

Structural Adjustment Program after Structural Adjustment Program, But Why Still No Development in the Philippines? *

**Joseph Y. Lim
Manuel F. Montes**

Abstract

Since the debt crisis of the 1980s, Philippine economic performance has been an outlier in East Asia, in spite of reform policies that generally have conformed to worldwide norms of trade liberalization and deregulation. In the 20-year period since 1980, the proportion of GDP attributed to manufacturing has declined from 24 to 22 percent. Dependence on commodity exports has declined, and the Philippines' export structure is now less diversified than it was 20 years ago. Market-oriented economic reforms are incomplete, as they are in many other countries, but the Philippines's poor economic performance is mostly a result of macroeconomic instability and low domestic savings, not inadequate reforms. Reform efforts have contributed to political instability, and macroeconomic instability has stifled investment. A model of macroeconomic shortages in domestic, external, and public savings is presented to illustrate the continuing constraints to Philippine economic growth and development.

* This a revised version of a paper presented at the Asian Economic Panel meeting on 25–26 October 2001 in Seoul, South Korea. All data, opinions, and analyses in this paper are the responsibility of the authors alone and should not be attributed to their home institutions.

1. Introduction

In 1999, the Philippine economy regained the per capita GNP it had achieved 20 years earlier, the 1980 value of around \$12,500 (measured in 1985 pesos). Macroeconomic volatility, political instability, and a protracted, conflict-ridden effort of economic liberalization characterized the intervening 20 years, and they continue to be the biggest challenges facing the Philippines in 2002. It is natural to ask:

1. How do these three factors interact?
2. What is their impact on Philippine economic performance?
3. What lessons, applicable at a more analytical level and relevant to the design of development policy in general, can be drawn from the Philippine experience?

Interest in asking the third question is prompted by the country's extended experiment at economic liberalization, which was intended to reposition Philippine development policy away from the inefficiencies attributed to the import substitution period. The Philippines was one of the first two countries to undertake a "structural adjustment program" in 1980, when the World Bank changed its focus on funding brick-and-mortar projects and introduced loans to support policy reforms. Many countries in Africa and Latin America subsequently had the same experience and began structural reforms.

One position is that there are no lessons, at least in the purview of economics, to be learned from this drawn-out effort. Under this view, economic liberalization is an uncompleted task, and the long sought-after policy millennium will arrive sooner the greater the political determination exerted in the liberalization effort. For those who hold this view, 1980 is a suitable starting point because it happens to be the year after the publication of Bautista et al. (1979), a study that provided the analytical basis of the first World Bank structural adjustment program¹. If there can be a grand theory associated with this long-running intellectual enterprise, it is that low productivity (inefficiency) lies behind Philippine underdevelopment. Low productivity, in turn, is explained by the industrial protectionist regime erected in the era of import substitution in the 1950s, which the Philippines has not managed to shake off.²

We note that this dominant view of development policy is relatively independent of theories about investment, something deemed quite important in the older development literature. For the economic reform school, the private sector takes pride of place in investment decisions, yet theories about private sector investment are left unspoken, other than the presumed responsiveness of such investment to the “right prices.” Ironically, the older, Keynesian-inspired development literature had a different view of the private

1 Major examples of such analyses include Hooley (1985), Dohner and Intal (1989), and Medalla et al. (1995/96). Power and Sicat (1971) provided the earliest comprehensive studies of the Philippine protectionist regime. Numerous other papers are in the same vein.

2 From the mid-1980s, ideas of “government failure” as the mirror image of market failure began to embellish this intellectual current. Fabella (1989) is a sterling example. See also Montes (1992).

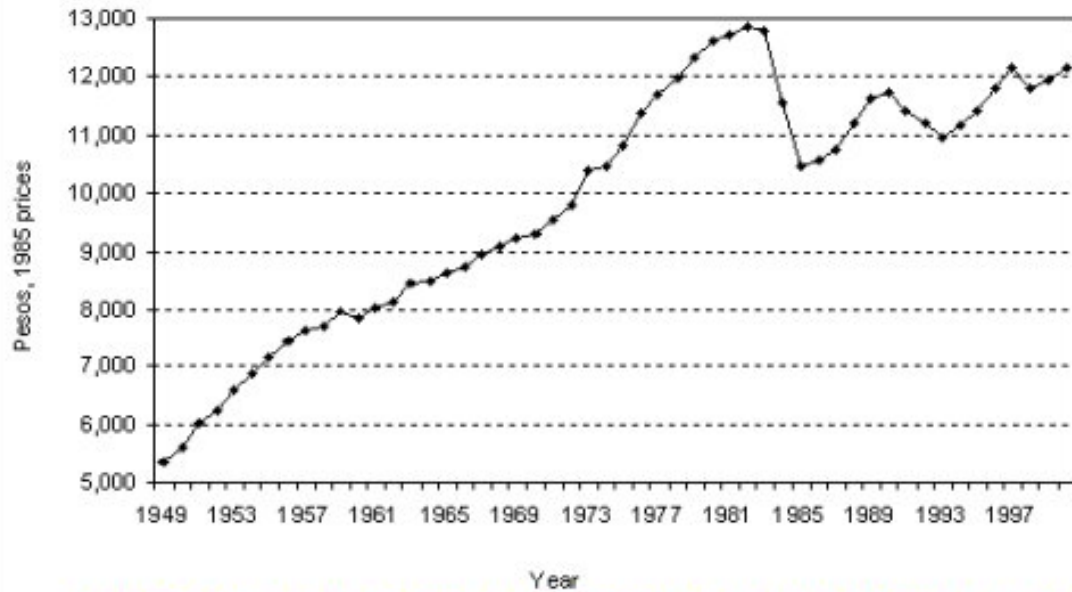
sector: the investment decision often precedes the savings action, and without prospects for stable growth, investment is less likely to occur.

In our assessment, the usual identification of protectionism and various forms of economic inefficiency as the primary causes for the absence of sustained growth in the Philippines is wrong. We believe that the correct way to view Philippine economic history is through the prism of the three-gap model (savings gap, foreign-exchange gap, and fiscal gap). The fundamental problem in Philippine development is its anemic domestic private investment and low savings rate, which makes the economy overly dependent on the inherently unstable flow of foreign capital. The tragedy is that whenever foreign capital inflow drops, the government of the day invariably implements orthodox IMF-style structural adjustment policies to handle the resulting balance of payments difficulties. The brunt of the tight credit policy is borne chiefly by the domestically anchored industrial tradable sector, hence preventing any sustained expansion of export-oriented enterprises and import-competing enterprises. The accompanying trade liberalization has an immediate negative impact on the sheltered import-competing industries and hence stops them from maturing into competitive industries. If the decline in output from the credit contraction and trade liberalization were to deepen the pessimism of the foreign fund managers, then capital inflow would decrease further. If this prompts a bigger dosage of the IMF medicine, output would decline further.

This paper is organized as follows. Section 2 outlines the common elements in the numerous balance of payments crises in the Philippines since 1949. Section 3 presents the

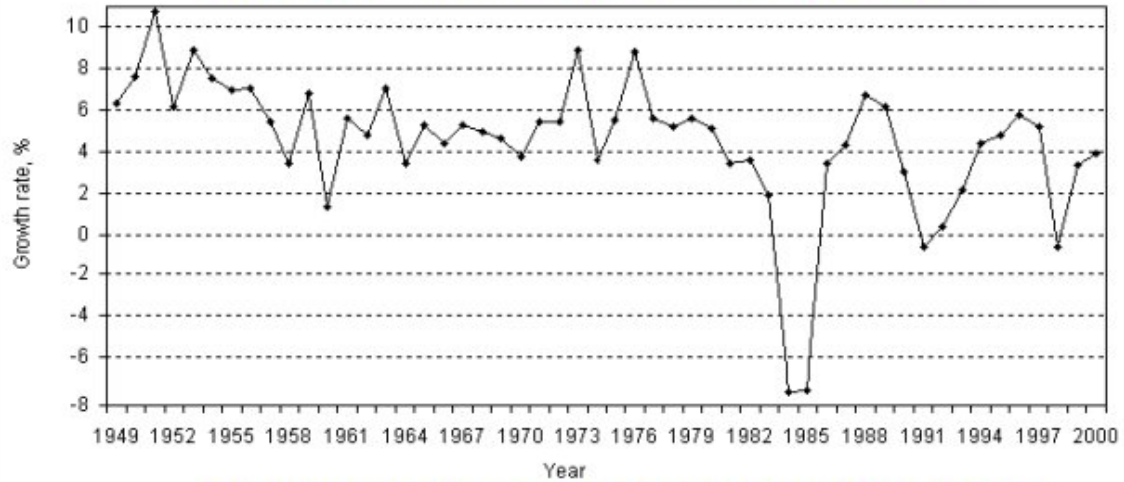
three-gap model interpretation of Philippine macroeconomic history. Section 4 discusses the political economy explanation for the economic malaise in the Philippines. We offer some final observations in section 5.

Figure 1. Per capita GDP of the Philippines, in 1985 pesos, 1949–2000



Source: Authors' calculations and data from the National Statistical Coordinating Board.

Figure 2. Growth rate of gross domestic product, constant 1985 prices, 1949–2000



Source: Authors' calculations and data from the National Statistical Coordinating Board.

2. Macroeconomic and policy instability

The most unmistakable feature of Philippine economic history is its periodic punctuation by balance of payments crises. Major crises that took place in 1949, 1960, 1970, 1983–85, 1991, and 1998 are indicated in figure 2, which shows the growth rates of GDP from 1949 to 2001. The recession-recovery cycles grew more intense and more frequent (with shorter periods) after the liberalization efforts of the 1980s. Before the 1980s the Philippine economy experienced slowdowns during the balance of payments crises, but not negative growth rates.

The Philippines fell behind its East Asian neighbors in the 1980s. The impacts of the crisis and depression years of 1983–85 pushed the Philippines back 12 years in terms of GNP per capita. GDP fell by almost 8 percent in 1984 and 1985 (figures 1 and 2). The recovery from 1986 to 1990 was short-lived, and the economy fell again in 1991–93. Another short-lived recovery occurred from 1994 to 1997, before the East Asian crisis began in late 1997. Although there was a modest recovery in 1999–2000, the series of crisis–recovery cycles in the 1980s and 1990s reduced GDP per capita levels to those experienced more than two decades ago.

