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# The peso appreciation and the sustainability of Philippine growth: need we worry?

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The rapid appreciation of the Philippine peso and the resulting loss of competitiveness militate against long-term "balanced and sustainable growth". A review of history shows that fighting inflation with appreciation of currency "seeds" a financial storm. In contrast, the undervaluation of the domestic currency has been shown to robustly improve economic growth in less developed countries like the Philippines. The government, however, need not embark on an aggressive depreciation of the peso but rather on keeping the exchange rate between Php 42 and Php 43 to a dollar for the next five years. This will likely raise further the foreign exchange reserves now at record levels. In order to achieve sustainable growth, the government has to craft an "exit strategy" from the remittance-driven economy by deploying the remitted OFW money to build first-class infrastructure. This can be done by selling infrastructure bonds to the Bangko Sentral ng Pilipinas, which create further demand for dollars and ease the pressure for appreciation coming from the continuing forex inflows.

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## 1. Introduction

As a lifelong observer of the Philippine development story, I have noted one lesson that stands out among all others: underdevelopment is not a story about the dearth of resources but about blown opportunities. William

Shakespeare, in *Julius Caesar*, gave perhaps the most eloquent rendition of the genesis of underdevelopment:

> There is a tide in the affairs of men that taken at a flood leads on to fortune: omitted, all the voyages of their life are mired in the shallows and in miseries.

The Philippines missed the tsunami of Japanese direct foreign investment in the second half of the 1980s because we could not get our political act together. The monumental collapse of the Marcos project in the early '80s was preceded by a flood of borrowed petrodollars for which we inherited nary but a slew of white elephants and bankrupt state banks. The ready availability of forest and extractive resources allowed the perpetuation of the increasingly unviable beauty parlor industries in the '50s and '60s. We have not yet stopped counting the cost to the nation of the Ninoy Aquino International Airport (NAIA) Terminal 3 fiasco! It is scary how, as a nation, we have managed to transform the opportunities embedded in available resources into a litany of "miseries". This, it seems, is bigger than Dutch Disease.

There is, as we speak, a spectacle rising up along Commonwealth Avenue in Quezon City that will buoy you up as it does me every morning I pass by. The Ayala Land–University of the Philippines Science and Technology Park stands as a cornerstone of the future we all wish for this country—global in outlook, high technology at its core, unfazed by competition. It will be a dollar earner for the country—a rare example of seizing the day. But alas, even before the first locator has moved in, its potential revenue in peso terms has already been slashed by 19 percent in 2007 alone! This, in my humble opinion, is unconscionable, even given the general weakness of the dollar.

Are we on the verge of blowing yet another great opportunity?

A question naturally suggests itself to dismal scientists: is current growth sustainable? The devil, they say, is in the details, and there are others; the detail that bugs us most is the rapid appreciation of the Philippine peso. What, if any, is this bug's message?

Allow a bit of history to deconstruct the message.

## 2. A bit of history

"Roaring" was also how the Philippine economy was described in 1996. Boosters were then claiming "tiger cub" status for the country. Malacañang and the Bangko Sentral ng Pilipinas (BSP) were singing paeans to peso appreciation (from Php 27 to Php 24 to a US dollar), the resulting retreat of inflation, and fiscal savings from reduced debt service. The devastating "power crisis" was all but a memory, thanks to the aggressive independent power producer build-operate-transfer (IPP-BOT) approach. Portfolio investment brokers were then applauding and deviously talking the peso even higher. "We are awash with dollars" was the BSP spokesperson's repeated refrain. Exporters who groaned under the burden were dismissed as perennial whiners. Punters in the stock market were making money hand over fist! Real estate was white-hot, and early birds were catching beakfuls of worms.

Talk of a possible "economic bubble" was dismissed as myopic and backward-looking prattle. It's different this time, we were assured: We have entered a "new economy". Is not the private sector bringing in the dollars? Is not the private sector incurring foreign borrowing? Indeed, it was different from the recent past when dollar inflows had to be greased with sovereign guarantees. "Prophets of boom" abounded and could be counted upon to salve lingering doubts.

In the annual economic summit of the first quarter of 1994, a small group of doubting Thomases largely identified with the University of the Philippines School of Economics, proposed an aggressive exchange rate adjustment to Php 35 from Php 25 to a dollar. Then Senate president Angara bannered it in the morning plenary session. Thunderbolts of scorn greeted the proposal. Malacañang and the BSP hissed at the thought. "Over my dead body", the BSP governor then was overheard to have boasted. It was a resounding victory for the strong-peso worldview.

Two more years of irrational exuberance, fueled additionally by a frenzy of foreign borrowing by local banks (and no doubt comforted by the BSP's overt embrace of the appreciating peso), appeared to confirm the yea-sayers. Then, the bottom fell out of the economy! The BSP had won the battle of the exchange rate—but only over the carcass of the Philippine economy. Pyrrhus would have loved the company.

