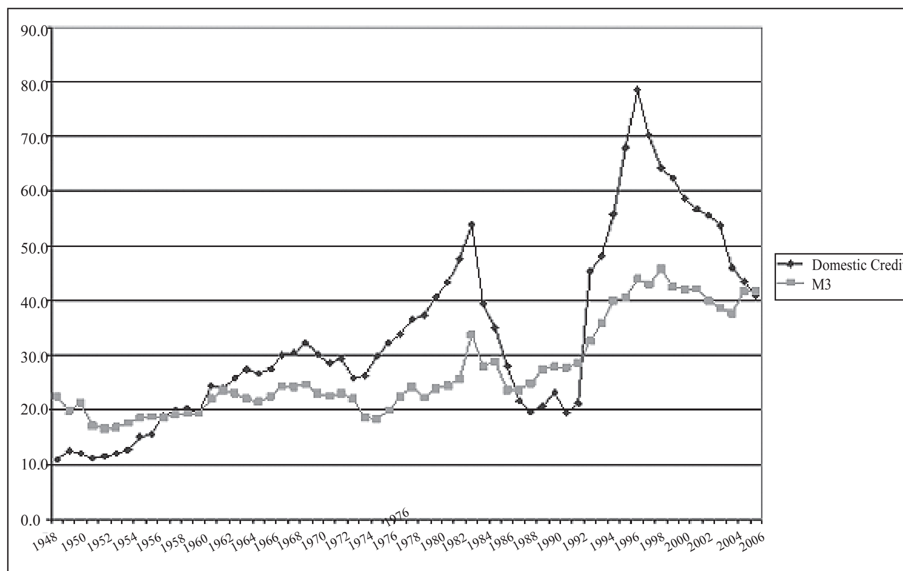
Thus the fall in the export share of the Philippines and its lacklustre performance in the global export market may be attributed only very partially to exchange rate movements.

Low Financial Confidence and Credit to the Private Sector

The post-Asian-crisis period has been marked by low financial confidence due to the trauma of non-performing assets suddenly increasing during the Asian crisis and due to the subsequent stringent financial supervision to achieve higher capital adequacy ratios and loan loss provisions.

Figure 6 shows M3 (money plus quasi-money and deposit substitutes) and domestic credit as percentages of GDP. It shows that the 1984-85 crisis and the 1997-98 Asian crisis were preceded by substantial increases in domestic credit (financed by both domestic and foreign financial institutions). Both crises were followed by declines in domestic credit and deliberate monetary contraction. Financial crises also bring down financial confidence. This is very clear in the decline of domestic credit (as a percentage of GDP) from the mid-1980s until 1992 due to the financial and economic collapse of

Figure 6: Domestic Credit and M3 as % of GDP



Source: IMF, International Financial Statistics

1984-85. It is happening again in the post-Asian-crisis period as both domestic credit and M3 as percentages of GDP declined from 1998 until 2004. Domestic credit remains in the doldrums in the latest 2008 data.

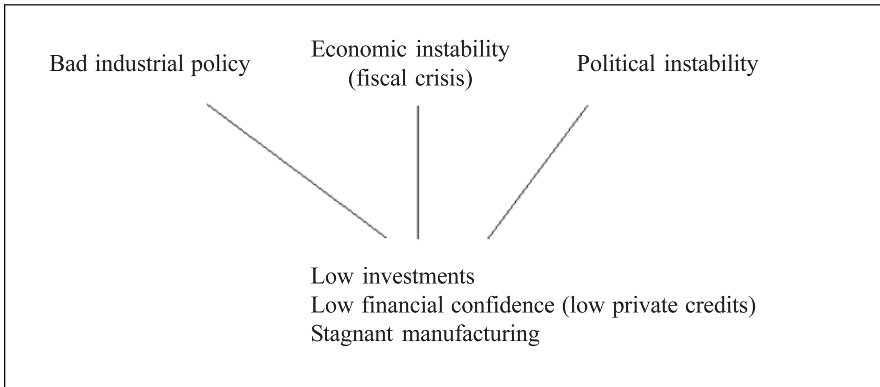
The Asian crisis increased financial regulations on banks. The Basel international standard for minimum capital adequacy ratios (net worth to risk-weighted assets) of banks is currently at 8%. The Philippines has been more stringent and imposed a minimum capital adequacy ratio of 10% starting 2001. The actual average capital adequacy ratio for Philippine banks ran to a high of over 18% in the mid-2000s (see Table 9). This was reduced to a still high 15% in 2008. Higher loan loss provisions were also imposed. The more stringent financial supervision, together with the perennial political crisis, has so far discouraged banks from aggressively lending to the private sector. From 2004 to 2008 the banking system was awash with liquidity with a strong appetite for government securities – whether peso- or dollar-denominated – rather than private lending. This is one of the main reasons for the weak investment and employment generation in an economy with

still underdeveloped long-term capital markets. The preference for government securities over private lending (despite political instabilities) can be attributed to the implicit guarantees of government securities with the prospect of International Monetary Fund (IMF) bailout programmes. Furthermore, none of the political opponents of the administration were calling for cancellation of foreign debts.

Domestic credit was also low because the government did not have a strong industrial policy that would at least give incentives for credit to flow to priority sectors.

The diagram below (Diagram 1) illustrates the joint problem of low investments, low real and financial confidence and stagnant manufacturing in the Philippines. All these are related.

Diagram 1: Factors Contributing to Low Investments and Low Financial Confidence



Although this is not a rosy picture, the low domestic credit vis-à-vis GDP made sure there was no overlending and overborrowing in the period from 2004 to 2007. This shielded the banking and financial sector from possible financial vulnerabilities due to bad loans and deteriorating non-performing loans during the current global turmoil. But it may not be able to stop the rise in non-performing loans as the manufacturing and export sectors decline significantly in 2009 and perhaps 2010.

The low domestic credit vis-à-vis GDP also precluded the need to strongly sterilize the external financial inflows especially in 2006 and 2007.

Summary

To summarize, the growth experience of the Philippines before the current global crash had been spurred by overseas workers' remittances in the midst of strong trade and financial liberalization, resulting in a consumption- and service-led growth. While net exports also contributed to growth in 2004 to 2007, investment was lacklustre. Political instabilities and a fiscal crisis did not lead to high domestic confidence for investments and loans. Foreign capital inflows came in quite late, mostly in 2006 and 2007, leading to a strong peso appreciation and reserve accumulation mainly due to overseas remittances and some foreign investments.