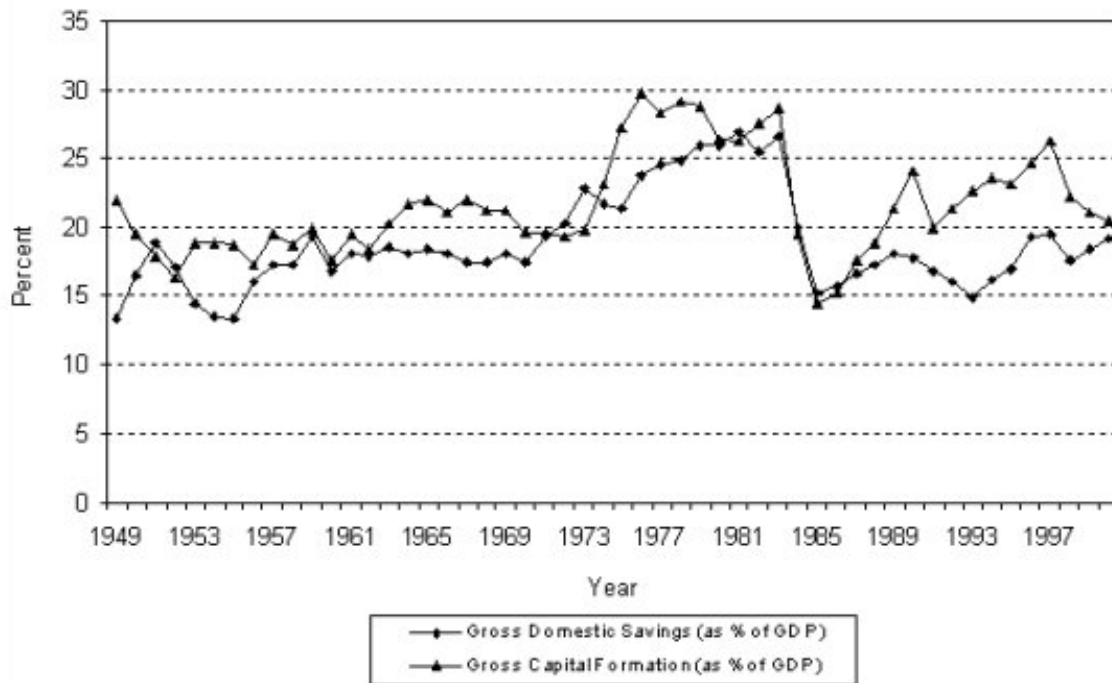
All Philippine crises have been of the classic Krugman (“first generation”) variety, triggered by foreign-exchange shortages resulting from a loss of confidence in the Philippine economy or attributable to external shocks, or both. These cycles are best understood as structural savings-investment gaps and trade deficits requiring external financing, an issue which has received limited attention in domestic policy discussions

(Montes and Lim 1996). Foreign financing eases this constraint and permits rapid growth and external debt build-up, setting the stage for the next crisis. Figure 3 depicts the pattern of gross capital formation and gross domestic savings as a percentage of GDP. Figure 4 shows the components of demand.

Insufficient attention to the structural savings-investment and import-export gaps during a trade liberalization program requires a fervent faith that key prices, such as the foreign-exchange rate, will not stray too far from levels that protect the economy and its domestic industries from an import surge. In the context of these structural constraints, constricting growth in response to an economic crisis is a standard response, but the adverse social impact and effect on private investment of such a policy can be long-lived. Compared with the downturns in the Philippines before the 1980s, the most recent crises have been deeper, the time between the crises has shortened, and the recovery in growth after these crises has been shallower. These trends suggest that the structural constraints have become tighter after the 1980s. It is ironic that in the 1990s when the private supply of external finance boomed globally, Philippine investment remained moribund. As the lone Asian participant in the world debt crisis of the 1980s, the Philippines traded the lost decade of the 1980s for the lost opportunity of the 1990s with only a lackluster payoff from its liberalization effort.

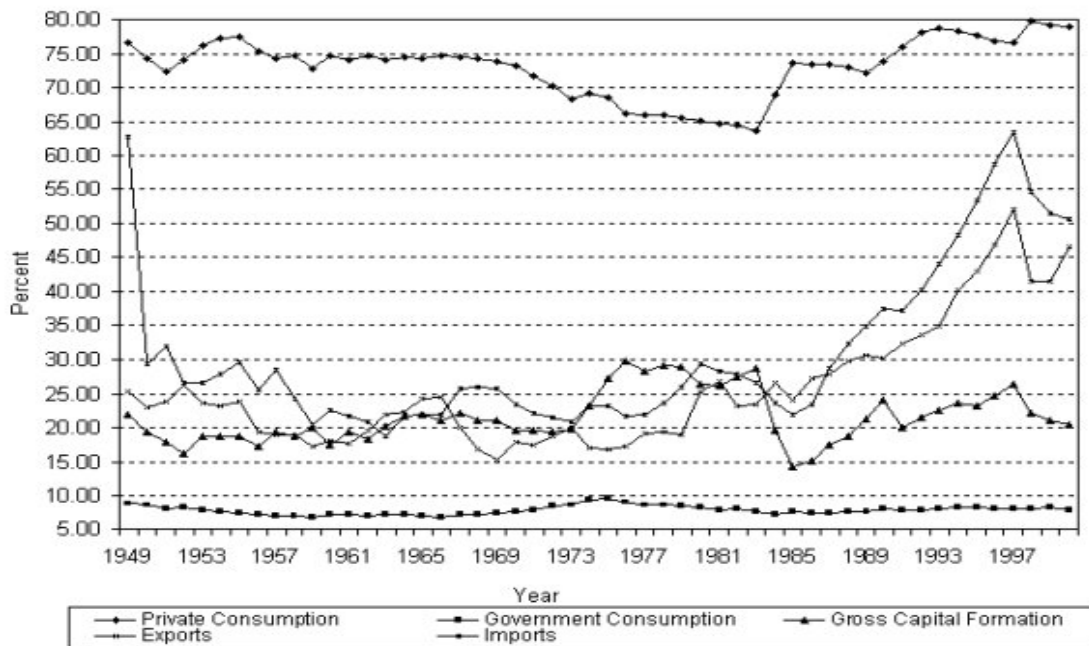
A brief survey of the country's major recession-recovery cycles suggests that each crisis has been accompanied by political instability, the loss of business confidence, and a standard stabilization response.

Figure 3. Philippine gross savings and gross investments (as percentage of GDP), 1949–2000



Source: Authors' calculations and data from the National Statistical Coordinating Board.

Figure 4. Demand components in the Philippines (as a percentage of GDP), 1949–2000



Source: Authors' calculations and data from the National Statistical Coordinating Board

2.1 1949–59: The import substitution era

The seeds for the problems of the Philippines were sown at the end of World War II. The pre-World War II peso-dollar parity was retained, largely to shield U.S. owners of Philippine assets from capital losses. A three-year binge in imports for manufactured goods during the postwar reconstruction in 1946–49 depleted the foreign-exchange reserves. This foreign-exchange crisis occurred during the Communist-inspired Huk rebellion, which was led by forces that had resisted Japanese occupation during World War II and now seriously threatened the elite, pro-U.S. government, many of whose members had collaborated with the Japanese.

In response to the balance of payments crisis, a foreign-exchange and import control system was instituted in 1949. This led to a decade of import substitution, which for the first eight years brought about high confidence and growth. Imports fell significantly (figure 4). GDP increased at an annual average of 7.4 percent, and the share of manufacturing in GDP grew significantly from 16.2 percent in 1949 to almost 25 percent in 1959. The country was touted as being on the verge of economic take-off. A popular president, Ramon Magsaysay, led the country during the crucial years of this period, 1953–1956,³ and contained the Communist rebellion.

The manufacturing sectors were mostly in the assembly and packaging stages and relied on imported inputs. Toward the end of 1950s, another foreign-exchange crisis loomed as

³ He perished unexpectedly in a plane crash.

foreign-exchange earnings were unable to sustain the large import demand. Because there were no backward linkages to establish a strong intermediate sector (steel, petrochemical complex, textiles, etc.) and no industrial export promotion, the foreign-exchange crisis was inevitable. The foreign-exchange crisis occurred in less than a decade, giving little time for the infant industries to mature.

Attempts to alleviate the growth slowdown from 1958 by relaxing the control regime through a multiple exchange rate system only exacerbated the drawdown on exchange reserves. The economic crisis became a political crisis when the opposition charged the government officials with corruption and illegal wealth obtained by the power to dispense import licenses and the capture of the rationed foreign exchange. In 1960, a severe slowdown occurred: the GDP growth rate fell below 2 percent and GDP per capita fell into negative territory for the first time in postwar history (figures 1 and 2).

2.2 1962–69: The end of import substitution and high spending

In 1962, the opposition won the national elections under a free trade banner, instituted limited trade liberalization, and devalued the peso by 100 percent (from 2 pesos per U.S. dollar to 4 pesos per U.S. dollar). For the first time, the government obtained standby credit from the IMF, a tutelage unbroken to this day, except for about seven months in 1981 when negotiations over a successor program broke down in the face of another looming exchange crisis.