The Asian crisis that followed was brutal but eminently avoidable. History had not been stingy with red flags. For one, there was the *Mexican tequila hangover*. The Mexican crisis that reared its head in late 1993 and exploded in 1994 should have been viewed as a shot across the bow by Philippine policymakers in the first quarter of 1994. Recall: the spike in the world oil prices at the end of the '80s had given the Mexican economy its first shot of adrenalin. When this was followed by the good news of the North American Free Trade Agreement (NAFTA), the stampede to get a piece of the Mexican action ensued. The Mexican authorities, tipsy with *maquiladora* success, rapidly laid open the capital account and, in their desire to stem inflation and encourage further foreign investment inflows, allowed the Mexican peso to appreciate rapidly (they had a floating-band exchange rate system). The implied Mexican peso overvaluation jumped from 15 percent to 30 percent between 1992 and 1994. But inflation fell from 18 percent to 7 percent in those years. Mexico experienced the highest GDP growth in 1994, accompanied by a rare fiscal surplus and record-level forex reserves. *Perfumados* (the derogatory hindsight-enabled moniker for the upper-class Ivy League-educated architects of the post debt-crisis *resorgimiento* founded on capital account liberalization and a floating exchange rate) were wined and dined on Wall Street by the leading investment houses. One of them was accorded the "Alumnus of the Year" award by Yale University.

In 1994, it all came crashing down. It did not matter that oil revenues—unlike portfolio flows—were not about to cease (although oil prices did soften toward the mid-'90s). The initial appreciation seeded an appreciation expectation that triggered a tsunami of fly-by-night carpetbaggers, further fueling appreciation. The Mexican tequila hangover thus entered the lexicon of development studies in 1994. The earlier-mentioned Yale awardee was placed under house arrest!

The Mexican tequila hangover was a lesson that was hotly debated, duly noted, and like the doubting Thomases, ultimately ignored by the powers in the mid-'90s. Why? Monetary and fiscal authorities were too captivated by the new and pleasantly unfamiliar "darling status" of the country, thanks to the aggressive capital-account liberalization. The magazine *Money* gave the finance secretary the "Man of the Year Award". In the contest for portfolio investment, we had turned eyes in the eyes of the judges, as one observer noted, by "raising our hemline".

Not long after the Asian crisis, the global economy was rocked by another crisis: the collapse of the Argentine economy in 2002. A spell before that, Argentina, in an attempt to exorcise its inflationary demons, drastically revalued the Argentine peso to a one-to-one exchange with the dollar. The result was one massive overvaluation of the Argentine peso, delivering a crushing blow to Argentine manufacturing. Jobs in the Argentine traded-goods sector quickly relocated to friendlier climes. But economic growth seemed to be on the march and inflation was tamed—so who cared?

To finance this exuberant fiesta, Argentina resorted to massive foreign borrowing. The strategy of fighting inflation by currency appreciation was celebrated for a while as the new wave of the future. As they did in Mexico, foreign banks would come knocking. Banco Santander of Spain led the charge, and others followed. In time, however, the binge stopped and the economy hit the wall of the Argentine crisis.

The painful but oft-ignored lessons of catch-up in economic history are the following: (1) fighting inflation by currency appreciation does not by itself bring about a financial storm; rather, it "seeds" that storm and whether the storm materializes or not depends on other ingredients; (2) raising red flags after the storm has gathered steam is too late; (3) sentiments change very quickly and, in a culture of very short time horizons and quick profit, the other ingredients—for example, cheap credit—can easily be rationalized. Even the dour and understated Ben Bernanke claimed in 2005 that the housing frenzy was just a reflection not of a bubble but of "the depth and sophistication of the country's financial markets". A few catchy phrases ("reverse redlining" or "structured investment vehicle") clinched the day for complacency and what we now know as the "subprime lending crisis".

## 3. A different reading of the history

That the Philippines and a few Asian neighbors failed to heed the writing on the Mexican wall in 1994 may just reflect the (Will and Ariel) *Durant rule*: "History teaches, but man never learns!" The exception to that rule has been China. China devalued the yuan by 40 percent in January 1994 and stayed with the old-fangled regime of fixed exchange rates and capital controls to maintain an undervalued yuan. That effectively burned portfolio investors and cooled off the then-simmering asset-price bubble. That set of policies, known otherwise as the "East Asian model" and declared dead and buried by the brain trusts of Western banks, effectively kept the Mundell-Fleming "Unholy Trinity" from making a beachhead and saved China from the Asian crisis contagion.

But does one swallow make a summer?

China is hardly a lone swallow in Capistrano. It had not been breaking new ground; it was and is still today following closely in the footsteps of Japan before the Plaza-Louvre accords and of the East Asian miracle economies before they fell under the spell of mobile capital in the 1990s. It was by then also lost on no one that the Plaza-Louvre accords-initiated rapid appreciation of the Japanese yen in concert with "easy money policy", triggered the Japanese bubble economy of the late '80s and the decade-long Japanese recession in its wake. This was a powerful object lesson that China learned but we still have to learn.