Chapter 2

THE IMPACT OF THE GLOBAL CRASH ON THE PHILIPPINES AND ASIAN COUNTRIES

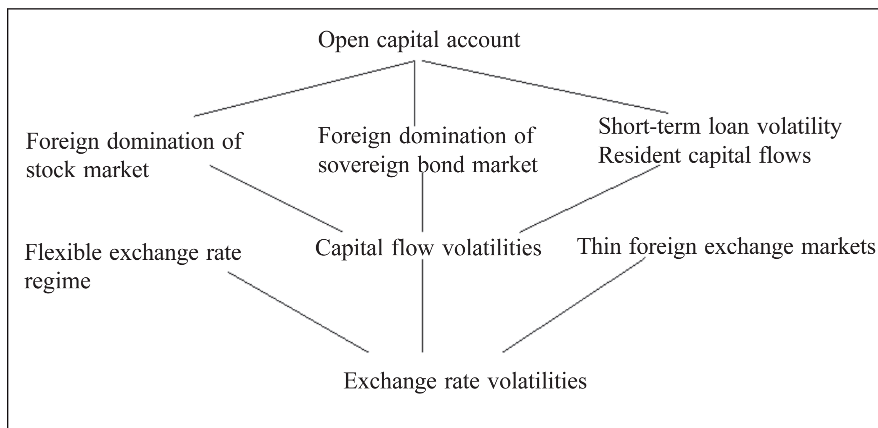
Capital Flow Volatilities

THE years before and during the Asian crisis and the current global meltdown were marked by the very unstable and volatile pro-cyclical capital flows which hit many developing and emerging economies that opened up their external capital account. Open capital accounts have caused tremendous pro-cyclical volatilities during 'good' times and during crisis periods. Diagram 2 illustrates this. An open capital account leads to foreigners going into the stock and sovereign bond markets. Being strong institutional investors, they are looked upon as lead investors (even if they are a minority) by local stock and bond market players, who just follow them in 'herd behaviour' mode. During 'good' times, there is massive buying of equities and sovereign bonds, leading to bubbles especially in the stock market. During crisis periods, there is much foreign capital flight and local players' withdrawal from the stock and sovereign bond markets, leading to strong asset price collapse.

During the current global crisis, several of the affected countries had to turn to the IMF for foreign exchange funds as they experienced depletion of their international reserves and external debt crises, similar to the East Asian countries during the Asian crisis.

Fortunately for most East Asian countries, they had accumulated considerable international reserves before the global crash, though this was at the expense of establishing a strong domestic demand base and strong domestic growth.

Diagram 2: Volatilities in the Capital Account and Exchange Rate Movements



In the Philippines in 2008, as is shown in Table 6, the net outflow from portfolio investments amounted to 1.6% of GDP while that from 'other investments' (mostly short-term loans and repayments) was 2% of GDP. There was another unrecorded net outflow (under the 'errors and omissions' item in the balance of payments) amounting to 1.4% of GDP. This was simultaneous with a sharp increase in the trade deficit amounting to 7-8% of GDP, as exports contracted.

Luckily, in 2008, when the global financial and economic meltdown started, the overseas remittances remained very high (net income inflows and net current transfers amounted to 9.7% of GDP in 2008) so that the massive capital outflows did not lead to a very strong reduction in foreign exchange reserves.

Furthermore, in the first quarter of 2009, imports declined more than exports as the Philippine economy teetered towards the brink of recession due to losses in domestic confidence. The continuing (increased) inflow of overseas remittances more than offset the capital flight from the financial account. The result was a bigger balance-of-payments surplus in the first quarter of 2009 compared to that of 2008. See Table 7.

Table 7: Balance of Payments, % of GDP: 1st Q 2009 vs. 1st Q 2008

	Q1	
	2009p	2008p
CURRENT ACCOUNT	5.45	2.84
Goods and Services	-3.43	-4.88
Export	26.17	32.77
Import	-29.60	-37.65
Income and Current Transfers	8.88	7.71
Credit: Receipts	13.35	12.08
of which Overseas Worker Remittances	10.55	9.06
Debit: Payments	-4.48	-4.36
CAPITAL AND FINANCIAL ACCOUNT	-1.90	1.12
Capital Account	0.04	0.05
Financial Account	-1.95	1.08
Direct Investment	-0.02	0.60
Credit: Liabilities, Non-Residents' Investments in the Phil.	0.11	0.59
Debit: Assets, Residents' Investments Abroad	-0.13	0.01
Portfolio Investment	-0.37	1.20
Credit: Liabilities, Non-Residents' Investments in the Phil.	-0.30	-1.33
Debit: Assets, Residents' Investments Abroad	-0.07	2.53
Financial Derivatives	0.08	-0.19
Other Investment	-1.64	-0.53
Credit: Liabilities, Non-Residents' Investments in the Phil.	-1.56	-4.94
Debit: Assets, Residents' Investments Abroad	-0.08	4.41
NET UNCLASSIFIED ITEMS	0.81	-0.17
OVERALL BALANCE	4.35	3.79

p Preliminary estimate

Source: Bangko Sentral ng Pilipinas

The second quarter saw a return of trade deficits as the export decline outpaced the import decline, signalling a temporary weak recovery in consumption. This can be seen in Table 1a. Furthermore foreign investments partly returned due to early (most likely premature) hopes of a global recovery. Preliminary data and statements from the central bank indicate that the balance-of-payments surplus and international reserves increased further in the rest of 2009.

Currency Depreciation

When the global meltdown, which hit the Philippines strongly starting early 2008, led to the capital outflows described earlier, together with actual and expected export declines as well as conjectures of a reduction in overseas remittances, the currency started to depreciate significantly from its strong levels in 2007 and early 2008. Figure 7 tracks the monthly movement of the peso exchange rate to one US dollar (average for the period) from January 2006 to April 2009. One can see that the period of net capital inflows and rising stock market prices led to a strong currency appreciation until early 2008. The US subprime crisis quickly reversed this and led to a sharp depreciation from March 2008 to early 2009. The sharp appreciation of the peso during the 'good' times and the sharp reversal during 'bad' times make the financial, export and import markets quite volatile. The sharp currency depreciation in 2008 increased the vulnerability of the Philippines during the period of high oil import prices in the first half of the year, and worsened the public and external debt burden of the country at a time when fiscal deficits had deteriorated (to be described later). This in turn caused a sharp drop in economic confidence, leading to lower real investment and stagnant private consumption in the economy.

Diagram 2 shows the exchange rate volatilities that cause wild appreciation and depreciation during 'good' and 'bad' times. An almost fully flexible exchange rate regime (given that the country's level of international reserves, while growing, is not as strong as in other East Asian countries when it comes to defending the exchange rate) and thin foreign exchange markets exaggerate currency appreciation and depreciation.

Especially during crisis periods, dollar holders hoard their dollars, while a tremendous number of peso holders try to unload their pesos for dollars. The thin supply of dollars and the massive amount of pesos being sold exaggerate the currency depreciation. Figure 7 shows the appreciation of the peso from around PHP53 to a dollar in June 2006 to less than PHP41 in February 2008. The global crisis sent this depreciating to PHP49 in November 2008, at the height of the Lehman Brothers fiasco in the US (a 20% depreciation in nine months). In 2009, the depreciation levelled off as the second quarter brought early but premature hopes of a world recovery. By early October 2009, the peso was still fluctuating back and forth between PHP47 and PHP48.5.

The wild swings in the exchange rate reflect the uncertainties of the times and the inability of the central bank to undertake a strong managed float of the currency because of the relatively small size of international reserves vis-à-vis the strong demand for dollars. The depreciation of the peso occurred despite increasing international reserves. It is a reflection of the 'flight from risk', the Philippines being seen by foreign investors as a high-risk, high-yielding emerging market. The depreciation of the peso at a time of contracting world export markets does not yield positive results but only adds to the loss in confidence in the economic system, affecting domestic investments and consumption, as we shall see in the next section.