The growth of the manufacturing sector slowed down between 1960 to 1965, and its share of GDP remained constant at slightly below 25 percent (figures 5 and 6). The

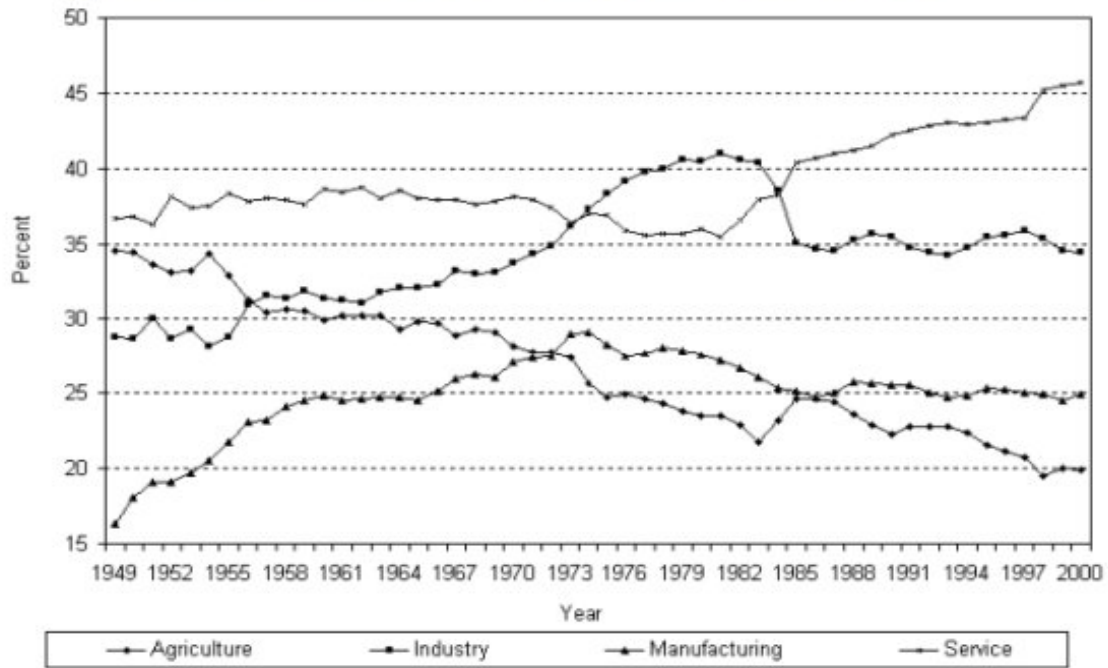
average economic growth rate from 1962 to 1969 was 5 percent. To offset the growth slowdown, the government boosted the construction sector (a nontradable goods sector) between 1963 and 1967, as an implicit substitute for an industrial strategy. (This is reflected in higher capital formation during these years, as shown in figure 4.) This policy was an implicit substitute to industrial strategy. The effect was some acceleration of manufacturing in 1966–68 and worsening current account deficits throughout the 1960s. From 1965, these deficits were funded by the new government led by Ferdinand Marcos through foreign debt from multilateral institutions (the World Bank and Asian Development Bank). As debt service accumulated, another exchange-crisis loomed.

The tumultuous year of 1969 was marked by student demonstrations and perceived election fraud. In early 1970, immediately after the reelection of Ferdinand Marcos, the peso was devalued (from 4 pesos per U.S. dollar to 7 pesos per dollar) as a response to the foreign-exchange crisis. Austerity measures were instituted under another IMF program. GNP growth in 1970 was 2.7 percent.

2.3 1971–80: High debt-driven growth of the martial law years

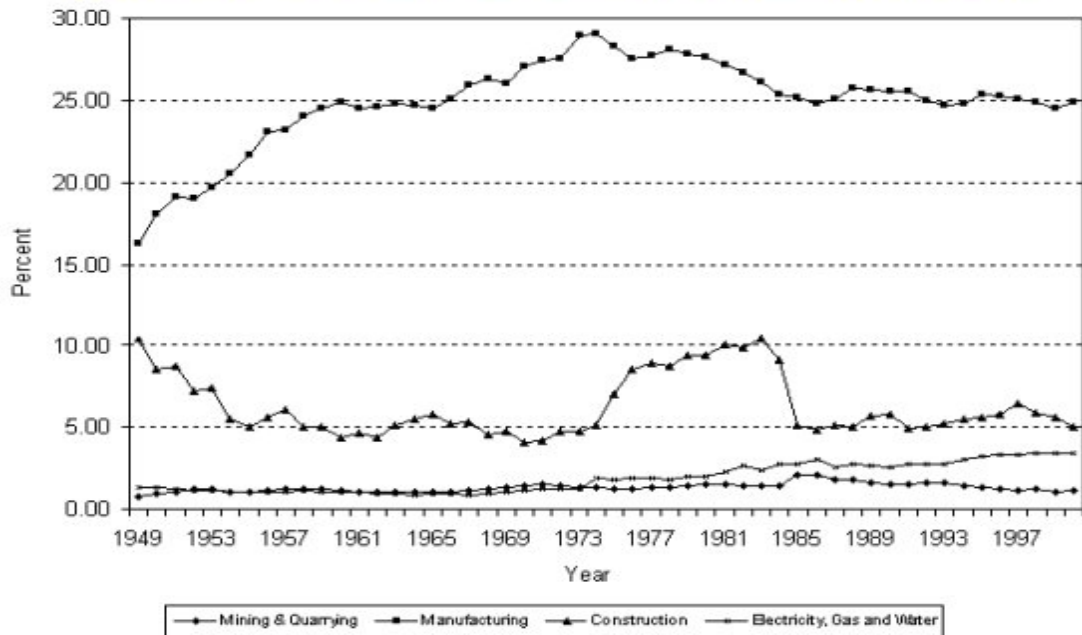
The unpopular devaluation in 1970 occurred during continuing student unrest and Maoist rebellion. The bombing of an opposition party rally in August 1971 led to more disorder and to the declaration of martial law in September 1972. As in many Latin American countries during this period, political repression was accompanied by strong business confidence. The first years of martial law saw accelerated manufacturing growth, as the sector's share of GDP went up to 28 percent of GDP in the 1973–75 period (figures 5 and 6).

Figure 5. Share of economic sectors in the Philippines (as a percentage of GDP), 1949–2000



Source: Authors' calculations and data from the National Statistical Coordinating Board

Figure 6. Components of the Philippine industrial sector (as a percentage of GDP), 1949–2000



Source: Authors' calculations and data from the National Statistical Coordinating Board

The (martial law) government turned once again to the nontradeable sector of construction to sustain economic growth rates, funding the program with foreign loans. Construction reached 10 percent of GDP in the mid-1980s (figure 6), and gross capital formation was close to 30 percent during 1976–79 (figure 3). This debt-driven development strategy enabled GDP to grow at an average annual rate of 5.9 percent during the 1971–80 period. Needless to say, much of this growth was sustainable for a decade as a result of the strong business support and confidence given to the regime.

2.4 1981–85: Economic slowdown and collapse

The share of manufacturing in GDP began what would eventually become a permanent tapering off following the second oil price shock in 1979 and the onset of high world interest rates. As opposition to the martial law experiment escalated, the government sought to undertake countercyclical policies, funded by foreign borrowing, to maintain domestic demand to offset the adverse effects of the worsening international environment. In 1981, the government committed to one of the first structural adjustment programs in the world, that emphasized trade and financial liberalization. Government largesse, however, was extended to the enterprises of the political supporters of Ferdinand Marcos in order to shelter them from the ravages of the liberalization program. In July 1983, the peso depreciated by 10 percent, and the liberalization program was withdrawn.

The assassination of an opposition leader raised doubts about continued U.S. support for the Marcos regime and led to an increase in capital flight. In October 1983, a moratorium on external debt payments was declared. A classic IMF program of tight liquidity and

credit constriction was implemented. Difficulty in obtaining working capital led to closures of firms and work stoppages in key industries. GDP growth plummeted to -7.6 percent in 1984 and 1985. Investments fell short of the amount needed to meet depreciation needs.

2.5 1986–93: The Aquino years

In February 1986, following a violence-ridden presidential election, the Marcos government fell from power. The new government of Corazon Aquino implemented trade and financial liberalization, with support from the IMF and the World Bank. Import restrictions were lifted in May 1986 (and another round in 1988), and tax reforms and large-scale privatization of state-owned enterprises were completed (Lim and Montes 2000). Trade liberalization for manufactured goods was especially difficult, and Aquino faced tough opposition from both business and labor. The GDP growth rate averaged 5.6 percent from 1987 to 1989 under the new government.

There were significant increases in public investment (to refurbish public infrastructure), which led to a run-up of fiscal deficits that had its equivalent in large and growing trade account deficits. A series of military coups, starting in 1987, undermined business confidence. Uncertainties in the international environment resulting from the Gulf War undermined business investment further. GDP fell 0.6 percent in 1991. Recovery became even more problematical with the onset of power shortages. The power crisis lasted until the first half of 1993.

2.6 1993 onward: More liberalization under Ramos; the Asian crisis

A new administration under Fidel Ramos intensified the liberalization program, from the lifting of import restrictions to genuine reductions in tariffs. The program was in line with international commitments to the ASEAN Free Trade Area (AFTA), the World Trade Organization (WTO), and the Asia-Pacific Economic Cooperation (APEC). Full capital account liberalization was achieved in the last quarter of 1993. The liberalization measures of the Ramos government occurred with much economic confidence and bullishness, as indicated by the skyrocketing of the stock market during 1993–97. The new optimism seemed to be justified by what was perceived as better economic management. With the capital account liberalization, foreign capital inflow reached its highest level in 1996, at approximately 5 percent of GDP. The economy's average growth rate for 1994–97 was 4.9 percent. This time, recovery did not bring about high inflation as it did in the 1980s, partly because of the steady appreciation of the real exchange rate until the onset of the Asian crisis.

As with previous growth spurts, however, current account deficits increased and the savings-investment gap widened to unprecedented levels (figure 3). Booming exports could not keep pace with explosive import growth. The sharp rise in import intensity (imports/GDP ratio) was obviously a natural response to the quick pace of tariff reduction, combined with a sharply appreciating currency (in real terms) that made imports and tradables particularly cheap. Figure 5 shows that the 1980s and 1990s were marked by a big rise in the share of the service sectors. Services became the dominant economic sector in the economy, whereas the share of agriculture was falling and the share of industry was stagnant. Trade liberalization and overvaluation made nontradables

more attractive than the tradables during the growth periods (1987 to 1990, 1994 to 1997). The service sector was a reliable absorber of employment and output as the frequency of recessions and losses of confidence increased.

The runup in short-term debts and portfolio investments caused the Philippines to succumb to the Asian financial crisis in 1997, three years after the capital account liberalization (Montes 1999).

3. Downward industrial and savings ratchets

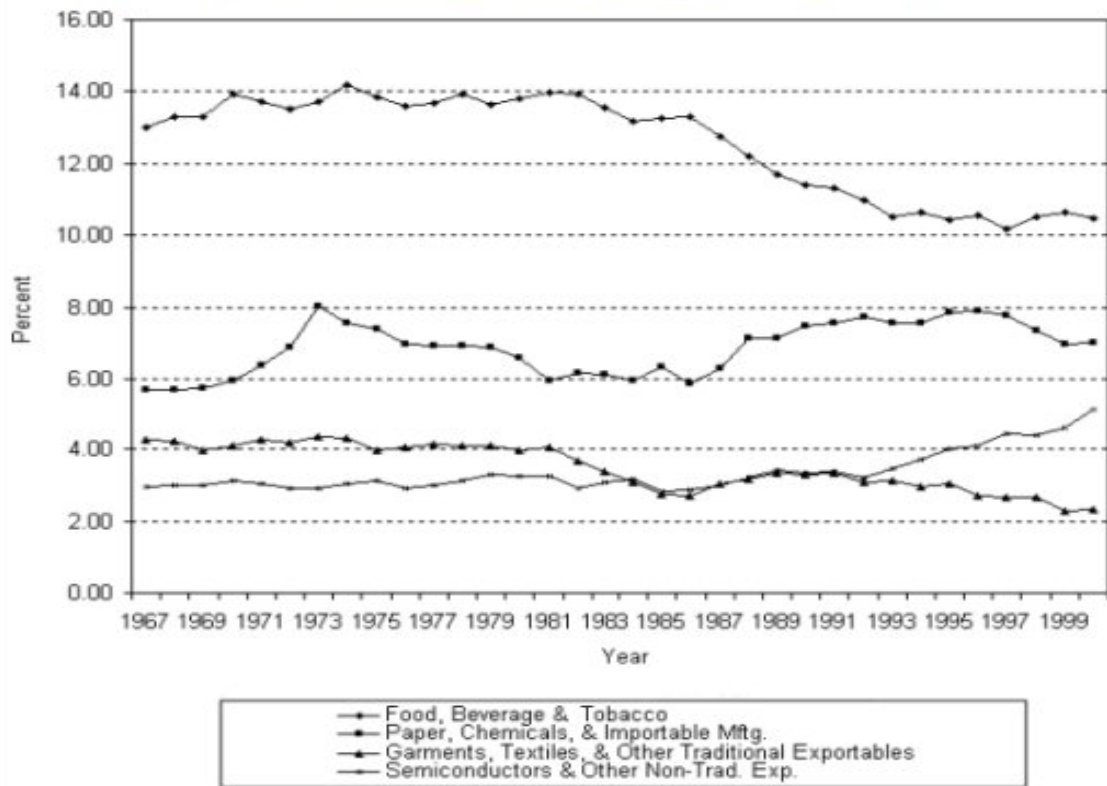
The impacts on long-term development of the events described in the historical survey of section 2 can be summed up by the following statistics, using the years 1980 and 2000 as convenient endpoints:

1. Industry as a proportion of GDP declined from about 40 percent in 1980 to slightly less than 35 percent in 2000, and manufacturing declined from 27 percent of output to 25 percent (figure 5). There is some evidence of a pickup in the “non-traditional” tradables sector from the low base of the 1990s (figure 7), and its contribution to an eventual manufacturing recovery rests on whether this sector (mainly electronics) can increase its domestic value-added content.
2. The share of services increased from about 36 percent in 1980 to 46 percent in 2000 (figure 5). The proportion from service trade has remained constant throughout this period, whereas the “private services” sector, which includes both low-skilled work and professional services, increased from 5 percent to 9 percent (figure 8).

3. Dependence on commodity exports has declined, and Philippine exports are less diversified in 2000 than in 1980. Figure 9 indicates that whereas the share of the electronics and semiconductor sector in the export structure has increased, the proportion of labor-intensive exports in total exports has been declining.

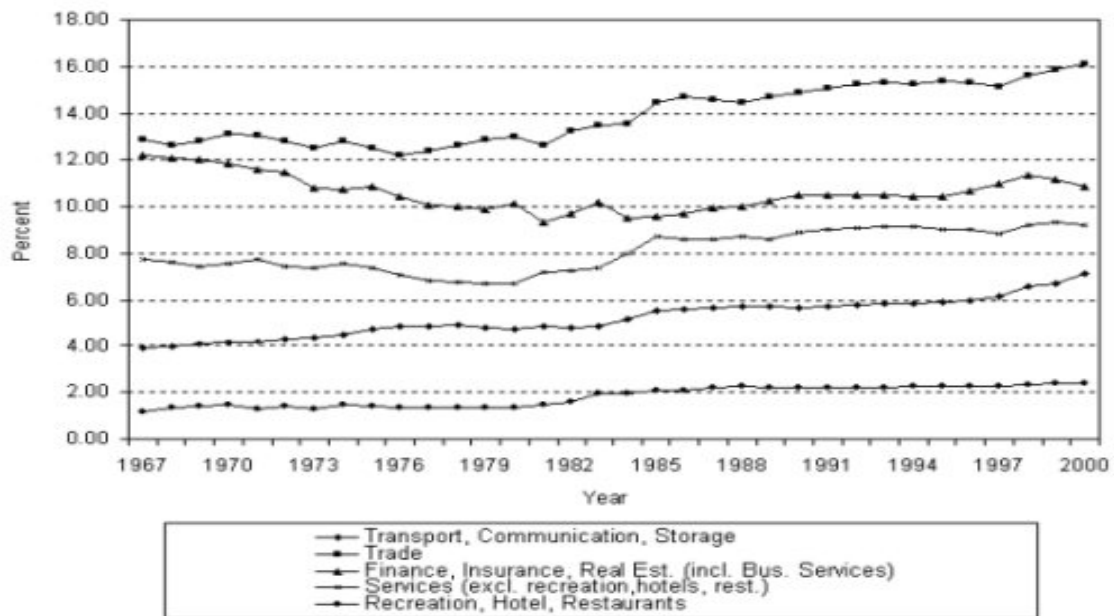
This section develops the contention that crises and macroeconomic-based interpretations, rather than protectionism and maintenance of inefficiency (i.e., the dominant economic discourse internally and in interactions with the donor community) go a long way in explaining these trends.

Figure 7. Components of manufacturing in the Philippines (as a percentage of GDP), 1949–2000

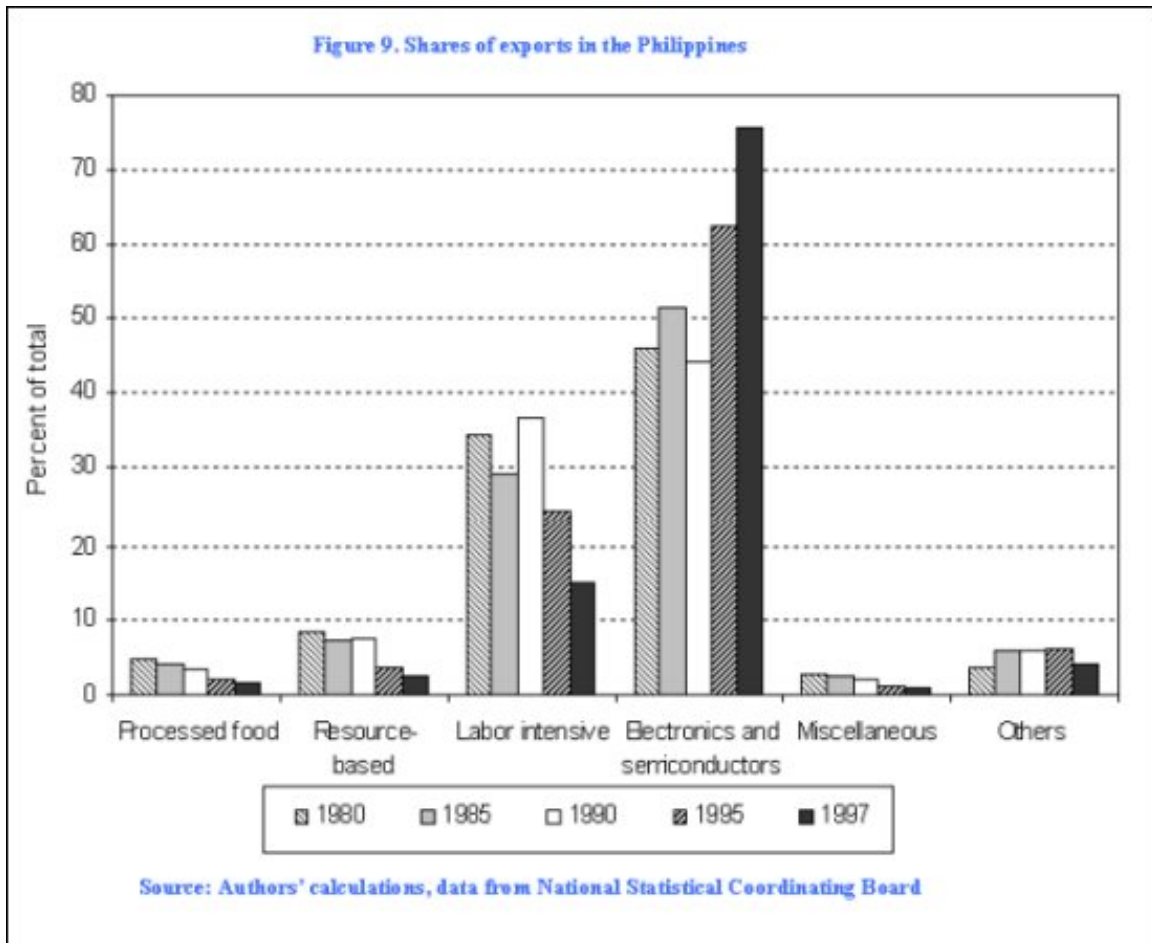


Source: Authors' calculations and data from the National Statistical Coordinating Board.