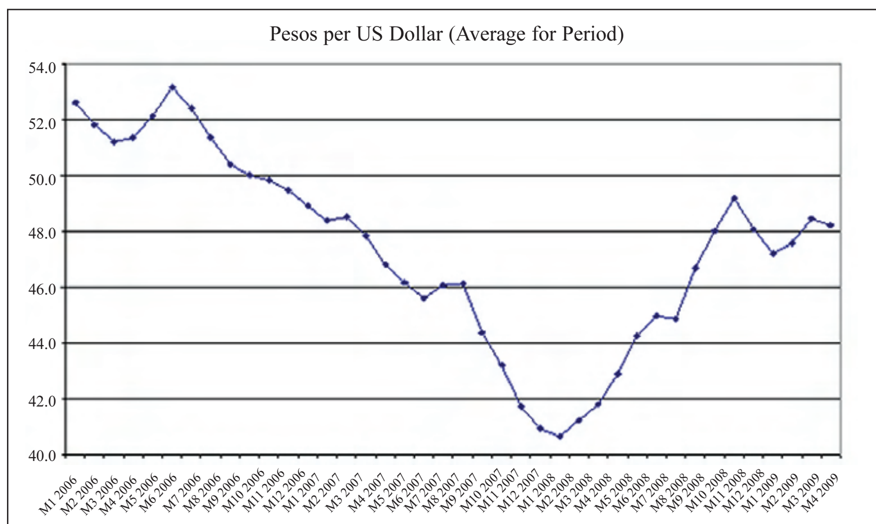
The Impact on the Real Sector

The economic slowdown in 2008 and the weak 0.45% and 1.5% GDP (year-to-year) growth in the first and second quarters of 2009 are direct consequences of the global financial meltdown that started in the US subprime market (see Tables 1a, 1b, 2a and 2b). The slowdown and near-recession[3] consists of the following:

- A sharp decline in both exports and imports occurred. In the first quarter of 2009, the year-to-year movements showed a stronger import decline

[3] Growth of GDP per capita is already negative in the first semester of 2009, but per capita GNP growth is still positive due to the overseas workers' remittances.

Figure 7: Nominal Exchange Rate

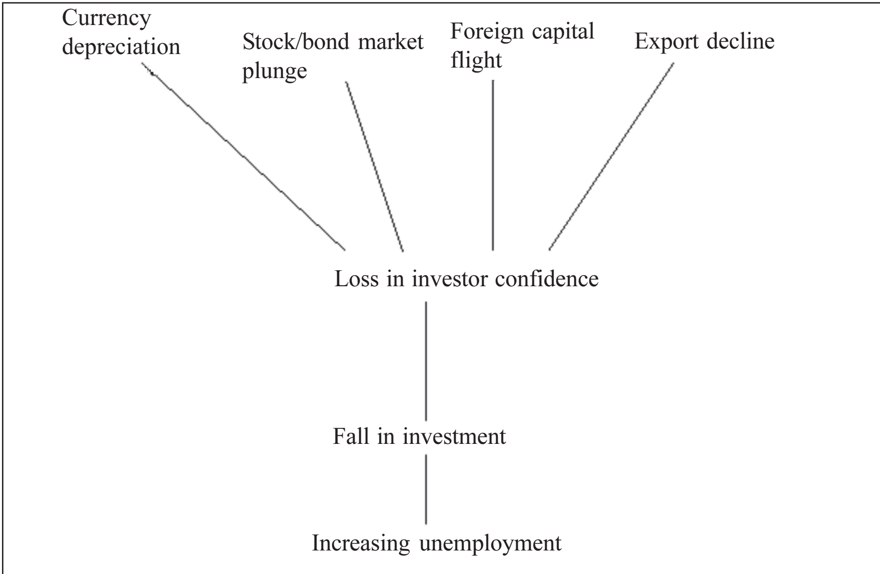


Source: IMF, International Financial Statistics

than export decline; this reversed in the second quarter when the import decline was small compared to the export decline.

- The near-recession clearly reflects a strong loss in confidence in the economy. Diagrams 3a and 3b show the fall in domestic confidence in investment and consumption brought about by the global recession and its accompanying volatilities. The strong export decline, steep stock market crash, currency depreciation, consistent stream of bad news issuing from the developed countries' economies, and the threat of unemployment to overseas workers – who had been a strong driver of growth – inflicted a direct hit on confidence, bringing down investment and stemming the growth of consumption. Both investor and consumer confidence fell strongly as in any recessionary condition. Thus we see investment fall in the first quarter of 2009 (falling 16.5% year-to-year, with durable equipment falling the most – by 18% year-to-year – see Table 1a). Personal consumption was flat, with a 0.8% real growth in the first quarter and 2.25% growth in the second quarter (compared to the 4-6% growth in previous years). Figure 4 shows clearly that gross

Diagram 3a: Contagion of Open Trade and Capital Account Leading to Losses in Investor Confidence

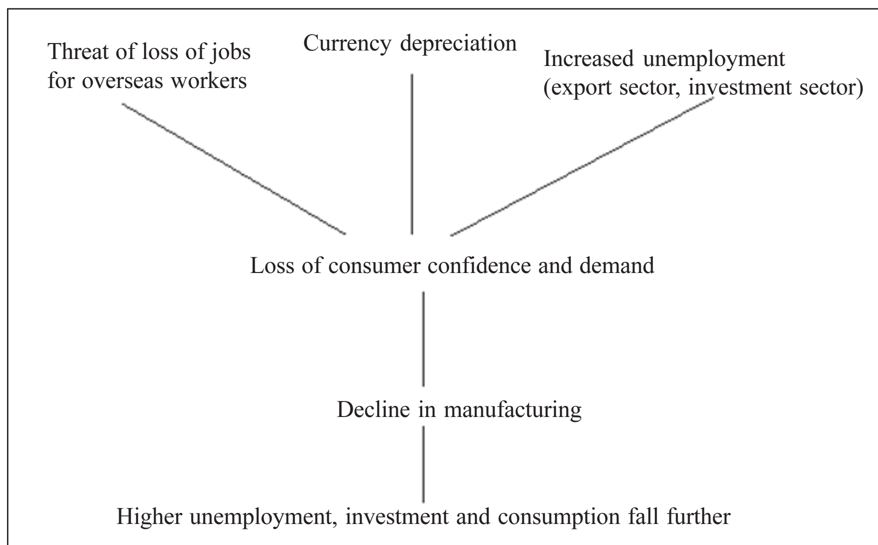


national savings as a percentage of GNP increased sharply in the first and second quarters of 2009 while investments (as a percentage of GNP) fell sharply.

On the supply side, it can be seen that the bleak performance in the first two quarters of 2009 was manifested in a fall in the growth rates of all sectors – agriculture, industry and services, especially industry and manufacturing. Industry declined mainly because of a more-than-7% (year-to-year) fall in manufacturing in the first two quarters of 2009.

Now we can explain why imports initially fell more than exports. Firstly, two-thirds of Philippine exports are made up of semiconductors and electronic parts. Most of the electronic inputs are chips and other high-tech inputs which are imported and then assembled in the country. Thus export decline also led to import decline. But, more importantly, imports fell more than exports because: a) investment in durable equipment fell significantly and most of such equipment is imported; b) manufacturing fell significantly, and much of the inputs to manufacturing are imported.

Diagram 3b: Explaining Losses in Consumer Confidence



The low GDP growth in mid-2009 was completely unexpected by all, including the pessimists. Everybody thought the Philippines would join China, India, Indonesia and Vietnam as major Asian countries that would escape recession. On the eve of the first-quarter report in late May, rating agency Moody's had predicted a positive 2.9% first-quarter year-to-year growth for the Philippines. The government predicted a growth rate of somewhere between 1.8% and 2.8%. It was the IMF that was nearest the mark but its prediction of 0% was based on the wrong assumption that overseas remittances would fall significantly. In November 2008, the IMF in its *World Economic Outlook* had predicted a 2.5% growth rate for the Philippines in 2009. By September 2009, however, the IMF was predicting only 1% GDP growth for 2009. In fact, the growth rate of GDP per capita is already negative.