Figure 8. Components of services in the Philippines (as percentage of GDP), 1949–2000



Source: Authors' calculations and data from the National Statistical Coordinating Board.



3.1 Industry ratchets downward

Decomposition analyses of sectoral shifts in employment since 1980 suggest that the most resilient sectors have been the service sectors, particularly wholesale and retail trade; government, community, and social services; and transportation, storage, and communications (Lim and Montes 2000, 172). These nontradable sectors, being less dependent on imported inputs and financial credit, have been less ravaged by the downturns throughout the balance of payments crises.

Among the tradable sectors, one can distinguish between those that are “domestically anchored,” such as food processing, because they have the potential of increasing

domestic value-added through a natural comparative advantage, and those of the “bonded warehouse” variety, such as semiconductor exports, in which the principal domestic input through the medium-term is labor. Because the operations of bonded warehouse industries are denominated in foreign currency (except for labor) and because of their access to foreign credit, their tradables have not been adversely affected by the national crises; instead, their output-employment cycles have conformed to international cycles. The decreasing diversity in the structure of Philippine exports is related to its success in attracting foreign investment, principally in the semiconductor export sector.

The frequent crises since 1980 have been devastating to the country’s domestically anchored tradable sectors,⁴ whereas they have left most of the nontradable sectors (except for construction) unscathed. Unlike nontradable sectors, domestically anchored tradable sectors must rely on the formal economy, particularly for credit and imported inputs. Constriction of these two inputs has been uniformly critical for economic adjustment.

The recovery phases have not been very kind to these domestically anchored tradable sectors either. Since 1946, periods of growth recovery have always been accompanied by real exchange rate appreciation. The trade liberalization and tariff reductions of the 1980s, combined with currency overvaluation, have made tradable goods cheap and have shifted relative prices in favor of nontradables (Lim and Montes 2000). After the capital account liberalization efforts of 1989–92, currency overvaluation was increased by portfolio capital inflows (Montes 1999).

4 In the case of the 1985 adjustment program, Montes (1987) argues that the adjustment policies themselves, notably the credit constriction, undermined the country’s ability to export.

The actual levels of output and employment showed a weak, if not negative, impact in sectors that had been expected to respond positively to the import liberalization program. Some authors attribute these unexpected results to the incomplete and politically sequenced character of the reform (including policy inconsistencies, such as exchange rate overvaluation) or to the fact that it is too early for valid evaluation, that is, the “long run” has not yet come to pass. Clearly, however, weak investment responses were evident in those sectors that had been expected to benefit from the reforms. In fact, many sectors experienced investment declines, compared with the period before liberalization, even those sectors in which the Philippines had a natural comparative advantage.

Since 1957, productivity increases did not accompany recovery-growth phases; instead, recovery was characterized by capacity utilization and increased inputs, through a revival of imports. At the start of growth periods, the economy was typically awash with dollars after coming from a recession, which allowed it to raise import levels. Initial high confidence led to increased flows of foreign funds to finance the increasing import needs. Bust periods, on the other hand, were characterized by foreign-exchange shortages that curtailed imports of raw materials and capital goods. Rising import needs or foreign debt payments outpaced foreign financial inflows, or net foreign inflows dropped as a result of losses of confidence caused by internal or external factors. (See De Dios 1998.) Paradoxically, this improved the external position of the Philippines during the recession periods and placed the country in a good position for the next input-intensive recovery phase.

The periods between growth interruptions have shortened and this may be attributable to structural adjustments made after the 1983 crisis. These reforms, though extensive, appear to have been insufficient to address other structural problems, such as the inevitable trade and current account deficits that emerge during growth periods, the low domestic savings rate, and the weak tax collection efforts (De Dios 1998). The recession-recovery cycles have persisted, and have become more dangerous than before, with shorter cycle lengths.

3.2 Savings ratchets downward

A second key pattern is the manner in which each crisis has reduced the share of domestic savings and has increased the share of consumption. This pattern is clearly seen in figure 3, in which gross domestic savings declined steeply in the mid-1980s, fell again in 1991–93, and again in 1998. The savings rates of the late 1980s and 1990s are comparable to those seen in the late 1950s. Figure 4 depicts the opposite effect of these crises on the share of consumption in the 1980s and 1990s. Each recession left in its wake a higher share of consumption and a lower share of savings. The most recent consumption share is hovering around an unprecedentedly high 80 percent, leaving little room for savings.

Each reduction in the savings rate has increased the country's dependence on foreign inflows, a source of financing that has not been very stable. The most recent and investment-savings gap (and the largest in terms of GDP share), which occurred in the mid-1990s (figure 3), was associated with a reasonable, but not roaring, recovery. Before the 1980s, growth rates on the order of 7 percent, a level that was touched only once in

the 1990s, were routine; thus the unavoidable inference is that for each percentage gain in GDP growth, the country has become more dependent on foreign financing. Growth, subsequent to structural adjustment, not only has a higher import content, but the financing of investment also has a greater external component (compare imports to exports and imports to gross capital formation from 1997 on with previous periods in figure 4).

After the gravest economic crisis of 1984–85, the decisions undertaken by the Aquino government to manage the Philippine external debt have proven to be fateful. A proper analysis of Philippine monetary policy needs to grapple with the effects that the debt strategy had on the domestic capability to generate resources to finance investment. These effects are (1) the impact on the domestic savings rate, (2) the impact on financial intermediation, and (3) the impact on private sector investment.

The most dramatic ratcheting up of consumption (and ratcheting down of savings) came with the 1984–85 crisis. The new Aquino government completed the nationalization of all the external debt inherited from the Marcos regime and complied with negotiated debt servicing schedules. This had the immediate impact of raising the proportion of public expenditure devoted to debt service from less than 5 percent in 1981 to 27 percent in 1988. More importantly, the government's domestic borrowing requirements ballooned in 1986, even as it was cutting back most other expenditures (table 1). The public sector, never an export-earner, collected the funds from the domestic market to service the external debt. Nominal domestic interest rates, measured by the government's 91-day treasury bill rate, reached 15 percent in 1986 (when inflation was nil), and in subsequent

years real interest rates stayed at 6 percent or higher. In the years before the Brady bond restructuring, it became more profitable for the private sector to liquidate physical assets (either through sale or by pledging these as collateral for loans) and to purchase treasury bills at favorable rates of return, than to devote resources to maintaining existing plant and equipment or carrying out new capital investment to respond to the new market opportunities implicitly created by the economic reform program.

Table 1: Trends in key macroeconomic indicators in the Philippines, 1970–2000

| | 1970 | 1971 | 1972 | 1973 | 1974 | 1975 | 1976 | 1977 | 1978 | 1979 |
|---|-------|-------|-------|--------|--------|--------|--------|--------|--------|--------|
| GDP growth rate | 3.76 | 5.43 | 5.45 | 8.92 | 3.56 | 5.56 | 8.81 | 5.60 | 5.17 | 5.64 |
| GNP growth rate | 2.74 | 6.21 | 5.55 | 9.75 | 4.21 | 4.85 | 8.11 | 5.80 | 5.34 | 6.24 |
| GNP per capita (1985 pesos) | 9,142 | 9,438 | 9,700 | 10,356 | 10,501 | 10,761 | 11,276 | 11,617 | 11,913 | 12,321 |
| Growth rate of GNP per capita | -0.21 | 3.24 | 2.78 | 6.76 | 1.40 | 2.48 | 4.78 | 3.03 | 2.55 | 3.42 |
| Unemployment rate | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| CPI inflation rate | 23.83 | 21.74 | 8.93 | 16.39 | 33.80 | 7.37 | 8.82 | 9.91 | 7.38 | 17.56 |
| Exchange rate (average) | 5.90 | 6.43 | 6.68 | 6.76 | 6.79 | 7.25 | 7.44 | 7.40 | 7.37 | 7.38 |
| Fiscal balance (% of GDP) | 0.14 | -0.37 | -1.96 | -1.17 | 0.45 | -1.19 | -1.74 | -1.82 | -1.22 | -0.16 |
| Goods: exports (% of GDP) | 14.82 | 14.58 | 13.52 | 17.49 | 18.38 | 14.30 | 13.84 | 15.13 | 14.20 | 15.61 |
| Goods: imports (% of GDP) | 15.18 | 15.23 | 15.00 | 14.91 | 21.45 | 21.86 | 19.98 | 18.80 | 19.62 | 20.83 |
| Current account balance (% of GDP) | -0.67 | -0.03 | 0.06 | 4.42 | -1.42 | -5.83 | -6.08 | -3.62 | -4.53 | -5.07 |
| Trade balance (% of GDP) | -0.36 | -0.63 | -1.49 | 2.57 | -3.07 | -7.56 | -6.14 | -3.67 | -5.42 | -5.23 |
| Gross capital formation (% of GDP) | 15.80 | 16.37 | 15.69 | 15.77 | 18.49 | 23.63 | 24.91 | 23.61 | 23.80 | 25.89 |
| Gross domestic savings (% of GDP) | 21.93 | 20.36 | 19.43 | 24.76 | 23.52 | 23.89 | 25.87 | 24.19 | 24.09 | 24.18 |
| Net foreign investments (% of GDP) | -0.08 | -0.25 | 0.50 | 0.03 | 0.61 | 0.69 | 1.01 | 0.42 | 0.02 | -0.33 |
| Short-term debt (% of GDP) | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | 11.85 | 16.01 | 18.03 |
| Long-term debt (% of GDP) | 22.57 | 20.89 | 21.56 | 17.43 | 15.47 | 18.14 | 22.17 | 24.91 | 25.92 | 24.27 |
| Public and publicly guaranteed | 7.96 | 8.31 | 9.86 | 7.70 | 7.19 | 9.23 | 12.21 | 14.51 | 17.25 | 17.24 |
| Private non-guaranteed | 14.61 | 12.58 | 11.70 | 9.73 | 8.28 | 8.92 | 9.96 | 10.39 | 8.67 | 7.03 |
| Use of IMF credit (% of GDP) | 0 | 0 | 0 | 0 | 0 | 1.22 | 2.22 | 2.53 | 2.73 | 2.76 |
| Long-term debt and IMF credit (% of GDP) | 22.57 | 20.89 | 21.56 | 17.43 | 15.47 | 19.36 | 24.39 | 27.44 | 28.64 | 27.03 |
| Total external debt (% of GDP) | 22.57 | 20.89 | 21.56 | 17.43 | 15.47 | 19.36 | 24.39 | 39.29 | 44.66 | 45.05 |
| Net portfolio investments (% of GDP) | -0.04 | -0.03 | 0.01 | -0.10 | 0.29 | -0.17 | -0.09 | 0.06 | 0.04 | 0.05 |
| Net other investments (% of GDP) | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | 4.58 | 9.65 | 11.27 |

Note: n.a. = not available.