The low GDP growth aggravated already existing tensions between the Bangko Sentral ng Pilipinas (BSP – central bank) and the planning agency (the National Economic Development Authority or NEDA), on one hand, and the Department of Finance (DOF), on the other. The BSP complained

that the DOF had been more concerned about keeping the fiscal deficits low (especially after fiscal revenues fell below target) rather than stimulating the economy. It therefore had not spent enough money – especially government investments – to counter the recessionary tendencies. NEDA has been discreetly backing the BSP stand. In recent months, the DOF, with its conservative head[4], publicly agreed to increase the targeted deficit to 3.2% of GDP and hinted that this may even be exceeded. But the threat of Moody's, S&P and Fitch[5] downgrading the Philippines' sovereign credit rating due to its fiscal weakness will constrain the DOF from spending significantly to stimulate the economy.

Stock Market Crash and Increases in Sovereign Bond Spreads

The US subprime crisis and the subsequent global financial crisis reduced the risk appetite of foreign investors for emerging markets' financial assets, specifically in the equity and sovereign bond markets. This 'flight from risk' led to the following negative impacts:

i) Bursting of the stock market bubble: Figure 8 shows the quick rise of Philippine stock prices in 2006 and 2007 – which created an asset bubble due to the 'emerging market' syndrome, quite similar to the years before the Asian crisis. The stock exchange index reached a high of 3835 on 10 October 2007. The bursting of the bubble started in late 2007, and the stock price collapse accelerated throughout 2008. It reached bottom one year later (28 October 2008) when the index hit 1704. This was more than a 50% decline. By February 2009, the index was below its levels in early 2006. The moderate recovery of the stock market from March to May 2009 is very fragile since the US economic recovery is far from being ascertained. The stock market collapse had led to strong capital outflows and strong currency depreciation, as described earlier.

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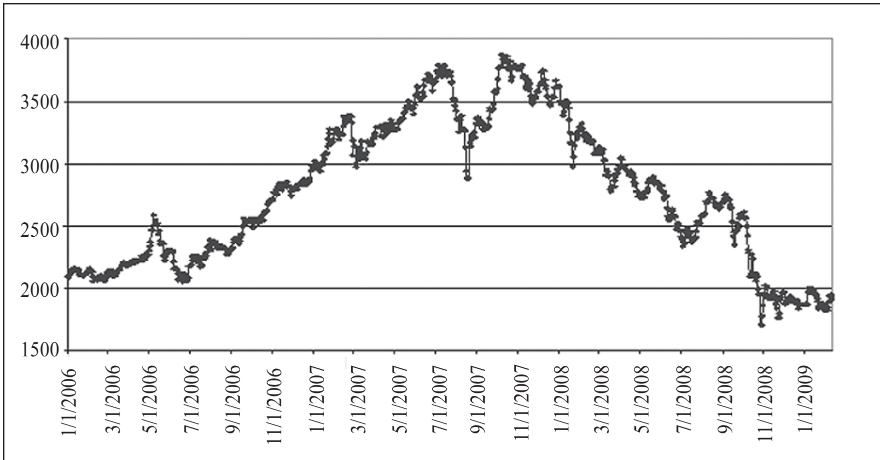
4 Department of Finance Secretary Gary Teves was named the best finance minister of Asia for 2008 by the London magazine *The Banker*.

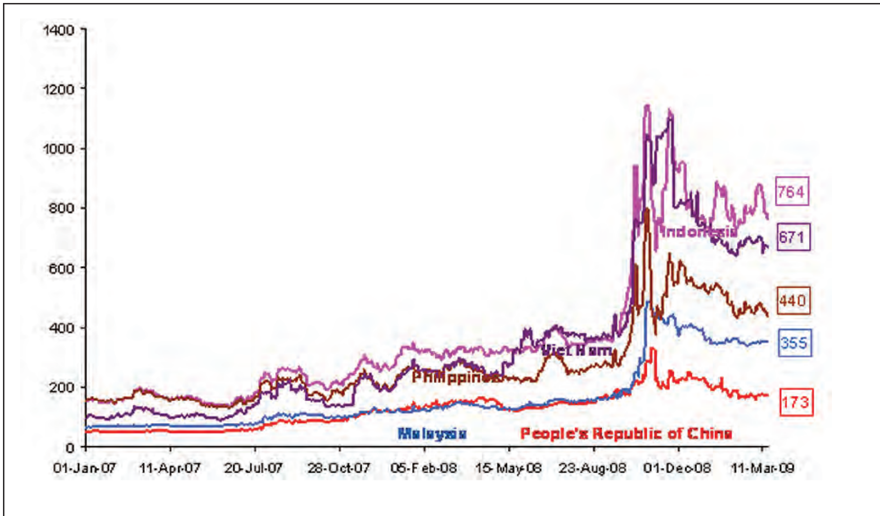
5 These are some of the very same rating agencies that gave a triple A rating to subprime loan assets and derivatives before the US and global financial crisis.

Figure 8: Philippine Stock Exchange Index: 1 January 2006 to 10 February 2009



Source: Philippine Stock Exchange (PSE)

Figure 9: JP Morgan Emerging Market Bond Index Spread (basis points)



Source: Bloomberg

It had also contributed to losses in confidence leading to declines in real investment and stagnation of private consumption.

ii) Higher spreads for sovereign bonds: Emerging market sovereign bonds also suffered in the 'flight from risk' of foreign investors and lenders. This makes it more difficult for the Asian countries to borrow commercially from abroad, especially to fund the fiscal stimuli the countries are all undertaking. This is shown in Figure 9, where it can be seen that the emerging market sovereign bond spread[6] of selected countries increased from the second half of 2007, accelerating in the last quarter of 2008.

The Fiscal Sector

The fiscal position of the Philippines has deteriorated since the global crisis made itself felt in the country. Table 3 already showed the deterioration in the tax effort from 2007 to 2008. National government expenditures as a percentage of GDP continued to decline from 2002 to 2008. This was critical in 2008 when pump-priming of the economy was urgently needed to prevent a serious slowdown. The result was a sharp drop in GDP growth from 7% in 2007 to 3.8% in 2008.

In 2009, with most countries of the world having committed themselves to undertaking significant fiscal stimuli to offset the export and confidence declines due to the global crash, the Philippines decided to follow suit. However, Table 8 below shows that the January-March 2009 revenue collection suffered a strong decline (7.2% decline). This made the fiscal deficit in the first quarter of 2009 reach 6% of GDP. Furthermore the Bangko Sentral ng Pilipinas as well as the National Economic Development Authority had criticized the Department of Finance for being too cautious in its fiscal stimulus. In the first quarter, even if national government expenditures rose by 16%, this lacked pump-priming in infrastructure spending that would

[6] The spread is the difference between the interest rate paid for the country's sovereign bond and the interest rate paid for a US Treasury bond of equal maturity.

make the stimulus more effective. In fact, government construction in the first quarter of 2009 fell 3% in real terms. This however was reversed in the second quarter when the government saw the real need for a fiscal stimulus.

From January to May of 2009 (which includes April when income tax payments are made) government revenues were down 5.4% compared to the same period in 2008. The fiscal deficit is now expected to be much higher than the government target of 3.2% of GDP. Table 8 shows that foreign financing of the fiscal deficit had increased in the first quarter of 2009. The government is planning to tap both foreign and domestic sources to finance the higher deficit. Despite Moody's surprising upgrade of the Philippine outlook in July 2009 due to the resilience of overseas workers' remittances, the credit rating agencies are threatening downgrades once the fiscal picture deteriorates. This leaves the Philippines with little room for increasing its fiscal stimuli.