(continued on next page)

Table 1. Continued

| | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 | 1987 | 1988 | 1989 |
|---|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|
| GDP growth rate | 5.15 | 3.42 | 3.62 | 1.87 | -7.32 | -7.31 | 3.42 | 4.31 | 6.75 | 6.21 |
| GNP growth rate | 4.51 | 3.41 | 2.43 | 1.65 | -9.11 | -6.96 | 3.64 | 5.15 | 7.21 | 6.21 |
| GNP per capita (1985 pesos) | 12,535 | 12,643 | 12,633 | 12,526 | 11,110 | 10,086 | 10,205 | 10,476 | 10,971 | 11,385 |
| Growth rate of GNP per Capita | 1.74 | 0.86 | -0.08 | -0.85 | -11.31 | -9.21 | 1.18 | 2.65 | 4.73 | 3.77 |
| Unemployment rate | n.a. | 8.7 | 9.4 | 7.9 | 10.6 | 11.1 | 11.1 | 9.1 | 8.3 | 8.4 |
| CPI inflation rate | 18.18 | 13.19 | 9.22 | 5.33 | 46.41 | 23.05 | -0.23 | 3.05 | 12.30 | 11.36 |
| Exchange rate (average) | 7.51 | 7.90 | 8.54 | 11.11 | 16.70 | 18.61 | 20.39 | 20.57 | 21.10 | 21.74 |
| Fiscal balance (% of GDP) | -1.39 | -4.32 | -4.54 | -2.02 | -1.90 | -1.95 | -5.03 | -2.45 | -2.91 | -2.11 |
| Goods: exports (% of GDP) | 17.84 | 16.05 | 13.52 | 15.07 | 17.16 | 15.06 | 16.21 | 17.23 | 18.67 | 18.37 |
| Goods: imports (% of GDP) | 23.82 | 22.29 | 20.64 | 22.54 | 19.33 | 16.63 | 16.89 | 20.29 | 21.54 | 24.47 |
| Current account balance (% of GDP) | -5.91 | -5.88 | -8.65 | -8.34 | -4.12 | -0.12 | 3.19 | -1.34 | -1.03 | -3.42 |
| Trade balance (% of GDP) | -5.98 | -6.24 | -7.12 | -7.47 | -2.16 | -1.57 | -0.68 | -3.06 | -2.86 | -6.10 |
| Gross capital formation (% of GDP) | 27.25 | 27.73 | 27.52 | 29.86 | 23.07 | 16.47 | 16.05 | 16.51 | 17.79 | 20.82 |
| Gross domestic savings (% of GDP) | 26.59 | 26.78 | 25.28 | 27.36 | 22.94 | 18.81 | 19.05 | 20.97 | 21.05 | 20.30 |
| Net foreign investments (% of GDP) | 0.48 | 0.04 | 0.32 | 0.03 | 0.04 | 0.43 | 0.92 | 2.47 | 1.32 | 1.20 |
| Short-term debt (% of GDP) | 23.29 | 26.71 | 30.87 | 28.36 | 30.12 | 29.79 | 18.02 | 11.44 | 10.20 | 9.29 |
| Long-term debt (% of GDP) | 27.17 | 28.70 | 32.54 | 41.24 | 44.61 | 53.07 | 72.17 | 74.49 | 63.28 | 55.25 |
| Public and publicly guaranteed | 19.61 | 20.95 | 23.85 | 31.83 | 35.98 | 44.61 | 64.49 | 68.96 | 59.02 | 52.46 |
| Private non-guaranteed | 7.56 | 7.75 | 8.69 | 9.41 | 8.63 | 8.46 | 7.68 | 5.52 | 4.25 | 2.79 |
| Use of IMF credit (% of GDP) | 3.22 | 3.18 | 2.69 | 3.30 | 2.82 | 3.80 | 4.24 | 3.80 | 2.89 | 2.76 |
| Long-term debt and IMF credit (% of GDP) | 30.39 | 31.87 | 35.23 | 44.53 | 47.43 | 56.87 | 76.41 | 78.28 | 66.16 | 58.02 |
| Total external debt (% of GDP) | 53.68 | 58.59 | 66.10 | 72.90 | 77.54 | 86.66 | 94.43 | 89.72 | 76.37 | 67.30 |
| Net portfolio investments (% of GDP) | 0.02 | 0.02 | 0 | 0.02 | 0 | 0.09 | 0.04 | 0.07 | 0.14 | 0.72 |
| Net other investments (% of GDP) | 10.98 | 9.17 | 9.53 | -2.16 | 1.83 | 1.01 | 0.02 | -0.02 | -1.10 | 1.20 |

(Continued on next page)

Table 1. Continued

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|
| GDP growth rate | 3.04 | -0.58 | 0.34 | 2.12 | 4.39 | 4.76 | 5.76 | 5.19 | -0.59 | 3.32 | 3.95 |
| GNP growth rate | 4.78 | 0.46 | 1.55 | 2.12 | 5.25 | 4.96 | 7.16 | 5.25 | 0.40 | 3.66 | 4.21 |
| GNP per capita (1985 pesos) | 11,661 | 11,456 | 11,382 | 11,151 | 11,456 | 11,743 | 12,298 | 12,657 | 12,432 | 12,615 | 12,871 |
| Growth rate GNP per Capita | 2.43 | -1.76 | -0.64 | -2.02 | 2.73 | 2.50 | 4.73 | 2.92 | -1.78 | 1.47 | 2.03 |
| Unemployment rate | 8.1 | 9 | 8.6 | 8.9 | 8.4 | 8.4 | 7.4 | 7.9 | 9.6 | 9.6 | 10.1 |
| CPI inflation rate | 13.11 | 18.52 | 8.56 | 6.88 | 8.43 | 7.99 | 9.00 | 5.87 | 9.71 | 6.71 | 4.37 |
| Exchange rate (average) | 24.31 | 27.48 | 25.51 | 27.12 | 26.42 | 25.71 | 26.22 | 29.47 | 40.89 | 39.09 | 44.19 |
| Fiscal balance (% of GDP) | -3.45 | -2.11 | -1.18 | -1.48 | 1.07 | 0.58 | 0.29 | 0.06 | -1.87 | -3.73 | -4.10 |
| Goods: exports (% of GDP) | 18.47 | 19.46 | 18.54 | 20.92 | 21.04 | 23.54 | 24.80 | 30.64 | 45.04 | 44.63 | 49.60 |
| Goods: imports (% of GDP) | 27.55 | 26.53 | 27.41 | 32.37 | 33.29 | 35.60 | 38.49 | 44.15 | 45.08 | 38.16 | 40.41 |
| Current account balance (% of GDP) | -6.08 | -2.28 | -1.89 | -5.55 | -4.60 | -2.67 | -4.77 | -5.28 | 2.36 | 9.98 | 12.43 |
| Trade balance (% of GDP) | -9.07 | -7.07 | -8.86 | -11.44 | -12.25 | -12.07 | -13.69 | -13.51 | -0.04 | 6.47 | 9.20 |
| Gross capital formation (% of GDP) | 23.12 | 20.04 | 20.92 | 23.77 | 23.63 | 22.20 | 23.42 | 24.42 | 21.04 | 18.97 | 17.84 |
| Gross domestic savings (% of GDP) | 18.69 | 16.64 | 14.94 | 13.76 | 14.84 | 14.54 | 14.60 | 14.21 | 12.83 | 14.93 | 17.01 |
| Net foreign investments (% of GDP) | 1.20 | 0.43 | 1.59 | 2.01 | 1.46 | 1.61 | 1.32 | 2.43 | 1.86 | 2.11 | n.a. |
| Short-term debt (% of GDP) | 9.99 | 10.89 | 9.92 | 9.26 | 8.92 | 7.12 | 9.62 | 14.32 | 10.97 | 7.49 | 7.91 |
| Long-term debt (% of GDP) | 56.97 | 58.17 | 50.30 | 54.61 | 50.92 | 42.93 | 38.35 | 40.12 | 59.61 | 57.99 | 58.63 |
| Public and publicly guaranteed | 54.26 | 55.17 | 48.36 | 50.55 | 46.33 | 38.17 | 32.43 | 31.82 | 43.00 | 43.79 | n.a. |
| Private non- guaranteed | 2.71 | 3.00 | 1.94 | 4.06 | 4.60 | 4.76 | 5.92 | 8.30 | 16.60 | 14.20 | n.a. |
| Use of IMF credit (% of GDP) | 2.06 | 2.39 | 2.08 | 2.23 | 1.66 | 0.98 | 0.49 | 1.04 | 2.40 | 2.38 | 2.70 |
| Long-term debt and IMF credit (% of GDP) | 59.02 | 60.57 | 52.38 | 56.84 | 52.58 | 43.91 | 38.84 | 41.16 | 62.01 | 60.37 | 61.33 |
| Total external debt (% of GDP) | 69.02 | 71.45 | 62.30 | 66.10 | 61.50 | 51.04 | 48.46 | 55.48 | 72.98 | 67.86 | 69.24 |
| Net portfolio investments (% of GDP) | -0.11 | 0.31 | 0.51 | 3.40 | 2.39 | 5.46 | 5.96 | 0.74 | 0.42 | 7.01 | n.a. |
| Net other investments (% of GDP) | 3.56 | 5.00 | 5.55 | 4.52 | 5.56 | 4.10 | 9.80 | 4.82 | -3.56 | 6.46 | n.a. |

Source: National Statistical Coordination Board.

Note: n.a. = not available.

Interruptions in growth have resulted from the Philippines' continuing dependence on the unsustainable inflow of foreign capital (or capital flight during crisis periods). This was the case in the balance of payment crises in 1949, the late 1950s and early 1960s, 1970, 1983–85, 1991, and 1998. Recessions are the temporary solution to this dependence on unstable foreign capital because they reduce the savings-investments gaps and the trade deficits. No doubt belt-tightening and output contraction have been prescribed for the Philippines as periodic solutions to its “profligate” use of foreign currency, but these increasingly frequent recessions are the main manifestations of the Philippines' lack of economic development.

The arguments in sections 2 and 3 permit us to propose answers to the first two questions we posed in section 1. Macroeconomic volatility and political instability are mutually aggravating factors that have remained unaltered even after economic reforms began in the 1980s. External events, such as the world debt crisis in the 1980s and the Asian economic crisis of 1997–98, have contributed to macroeconomic instability, and political business cycles have also played a key role in the Philippine's economic performance (e.g, the boosting of construction during the recovery phase).

Economic liberalization has long been a part of the political debate—since the 1962 economic crisis. We believe that the more comprehensive economic reform programs of the 1980s have aggravated macroeconomic volatility. The observed increased dependence on external finance in the most recent period has made the foreign-exchange constraint, already binding before the 1980s, even more decisive. What has been reinforced is the unhealthy cycle of foreign exchange constraining output, and

constrained output in turn constricting domestic savings, which in turn magnifies the role of external finance.

3.3 A structural model

To illustrate these ideas formally, we present a “three-gap” model of structural deficits in the style of Bacha (1989) and Rattso (1988). Such a model allows for the analysis of the relative importance of deficits in domestic savings, fiscal balances, and foreign-exchange constraints with respect to how these deficits affect medium-term growth. There is some degree of hostility to the modeling of these structural deficits, because the structural equations are unmediated by price variables. One example of a fully parameterized model for the Philippines is that used in Montes, Lim, and Quisumbing (1993).

The savings gap The savings-investment equation is from the national income identity:

$$I = (Y - C_p - C_g) + (M - X), \quad (1)$$

where I is fixed capital formation, Y is the gross domestic product, and C_p and C_g are private and government expenditures, respectively. M and X are imports and exports, respectively, of goods and nonfactor services. It is assumed that

$$C_p + C_g = cY, \quad (2)$$

where c is society's marginal propensity to consume. In addition, the excess of imports over exports is equal to capital inflow from abroad (F),⁵ less the net factor service payment (composed mainly of interest payments) to the rest of the world (J). That is,

$$M - X = F - J. \quad (3)$$

Combining (1), (2), and (3) generates the savings-investment equation:

$$IS = (1 - c)Y + (F - J). \quad (4)$$

The sources of investments are internal savings and foreign transfers (Bacha 1989, 4).

The right-hand side of equation (4) can be further decomposed as

$$IS = S_p + (T - G) + (F - J), \quad (5)$$

where S_p is private savings and $(T - G)$ is the budget surplus in the current account. If we divide both sides of the equation by Y , we derive

$$is = s + f = (1 - c) + f \quad (4')$$

and

$$is = s_p + s_g + f, \quad (5')$$

where the lower case letters denote the variables as fractions of Y ,

5 We shall follow Bacha's (1989)] approach of netting out foreign reserves accumulation from F .

$$s_g = (T - G)/Y$$

and

$$f = (F - J)/Y.$$

The foreign-exchange gap The foreign-exchange gap starts with equation (3). Imports can be broken down as follows:

$$M = M_k + M_r + M_o, \quad (6)$$

where M_k is capital good imports, M_r is imports of raw materials and intermediate inputs, and M_o is consumer and other imports. We also assume that

$$M_k = m_k I,$$

where m_k is the import coefficient of capital investment, and

$$M_r = m_r (C_p + C_g + I + X), \quad (7)$$

where m_r is the import coefficient for raw material inputs into domestic production.

Putting equations (3), (6), (7), and (8) together yields the foreign-exchange equation:

$$IE = (1/m_r + m_k)[(1 - m_r) X - m_r (C_p + C_g) - M_o + (F - J)]. \quad (9)$$

Dividing both sides by Y yields

$$ie = (1/m_r + m_k) [(1 - m_r)x - m_r(c_p + c_g) - m_o + f], \quad (9')$$

where the lower-case letters again denote the division by Y . Since $m_r + m_k$ is most likely less than 1, the foreign-exchange equation will yield a steeper slope than the savings-investment equation in the foreign finance-investment space, $(F - J) - IE$, or equivalently in the $f - i$ space.

The fiscal gap The fiscal balance can be stated as

$$T + NT + GB + \mu (F - J) = C_g + I_g + D_g + O, \quad (10)$$

where T is tax revenue; NT is non-tax revenue, excluding grants and aid from abroad; GB is government domestic borrowing; $\mu (F - J)$ is the amount of net foreign transfers that go to the government; C_g is government consumption, not including interest payment for foreign debt; I_g is government investment; D_g is principal and interest payments on government domestic debt; and O is a combination of other items, specifically, nonbudgetary items and increases in cash balance.

The left-hand side of (10) gives the government revenue and government borrowings net of foreign interest payments, and the right hand-side gives the expenditures of the government, including debt service. The coefficient μ is the proportion of $(F - J)$ that goes to the government and $(1 - \mu)$ is the proportion that goes to the private sector.

It is assumed, as in Rattso (1988) and Montes (1989), that private investment (I_p) benefits from an “animal spirits” parameter a and reacts positively to both government investment (I_g) and capacity utilization (u). The coefficient b represents the “crowding in” effect of

government investment, net of the traditional negative “crowding out” effect as higher I_g increases domestic borrowing by the government. The variable b is assumed to be positive and less than 1.⁶ Private investment can be expressed as

$$I_p = a + b I_g + c u . \quad (11)$$

Since

$$I = I_p + I_g , \quad (12)$$

$$I = a + (1 + b) I_g + c u \quad (13)$$

or

$$I_g = [I - a - c u] / [1 + b] . \quad (14)$$

Substituting (14) into (10) yields

$$IT = (1 + b) [(T + NT - C_g) + (GB - D_g) - O] + a + cu + \mu (1 + b) (F - J). \quad (15)$$

The fiscal equation can thus be written as:

$$IT = e + \mu (1 + b) (F - J), \quad (16)$$

where e captures all the terms on the right-hand side except the last. Once again, dividing both sides by Y yields:

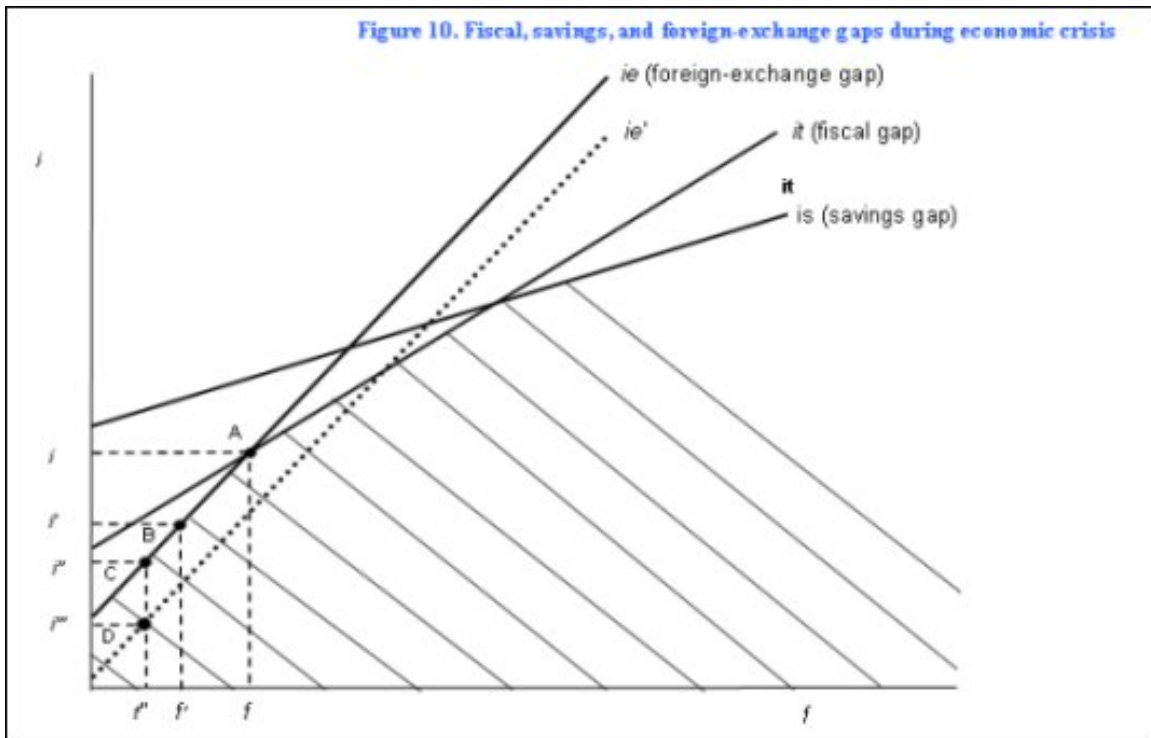
$$it = e' + \mu (1 + b) f, \quad (16')$$

⁶ Stylized data on the Philippines seem to indicate that b is between 0.5 and 0.6.

where e' is e divided by Y .

A three-gap explanation for low savings and investment rates Of the equations above, (4'), (9'), and (16') can be drawn on the i and f space, in which higher levels of foreign financing are associated with higher investment rates. Figure 10 depicts the typical fiscal, savings, and foreign-exchange gaps during times of crises.. The ie and it have slopes larger than is . The slope of ie is steeper than that of it , that is, $1/(m_k + m_r) > \mu$ ($1 + b > 1$ (see Lim 1990)).