The Appendix gives some simple mathematics to show that the public debt burden, defined as public debt as a percentage of GDP, would be aggravated by:

1. a higher fiscal deficit brought about by: a) lower tax effort, b) higher government spending, c) higher domestic interest rates, d) higher foreign interest rates
2. a significant depreciation of the currency
3. higher initial stock of government (domestic and foreign) debt
4. a lower economic growth rate.

Most of these (except the higher interest rates) are occurring due to the global recession and losses in confidence. The public debt burden will most likely have been back to more than 60% of GDP by mid-2009 (see Table 4).

The Financial Sector

The banking and financial institutions of Asian countries were largely protected from the financial aspects of the global crisis. This was because, in the first place, the Asian countries had improved their financial supervision and regulations after the Asian crisis. This can be seen in the high capital adequacy ratios (Table 9) and low non-performing-loan ratios (Table 10) on the eve of the global financial crisis.

Table 8: National Government Revenues and Expenditures: 1st Quarter 2008 and 2009 (in million pesos)

	Jan-Mar	
	2008	**2009p**
I. Revenues	**253,516**	**235,359**
Annual Growth Rate (%)	6.8	-7.2
A. Tax Revenues	217,915	200,744
Tax Effort	11.9	10.0
B. Non-tax Revenues	35,601	34,615
II. Expenditures	**305,075**	**355,045**
Annual Growth Rate (%)	5.5	16.4
of which:		
A. Interest Payments	100,242	106,321
1 Domestic	57,355	56,679
2 Foreign	42,887	49,642
B. Net Lending & Equity	2,268	3,956
III. Surplus/Deficit (-)	**-51,559**	**-119,686**
Ratio to GDP	-3.1	-6.0
IV. Financing	**13,320**	**29,491**
A. Net Domestic Borrowings	3,932	-5,433
Gross Domestic Borrowings	130,079	119,035
Less: Amortizations	126,147	124,468
B. Net External Borrowings	9,388	34,924
Gross External Borrowings	22,357	95,686
Less: Amortizations	12,969	60,762

p Preliminary estimate

Source: Bangko Sentral ng Pilipinas

Table 9 reveals that the capital adequacy ratios (CAR) of the financial systems in Asia were way above the Bank for International Settlements (BIS) requirement of around 8-10%. This shows clearly that there was not much over-leveraging in the financial systems of the Asian countries. The Philippines' CAR went over 18% in the mid-2000s but went down to around 15% by September 2008. This is still quite safe and reflects the financial system's cautious lending to the real sector, as described earlier.

Table 10 shows that the non-performing-loan ratios of the different Asian countries were very low before the global financial crisis erupted. There was no over-risky lending and defaults as what happened in the US and Europe, due to stricter financial regulations and supervision, such as restrictions on property loans and strong prohibitions on unhedged dollar borrowings. The Philippines' non-performing-loan ratio was a low 3.7% by April 2009, but the BSP admits that it expects this to increase (but within reasonable and safe levels) as the economy weakens.

Furthermore, the Asian financial markets, including the Philippine financial market, were not so sophisticated as to invest in the complicated financial securities such as mortgage-backed securities (MBS), collateralized debt obligations (CDOs) and credit default swaps which plagued the subprime and other lending sectors in the US and Europe. The exposure to the toxic assets from the Western countries was very small. This can be seen from the low levels of asset writedowns in Asia compared to those in the US and Europe during the most turbulent period of the global financial crisis (see Figure 10). Table 11, however, shows that three Philippine banks were among the most exposed to Lehman Bros. when it went bankrupt. Banco de Oro, Development Bank of the Philippines and Metropolitan Bank and Trust Company had to write down their Lehman Bros. assets worth a total of around $300 million. It is not clear how much more assets are exposed in case another US or European financial institution goes bankrupt.

All in all, though, the financial sector was not too vulnerable to the toxic assets from Western financial sectors and the over-leveraging that led to the bursting of asset bubbles and defaults in the Western developed countries.

Table 9: Risk-Weighted Capital Adequacy Ratios (% of risk-weighted assets)

Economy	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Hong Kong, China	17.9	16.5	15.7	15.3	15.4	14.9	14.9	13.4	14.8	…
Indonesia	21.6	18.2	22.4	19.4	19.4	19.3	21.3	19.3	16.8	17.8
Japan	11.7	10.8	9.4	11.1	11.6	12.2	13.1	12.9	12.3	…
Korea, Rep. of	10.5	10.8	10.5	10.4	11.3	12.4	12.3	12.0	12.7	…
Malaysia	12.3	12.8	13.2	14.0	14.3	13.5	13.1	12.6	12.2	12.5
Philippines	15.6	15.3	16.6	17.4	18.7	17.7	18.5	15.9	15.5	
Singapore	19.6	18.2	16.9	16.0	16.2	15.8	15.4	13.5	14.3	…
Taiwan	10.8	10.4	10.6	10.1	10.7	10.3	10.1	10.6	10.8	…
Thailand	11.4	13.3	13.0	13.4	12.4	13.3	13.9	14.9	14.0	14.6

…=data unavailable

Notes:

2008 data for Japan as of March 2008; Philippines as of September 2008; and Singapore as of September 2008.

2009 data for Indonesia as of January 2009; for Malaysia and Thailand as of February 2009.

2000 and 2001 data for Indonesia includes capital adequacy ratio of top 16 banks sourced from Global Financial Stability Report.

Based on officially reported risk-adjusted capital adequacy ratios under Basel I and applied to commercial banks.

Data for Hong Kong, China refers to authorized institutions; Singapore local banks; Taiwan domestic banks; and for the rest, data refers to commercial banks.

Data for the Philippines refers to consolidated basis.

Sources: National sources accessed through central bank websites; Global Financial Stability Database, International Monetary Fund, and CEIC; data compiled by Asian Development Bank

Table 10: Non-Performing Loans (% of total loans)

Economy	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
China, People's Rep. of	22.4	29.8	21.6	17.8	13.2	8.6	7.1	6.2	…	…
Hong Kong, China	5.9	5.2	3.9	3.2	1.6	1.4	1.1	0.8	1.2	…
Indonesia	18.8	12.1	8.1	8.2	5.8	8.3	7.0	4.9	3.8	4.3
Japan	5.3	8.4	7.2	5.2	2.9	1.8	1.5	1.5	1.4	…
Korea, Rep. of	6.6	2.9	1.9	2.2	1.7	1.1	0.8	0.6	0.9	…
Malaysia	8.3	10.5	9.3	8.3	6.8	5.6	4.8	3.2	2.2	2.2
Philippines	15.1	17.3	15.0	14.1	12.7	8.5	6.0	4.5	3.5	3.7
Taiwan	5.3	7.5	6.1	4.3	2.8	2.2	2.1	1.8	1.5	…
Thailand	17.7	10.5	15.7	12.9	10.9	8.3	7.5	7.3	5.3	…

…=data unavailable

Notes:

2008 data for Japan as of March 2008.

2009 data for Indonesia and Malaysia as of February 2009; 2009 data for the Philippines as of April 2009.

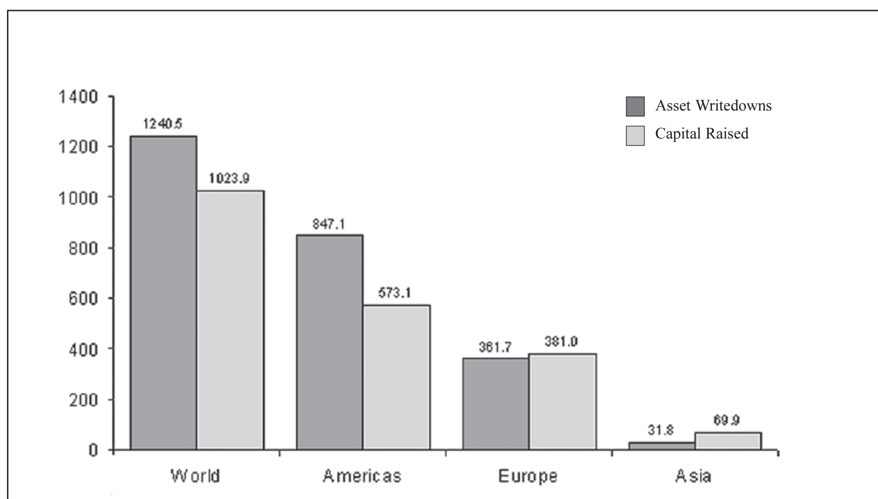
Data for Hong Kong, China; Indonesia and Taiwan refers to non-performing loans of the banking system; for the rest, non-performing loans of commercial banks.

Data for Hong Kong, China from 2006 onwards refers to gross substandard, doubtful and loss loans as percentage of total loans.

Sources: National sources accessed through central bank websites; Global Financial Stability Database, International Monetary Fund, and CEIC.

Data compiled by Asian Development Bank

Figure 10: Writedowns and Capital Raised by Major Banks Since the Third Quarter of 2007[1] ($ billion)



[1] As of 16 March 2009

Source: Bloomberg

Table 11: Selected Asian Banks With Exposure to Lehman Bros., September 2008

Bank name	Economy	Exposure ($ million)
Citibank (Hong Kong, China branch)	Hong Kong, China	275
Mega Financial	Taiwan	200
Industrial and Commercial Bank of China	People's Rep. of China	152
Banco de Oro	Philippines	134
Bank of China	People's Rep. of China	129
Bangkok Bank	Thailand	101
Bank of Nova Scotia (Singapore branch)	Singapore	93
Development Bank of the Philippines	Philippines	90
Shin Kong Fin	Taiwan	80
Metropolitan Bank and Trust Company	Philippines	71

Source: Asian Development Bank, *Asian Development Outlook 2009*

Chapter 3

RESPONSES TO THE CRISIS

Financial Sector Policies

THE Philippine government response to the global financial and economic meltdown concentrated on financial and monetary policies in the beginning. The initial objective was to protect the banking and financial sector from the havoc that wrecked the US and European financial markets and institutions. One of the first legislative proposals in the Philippine Congress made in the second half of 2008 was to increase the deposit insurance coverage from PHP250,000 to PHP500,000. This was passed into law on 3 March 2009.

On 17 October 2008, the BSP opened a US dollar repurchase agreement facility and allowed the use of sovereign debt securities as collateral for loans availed under this facility. On 23 October 2008, the BSP approved guidelines on allowing financial institutions to reclassify their investments in debt and equity securities. The BSP also eased Foreign Currency Deposit Units asset cover requirements effective 30 October 2008 until 31 March 2009. The easing consisted of banks not having to deduct from the 100% required asset cover their unrealized losses arising from their financial assets/ liabilities (e.g. drop in prices of sovereign debt securities) and revaluation of third currencies. This easing of asset cover requirements was accompanied by relief to banks having dollar sourcing problems.

But the measures of the BSP also included further foreign exchange and capital account liberalization, rationalized on the grounds of increasing available foreign funds for the banking sector: 'As a continuation of the foreign exchange liberalization program, the BSP approved on 15 January

2009 the third phase of reforms, which includes the liberalization/streamlining of rules on foreign borrowings of private banks for relending purposes and the registration of inward foreign portfolio investments. The third phase of foreign exchange regulatory reforms also includes all the provisions in the first and second phases of reforms initiated in 2007 as well as the provisions that are intended to improve monitoring of foreign exchange flows and to formalize/clarify existing practices. Moreover, the Monetary Board (MB) approved on 23 April 2009 the streamlining of the documentation requirements and other reforms on the sale of foreign exchange by foreign exchange dealers/money changers (FXDs/MCs). The streamlining of the documentation requirements will make it possible for residents with foreign loans/foreign currency loans as well as foreign investors that chose not to seek BSP approval and/or registration of the loans/investments to source their foreign exchange requirements from FXDs/MCs without necessarily compromising compliance with anti-money laundering regulations.'[7]

Monetary Easing

Just like in most countries hit by the global financial turmoil, the BSP eased monetary policy by reducing the policy interest rates. In 2008, the BSP had increased the policy rates to stem inflation caused by rising global oil and food prices. Inflation in the Philippines approached 10% in the third quarter of 2008. The overnight borrowing or reverse repurchase (RRP) rate – the rate at which the BSP borrows from banks, or the interest rate given to banks' deposits with the central bank – was increased by 100 basis points from 5% in February 2008 to 6% in September 2008. Similarly, the overnight lending or repurchase (RP) rate – the interest rate charged as the BSP lends to banks with government securities as collateral – was increased from 7% in February 2008 to 8% in September 2008.

But as the food and oil price hikes subsided in late 2008, inflation started to fall. Because of the intense onslaught of the global financial turmoil

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[7] Bangko Sentral ng Pilipinas (2009).

which caused the economy to slow down significantly, the BSP brought the policy rates down six times in 2009, for a total reduction of 200 basis points. Thus, by 9 July 2009, the overnight borrowing or reverse repurchase rate was down at 4% and the overnight lending or repurchase rate at 6%. The policy rates are the lowest ever. The latest 25-basis-point cut on 9 July 2009 was after the announcement of the June 2009 (year-to-year) CPI inflation rate of 1.5%, the lowest in 22 years, signalling that deflation may have arrived in the Philippines.

In November 2008, the BSP also reduced the regular reserve-requirement ratio on bank deposits and deposit substitutes by 2 percentage points, from 10% to 8%. It also raised the budget for the peso rediscounting facility from PHP20 billion in mid-2008 to PHP60 billion by February 2009, and the interest rate for the facility had been reduced at the same pace as the policy rates described above (the interest rate for the peso rediscounting facility is about 50 basis points below the overnight borrowing rate). In addition, the Monetary Board increased the loan value of all eligible rediscounting papers from 80% to 90% of the outstanding balance of a borrowing bank's credit instrument (but not to exceed 70% of the appraised value of the underlying collateral).

Fiscal Stimulus

But just as in most countries in the world undertaking monetary easing, there is a 'liquidity trap' wherein the monetary easing does not stimulate the economy because of the absence of confidence.

In January 2009, with the global near-depression clearly wreaking havoc on economies all over the world, the Philippine government announced a PHP330 billion Economic Resiliency Plan, which included: a PHP160 billion increase in budget allocation that will fund government employment, rehabilitation of public buildings, social services, infrastructure development and various forms of agriculture support; a PHP100 billion infrastructure fund to be pooled from government corporations, financial institutions and the private sector; PHP40 billion in the form of corporate and individual income tax cuts (including doing away with the withholding taxes and actual

taxes of minimum wage earners); and PHP30 billion in temporary additional benefits from social security institutions. The government also announced a PHP250 million reintegration and livelihood assistance programme for displaced overseas Filipino workers. The above total was to comprise 4.2% of GDP.