Figure 10 is drawn with the foreign-exchange constraint binding, so that reversals in exchange availability, as happened during the crises of 1983–85, 1991–93, and 1997–2000, would generate a balance of payments crisis. Crises usually begin with a contraction of net capital inflows (f) because of capital flight, foreign credit stoppage, or elevated debt service. In figure 10, the equilibrium moves from point A to point B. Stabilization policies supervised by the IMF that are designed to reduce aggregate demand (via monetary contractions, devaluations, and fiscal tightness) can erode confidence further and lead to more net capital outflows (net IMF loan inflows). This is shown in the movement from B to C in figure 10 along the ie curve.



The movements from A to B to C create “gaps” in terms of surpluses in the savings (*is*) and fiscal (*it*) schedules and provide room for recovery when the foreign-exchange constraints are eased. However, starting from the 1983–85 crisis, which was particularly deep in terms of output, downwards shifts in all three constraints, and especially in the *ie* curve itself, reduce savings and constrict growth. The Engel and Duesenberry effects suggest that in response to a drastic contraction in *Y*, people attempt to maintain their subsistence and/or relative income positions, and increase their consumption share. This is tantamount to an increase in the coefficient *c*, with implications for a shift downward in the *is* and *ie* schedules, and perhaps a move to point D in figure 10. Based on the parameters of the model, a downward rotation in *ie* would also be caused by any increased import content of growth, as might be induced by an import liberalization program that did not generate sufficient export response in the medium term.

The strain on the fiscal finances imposed by the chosen debt strategy of the mid-1980s would have also caused a downward movement of the *it* curve. Moreover, cutbacks in government investment would have reduced private investment (and private savings by the corporate sector), if the hypothesized crowding-in parameter *b* remained constant. Disorderly import liberalization (perhaps made disorderly by successful political lobbying), coupled with determined government pronouncements to abjure all forms of industrial policy, can reduce private responsiveness to government investment even further and actually reduce the coefficient *b*. This would be consistent with a downward rotation of the *it* schedule at any lower investment rate value. The shortening of periods between crisis, so that the memories of recent crisis are persistent, can reduce the “animal spirits” coefficient *a* and shift the *it* schedule downward.

A downward shift of the *ie* curve is consistent with greater volatility in foreign-exchange financing. In figure 10, the movement from point C to point D in investment, from a pre-crisis position *i* to *i'''*, is a ratcheted fall in the investment and savings shares. The series of sharp declines in *i* and *s* in the series of recessions in the 1980s and 1990s explain why investment and savings rates are exceedingly low for the Philippines compared with those of its more successful East Asian neighbors.

4. Political economy and all that

The paradox of the lack of success in the Philippine’s economic development, despite two decades of structural adjustment and economic reform, is normally resolved by pointing to obstacles arising from “political economy.” The Philippines is seen as a “soft

state” that is unable to resist demands from particular business interests and thus fails to undertake economic reform in a comprehensive fashion (see Fabella 2000). Shortfalls in the reform process are thought to explain the country’s lack of success in overcoming its foreign-exchange constraint.

Discussions of more effective forms of industrial policy or development policy beyond deregulation and liberalization are rare in the professional literature, and references to this literature are couched in terms of the inappropriateness of such a strategy being undertaken by a state captured by private interests (see Bautista and Tecson 2001). Philippine thinking on economic development remains relatively unscathed by ideas of increasing returns, or “new trade economics” and its subsequent elaboration in the field of industrial organization. Industrial policy might work in Korea or Taiwan Province of China, but would be inappropriate in the Philippines, according to this line of argument.

It is also often surmised that better income distribution can lead to support for better remedies, such as avoiding real exchange rate appreciation during an import liberalization program. Conceptually, is it possible to properly define “better policies” independently of the social capacity of the state, the capacity and nature of the economy’s private sector (on whose response the current development strategy hinges), and the external political and economic constraints facing the country? If the Philippine state is too “soft” to resist special interests, is it then necessarily strong enough to liberalize in the proper sequence and without exchange rate appreciation? Can the private sector, whether domestic or foreign, be relied upon to respond to the “right prices” and, without subsidies and government assistance, to serve as the key actor of Philippine development?

Our alternative first-order explanation relies on the depth of the 1983–85 crisis (worsened as it was by the policy response at the time) and the increased frequency of macroeconomic crises that followed it. The state intervention (soft state) hypothesis is at best a distraction, and, at worse, inimical to the search for more sensible and politically feasible policies to improve Philippine development. This approach regards liberalization and deregulation as the single answer, which means it has inaccurately defined or unduly redefined the problem. Instead, we believe that the liberalization effort played a part in worsening macroeconomic imbalances and exacerbating investor uncertainty, and that more attention should be placed on macroeconomic constraints. Although a liberalized economy is extremely desirable for efficiency reasons, steady growth and investment need to be addressed first, and this requires an understanding of the role and the responsibilities of the state.

Since the late 1950s, state intervention and liberalization have been issues of political debate in the Philippines and have also been the most popularly understood explanations of Philippine macroeconomic crises. This has made it easier for successive Philippine governments to adopt Washington-consensus approaches to market liberalization, even though, as in other countries, actual implementation has been incomplete. At the level of rhetoric, these approaches to liberalization have also proven to be politically convenient because they seem to insinuate that, over the medium term, markets alone will provide the technologies, skills, infrastructure, and governance structures needed for development. The structural regularities behind these crises, for instance, Philippine import dependence and dependence on foreign savings, reflect the lack of backward linkages and the lack of productivity and technological improvements over time.

Stabilization programs primarily have proven to be a set of drastic and temporary demand-reduction strategies and structural adjustment programs, including reductions in quotas, tariffs, and instances of deregulation or privatization. It is the impact of these efforts that is important, such as increases in agricultural productivity (investing in rural infrastructure, and giving proper economic incentives through property rights changes and conglomeration economies), enhanced technological expertise (promoting human capital and skills formation, improving quality of education), and improved industrial infrastructure (building railway lines, shipping centers, harbors, airports, etc.). All these measures were not linked to macroeconomic development strategies, and therefore were haphazardly implemented.

Providing skills and technologies often requires picking winners, particularly among products with clearly identifiable overseas markets (call these “exports”). Identifying the skills and technologies needed in the information technology sector, or in jewelry design, or for electronics production, are some examples of focusing on markets that can ease the foreign-exchange constraint and improve the structural coefficients of the foreign-exchange constrained model. Traditional economists and international public bureaucrats from the donor community have almost always looked upon such proposals as incitements to commit a mortal sin.

In addition, economic confidence is a very important variable that may be critical for strong social institutions and governance structures. The East Asian “miracle” economies have been examples of confidence-building growth and economic development. Only a

few periods of extended economic growth in the Philippines have been characterized by strong confidence and perceived effectiveness in governance.

Managing conflict and building social cohesion have not been strong points of Philippine governments,⁷ which is why every crisis is accompanied by political infighting, discontinuity in policies, a lack of social consensus, and often a breakdown in the rule of law. Building strong markets also requires strong social institutions and governance, including good judicial and law enforcement structures and effective regulatory bodies, particularly as the international community is now more aware of market failures, moral hazard, and asymmetric information.

Recent theories that associate market failure with principal-agent incentive problems propose first- and second-best solutions to these. These considerations, however, do not identify who is going to implement these solutions, what institutions, coordination, and consistency of policies are needed, and how to get social cohesion and consensus with respect to the solutions and among its implementers. These are macroeconomic problems of immense proportions, which the Philippines must solve to even think of catching up with its neighbors.

The pivotal external debt episode of the mid-1980s illustrates these simple-minded considerations. Economic logic dictates that the uncertainty over the costs of debt service, coupled with the high interest rate regime, will induce uncertainty over asset values,

⁷ In the period before 1992, when U.S. military facilities were based in the Philippines, these tasks had been complicated by the role of the U.S. as an actor in domestic politics.

balance sheet values, and the rate of return on productive assets. The macroeconomic stance of servicing the debt undermined the will to invest and to maintain productive assets. The uncertainty induced by the program to reform the industrial protection regime as part of the crisis response, operating within the same type of political debate as in the late 1950s, also caused an undermining of private investment.

5. On the importance of being sensible

Economists of all persuasions share the view that investment is necessary for growth and structural change. However, the dominant economics paradigm emphasizes a crime-and-punishment⁸ view of economic crises, in contrast to more heterodox approaches that suggest that the impact of economic crises on investment (and perhaps the liberalization process itself) be the subject of analysis. Avoiding or at least moderating crises is in the Keynesian tradition, a tradition which originally had motivated the establishment of the Bretton Woods institutions, based on lessons learned in the 1930s. Beyond this tradition are propositions about the role of government in investment, over and above the role of sustaining effective demand.

The good news is that in late 2001 the Philippine economy is caught in the doldrums for reasons principally related to business confidence; this means that the economy is not

8 One advantage is that the “punitive view” of economic crises has popularized economic policy discussions to the point that those trained in other social sciences are now able to appreciate arguments in favor of market-oriented reform (e.g., see Magno 1996).

running up large external deficits⁹ and heading toward another economic crisis. The bad news is that a more salutary international economy is receding, and the Philippine state has lost most of its tools to intervene in the development process.

Given the apparent failure of the dominant paradigm in a country where data can actually be gathered, Philippine development thinkers ought to seize the opportunity and undertake path-breaking research. The fear is that a reconsideration of the record will only uncover political artifacts not useful for an economics career. We believe, however, there are sufficiently rich analytical tools to make such efforts valuable. An enhanced understanding is needed of the actual impact of crisis management and liberalization policies on private sector behavior, and any crime-and-punishment considerations should be suspended.

While waiting for the results of such research, analysts and policymakers should identify policies that work (i.e., measures that do not undermine growth, demonstrably as opposed to hypothetically secure increases in employment, and enhance business confidence), even if these strategies seem to be more regulatory or interventionist. Such policies would have to be cost-effective and generate foreign exchange because resources in the Philippines are extremely limited, as they were for resource-challenged developing countries in earlier times.

⁹ There has been significant backsliding on fiscal deficits from the near balance achieved immediately before the Asian financial crisis, and this has been implicated in the loss of business confidence.

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