But by end-January, Congress approved a PHP1.415 trillion national budget which included a fiscal stimulus of only PHP50 billion (a mere 0.67% of GDP) for 2009, a third of which was to be financed by reducing debt service. (The debt service reduction was vetoed by the president.) The planned PHP100 billion infrastructure spending to be funded by government financial and non-financial corporations as well as the private sector, and which is supposed to create 1 million jobs, has yet to materialize.

The original cap of PHP102 billion on the fiscal deficit targeted by President Arroyo (estimated at 1.2% of GDP) in January 2009 was exceeded in the first five months of the year, as national government deficits had already hit PHP123 billion from January to May of 2009 (the new target deficit is 3.2% of GDP). The ballooning deficits, as mentioned previously, had arisen due to below-target revenues (a result of a slowing economy, bad tax collection, and the reduction of corporate tax and taxes from minimum wage earners as part of the response to the crisis) and the need for a stronger fiscal stimulus due to the lower-than-expected GDP performance of the economy in the first quarter of 2009. Everybody expects the actual national government deficit to approach at least 4% of GDP. As mentioned above, this raised concerns among the credit rating agencies and the IMF, given that the Philippines has the highest public and external debt burden among the major economies of Southeast Asia. Even the PHP50 billion fiscal stimulus passed by Congress is now in question due to lower revenue collection and protests from the Department of Finance that reduced debt service payments (whose budget was cut to give way to the stimulus) may lead to a sovereign credit downgrade.

There are also concerns about the proper use of the fiscal stimulus funds since there will be presidential, senatorial, congressional and local elections – all in May 2010. There is a perception that corruption will thrive and the stimulus may go to the wrong pockets and may not yield the right

economic push and multiplier effect needed to escape recession. In the May 2004 elections, for example, it was charged that fertilizer funds were used by one high official in the Department of Agriculture to bribe congressional and local officials to ensure President Arroyo's victory.

Chapter 4

ALTERNATIVE RESPONSES TO COUNTER RECESSIONARY CONDITIONS AND PREVENTIVE MEASURES TO AVOID FUTURE CONTAGION

WE have seen that so far, the near-recession in the Philippines has been caused primarily by a loss in investor and consumer confidence simultaneous with a strong export collapse, especially in semiconductor and electronic products comprising two-thirds of Philippine merchandise exports.

Room for Monetizing the Fiscal Deficits

The fiscal stimulus to counter this is extremely important. The current biggest constraint on a strong economic stimulus package is the lack of fiscal capacity and revenue collection to come up with an adequate and effective fiscal stimulus. If the government decides to go for higher fiscal deficits, say 5% of GDP and above, the credit rating agencies and multilateral institutions will start downgrading the Philippine creditworthiness and will start talk of debt defaults, which may worsen the loss of confidence and cause massive capital flight and currency depreciation. The Philippines must therefore be astute in tackling this problem.

One reason why many countries are facing a fiscal problem in trying to stimulate the economy is that mainstream economics continues to hold on to the false claim of monetarism that too much money will cause inflation. In a period of very high excess capacity, low commodity prices and deflation, this is just a fictitious danger. There is much room for the Philippines and many other developing countries to monetize the deficit. This will avoid increasing the public and external debt burden and at the same time will not cause inflation. Thus the Philippines should allow the BSP to buy treasury

bills in order to finance the deficit spending of the government. As the credit rating agencies, IMF, World Bank and Asian Development Bank (ADB) are likely to condemn such a move, the importance of regional cooperation will come into play here. Countries in a tight fiscal bind (Malaysia, Thailand, Indonesia, India, etc.) could monetize their deficits simultaneously and get the support of China, Korea and other Asian countries. At the same time influential progressive economists and international think-tanks and lobby organizations such as the South Centre, Third World Network, Focus on the Global South, etc. should all lobby for this.

Resuscitating and Remoulding the Chiang Mai Initiative: Towards an Asian Monetary Fund and Fiscal/Social Fund

Another alternative is to reinvent and rethink the Chiang Mai Initiative Multilateralization (CMIM) as not just a currency swap fund for countries hit by capital outflows which require foreign exchange reserves, but as a fund for economic and fiscal stimuli and even a social and anti-poverty fund as well. The CMIM has thus far been a disappointment, with only committed – not actual – funds (a total of $120 billion with quotas committed by the ASEAN+3 – Association of Southeast Asian Nations member states, and China, Japan and Korea – with China and Japan having the biggest committed funds). It has not been used at all in this deep crisis. Korea had to run to the US Federal Reserve, Japan and China for currency swaps to defend the won when it was depreciating rapidly in late 2008 and early 2009. The Philippines is turning to sovereign bonds as well as the ADB to finance its stimulus and anti-poverty programmes. It is planning to float $750 million samurai (yen-denominated) bonds in late 2009.

The region needs its own Asian Monetary Fund that would not only save countries from foreign reserve depletion, potential debt default and currency attacks but also provide budgetary support for fiscal stimulus and for the social and safety net spending vitally needed during crises and recessions. The region urgently requires an alternative IMF with none of the IMF conditionality (the CMIM requires 80% of the funds disbursed to be under IMF conditionality) – a fund that will give both budgetary and balance-

of-payments support. In the meantime the ADB has just set up in July 2009 a $3 billion facility for fiscal support called the "Countercyclical Support Fund" for member countries. It is giving $1.3 billion to the Philippines in 2009 and 2010 (and may increase the amount) especially for infrastructure. But the ADB is known to have conditionalities similar to the IMF's.

Protection Against Further Crisis of Currency Depreciation, Capital Flight, Debt Burden and Balance-of-Payments Deterioration

As shown above, the Philippines still has a strong current account surplus and growing international reserves. Still it experienced considerable capital flight and currency depreciation throughout 2008 and the first quarter of 2009. Even the growing international reserves may be threatened if the crisis becomes much worse – for example, if it intensifies into the double-dip global recession that is now increasingly talked about and becoming increasingly probable. This will make the current economic difficulties deeper and more prolonged than expected. If the world recession deepens and is prolonged, it may trigger two dangers for the Philippines: a) many overseas Filipino workers might lose their jobs and drastically reduce their remittances of foreign exchange; and b) further massive capital flight from risk will occur as the Philippines is seen as one of the riskier emerging economies in Southeast Asia. This will lead to deeper and faster currency depreciation, higher sovereign bond spreads, deeper stock market collapse, dwindling international reserves and a replay of the Asian crisis, with possibilities of potential debt default and deteriorating balance sheets in the corporate and financial sectors.

This again requires an Asian Monetary Fund or CMIM multilateral currency swap fund without any strong IMF-type conditionalities. A stronger approach would be to move towards capital account and exchange controls to stem volatility of capital flows and currency depreciation. Again this needs a regional or global arrangement which will allow developing/emerging economies to take such steps without being punished by the global financial markets and by the multilateral funding institutions.

This crisis offers the opportunity and justification to push for a new international financial architecture that allows countries to determine their capital account rules and regulate the capital inflows and outflows (especially short-term ones) in their own economies. The bad experiences of many emerging markets that made no mistakes apart from opening their capital account before and during the period of global near-depression, including those that are now in dire crisis and have had to run to the IMF – Hungary, Ukraine, Pakistan, Serbia, etc. – point to the need for radical change in the global rules on short-term capital flows and 'hot money'. This requires a global and regional acceptance of capital controls as an acceptable policy in financial and external account management.

Towards a New Development Strategy and a New International Financial Architecture

After the Asian crisis, the Philippines and other East Asian economies had expected that the next financial crisis would again involve foreign exchange reserve depletion and competitive currency depreciation leading to potential debt defaults and deterioration in the balance sheets of corporations and banks. Thus the countries built up their international reserves and, except for China, sacrificed investments to have large savings-investment or current account surpluses. The Philippines differed from other East Asian 'miracle' countries by having trade deficits but still had large current account surpluses due to large inflows of overseas workers' remittances. The stronger international reserve position was helped by inflows of portfolio investments ('hot money') during the 'good' years 2005 to 2007, but during the 'bad' times of capital outflows, it was mainly the remittances of overseas workers that sustained the international reserves.

But the current crisis and near-recession hit the real sector drastically – through export declines and sharp losses in investor and consumer confidence. Of course, the healthy international reserves position of the Asian countries helped them weather the storm of capital flight and currency depreciation at the height of the global financial meltdown in late 2008 and early 2009. Thus none of the East Asian countries went through the Asian-crisis type of

financial and economic collapse suffered by other emerging countries like Hungary, Ukraine, Serbia, Pakistan and Kazakhstan. But this was not enough to shield the economies from recession and a significant decline or slowdown in GDP.

It is therefore time to take a holistic view of the globalization processes that intensified in the 1990s and address the dangers to which they had exposed all the countries in the world. Criticism against capital account and financial liberalization became fashionable after the Asian crisis, even among mainstream economists (Bhagwati, Krugman, Feldstein, Stiglitz, etc.). But trade liberalization remained a sacred doctrine to all except for some courageous souls.

Hausmann and Rodrik (2006) have emphasized the role of a strong industrial policy and development strategy in the economic development of successful countries. The lesson of the global near-depression for the formulation of industrial policy is definitely that it requires a good balance between domestic demand and external demand. It must be pointed out that Figures 3a and 4 show that investment has been declining in the Philippines from the 1980s up to the present, especially during and after the economic collapse of 1984-85 and the Asian crisis in 1998. These are exactly the periods of strong trade, financial and capital account liberalization. At the same time, exports and imports went up, peaking in the late 1990s and remaining high until recent years. 2008 and the first quarter of 2009 saw a sharp decline in both exports and imports as global trade collapsed – this is a strong feature of the current crisis.

The new development strategy should boost investment and create a strong domestic demand and production sector. It is a strong domestic sector with strong domestic demand which has shielded China, India, Indonesia and Vietnam from entering a recession in the current turmoil.

Thus the fiscal stimulus in the Philippines, once the government can generate the funds and political will and integrity to implement a genuine, sizeable and effective economic stimulus, should be based on a well-conceived development strategy to create strong domestic demand and domestic production. This requires infrastructure spending with emphasis on improving and integrating the economies of poor areas, provinces and

regions with the mainstream economies of the urban and metropolis areas. Income and wealth distribution should be addressed to ensure significant purchasing power for all segments of the population – the peasant and rural sector, working class and urban sector and middle class. Towards this end, it is vital to revive efforts to effect agrarian reform, which have been stalled. The country's comprehensive agrarian reform law enacted in 1988 has yet to be significantly implemented, with the majority of compulsory acquisition and distribution of the larger-sized lands still on hold up to this day. An extension of the expired law has been stalled in a Congress dominated by landed interests.

Finally, one must not forget that the strong international reserves position of Asian countries has been crucial in shielding them from the Asian-crisis-type financial and balance-of-payments crisis that hit emerging countries like Hungary, Ukraine, Serbia, Pakistan and Kazakhstan. However, at the same time, this accumulation of reserves has been very costly to the Asian economies as (except for China) it reduced the investment and growth rates of the countries and contributed to their exposure to the current global recession by offsetting the investment decline with overdependence on the export and external sector. Correction requires exchange and capital controls now and to prevent future contagion from global crises. Also required is another regional or global fund that does not come with the antiquated conditionalities of the IMF which demand ever more liberalization. But individual Asian countries, especially economically weak ones like the Philippines, cannot undertake these policies without a regional and global reform of the international financial architecture.

Crises open opportunities for countries to change their strategies and to change the global economy. The Asian countries had failed to do so after the Asian crisis. It seems that they will fail again with this crisis since there has so far been no serious initiative to change the dogma of financial, capital account and trade liberalization.

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Appendix

Decomposition of the Public Debt Burden

$$GD = DD + dDD + e\,(FD^* + dFD^*) \quad (1)$$

where GD is government debt; DD is initial public domestic debt; FD* is initial public foreign debt expressed in dollars; dDD is change in DD for the current period; dFD* is change in foreign debt expressed in dollars for the current period; and e is the exchange rate for the current period. First differentiation gives us

$$d(GD)/dt = dDD/dt + e\,(dFD^*/dt) + (FD^* + dFD^*)\, de/dt \quad (2)$$

We further have:

$$dDD/dt + e\,(dFD^*/dt) = BD \quad (3)$$

BD is the budget deficit. Equation (3) assumes that the rate of increase of new government debt is made up of the budget deficit less payment of principal debt. The latter is an exogenous fixed amount ignored in this analysis with no significant change in the results.

$$BD = (G - T) + i\,DD + e\,(i^*\,FD^*) \quad (4)$$

where G is non-interest government spending (including government investments), T is tax revenues, i is domestic interest rate for domestic government debt, and i* is foreign interest rate for foreign government debt.

The above all show that the public debt GD will increase with:

1. a higher fiscal deficit BD – which can be caused by higher G, lower T, higher i or i*
2. currency depreciation – with e increasing significantly
3. a higher initial stock of DD and FD

The public debt burden is defined as GD/Y, where Y is GDP. The public debt burden will definitely increase if d(GD)/dt grows faster than dY/dt or GDP growth. Thus, lower GDP growth will *ceteris paribus* increase the public debt burden.

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Prior to the crisis, economic growth in the Philippines was largely spurred by remittances from overseas Filipino workers which were channelled towards private consumption. This externally driven growth masked a lack of dynamism in domestic investment, which in turn stemmed from low investor confidence in the economy.

Economic confidence further plunged when the global crisis struck the Philippines. This paper surveys the adverse effects wrought by the crisis on the Philippine economy, including huge capital outflows, sharp currency depreciation, strong export, investment and manufacturing contractions, and an overall marked slowdown in growth. The national government's policy response to the economic tumult has comprised a combination of fiscal and monetary stimulus, but concerns surround the effectiveness of these measures and their impact on the fiscal deficit and public debt.

In this paper, the author puts forward some alternative policy options both to counter the downturn and to prevent contagion from future crises. Among the former, he suggests monetizing fiscal deficits and establishing an Asian Monetary Fund that will provide support (including fiscal funds) to crisis-hit regional economies. In terms of preventive measures, capital and exchange controls are advanced as a means of curbing volatility in capital flows. This requires international and regional financial systems that look favourably at capital controls as an acceptable financial practice. The paper also prescribes for the Philippines a new development strategy that avoids overdependence on the external sector and focuses instead on domestic sources of sustainable growth, including investments that are crucial to building up long-run productive capacity, especially in depressed and backward regions.

JOSEPH ANTHONY LIM *is a Professor at the Economics Department of Ateneo de Manila University in the Philippines.*

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