A weak yen remains, to this day, the anchor of China's monetary posture and the most contentious issue in the world financial architecture before the subprime crisis. Despite immense pressure from the West and other trading partners (with Japan being the latest to register its discomfiture), a 7 percent appreciation was all China would grudgingly allow in 2007. China is doing everything *except* comply with the West's demand for rapid appreciation: voluntary export restraints, well-timed shopping sprees for Boeing Jumbos, financing the trade deficits of partners, etc. True to its East Asian roots, China refuses to sacrifice the future for present gratification. That is standing the Durant Rule on its head. The contrast with the Philippines cannot be starker.

## 4. The Philippines in 2008

"We are awash with dollars," says the BSP yet again, as it did in 1995. And again we are reassured, it will be different this time around. To be sure, there *are* obvious differences. The fiscal picture is better. The inflation picture is better. The balance of payments picture is encouraging. The BSP, since 2002, has embarked on a new monetary policy modality called "inflation targeting" (IT). Dollar inflows today consist much less of foreign borrowing and portfolio flow than in Argentina and the Philippines in the '90s. Rather, they consist predominantly of overseas Filipino workers' (OFW) remittances, which won't hotfoot on you even if you treat it shabbily. But in one fundamental aspect, nothing has changed.

The community of dollar earners is once again getting a "scourging at the pillar". Millions of OFWs and their families, whose sweat and tears form the very wellspring of current prosperity, are being treated as doormats. The tradeable sector is experiencing an output shock. Seventy-five small and medium firms had folded up in 2007. Toshiba's laptop unit has seen the light and has wisely migrated to friendlier climes. Jobs are being lost. Intel's well-reported agony over whether or not to ramp down its local chip production in favor of China is publicly charged to very high power cost but no one would be surprised if the 19 percent appreciation was the backbreaker. The brightest star in our economic horizon and a possible cornerstone of an *exit strategy* from the dependence on OFW remittance, the business process outsourcing (BPO) industry, is being blindsided. Tourism, another promising cog in this exit project, is being pounded.

The Filipino nation benefits mightily from the OFW remittance and export earnings *even* without appreciation. Having the wherewithal to import allows the nation to benefit from the dis-inflationary *China effect* and *Silicon Valley effect* on prices. This is how we share in productivity gains elsewhere in the world. Likewise, it allows the public and private sectors to borrow dollars at a lower interest premium than otherwise. OFW dollars have a "public good" dimension. That is why we sometimes refer to OFWs as "heroes". For that reason alone, dollar earners deserve a subsidy, not a penalty. That is why the doubt lingers. But the economy, as the government claims, is hurtling along (7.2 percent GNP growth in 2007)—so who cares?

We have obviously seen this all before. The arguments for appreciation coming from the BSP and Malacañang echo those of 1996 (more on this below). Is this a case of: *Plus c'est la meme chose?* Again the BSP argues: "Exporters and families of overseas Filipinos have suffered but everyone else benefited" [*Business World*, 5 February 2007]. Sounds too much like the high priest Caiaphas declaring the "expediency" of *one man* dying for the rest of the nation!

## 5. The Latin American syndrome

The peso appreciation would be less of a threat if it were just an isolated happenstance rather than the tip of an iceberg: a worldview that we refer to as the "Latin American syndrome" (LAS). LAS is rooted in the idea that a strong currency is the proper gauge of a strong economy. That it was conveniently congruent with extended vacations in Rome and Paris favored by the *latifunderos* of Latin America, was, one suspects, not just a pleasant afterthought. A strong currency results in cheap imports, cheap foreign travel, and unprofitable exports. Why produce when you can consume on the cheap today? LAS is a "celebration of today". It is more than the prosaic "Dutch disease" because it involves a romance with strong currency. The peso appreciation must be viewed with apprehension as a possible manifestation of LAS.

The East Asian way, by contrast, is "a celebration of the future"; it is about postponed gratification and capability building to empower the morrow. It is less about us as it is about our children. It is about giving a man a hook and a line so he will eat the rest of his life. That is mainland China today.

## 6. In lieu of frittering away our arsenal

If we have any East Asian wits about us at all, we should be using the OFW bonanza to craft and finance an "exit strategy" from the "remittance-driven economy" (see de Dios, Fabella and Medalla [2007]). The remittance-dependent economy is largely still based on the low cost of labor. In other words, it is partly a "poverty-driven" phenomenon. An exit program should involve deploying the OFW remittance bonanza to close the gaping 20-year infrastructure hole (witness the shame of our international gateway, NAIA, being downgraded by the US Federal Aviation Administration [FAA] for substandard facilities). That is this generation's overarching responsibility. This will then progressively reduce, via investment and employment creation, the economy's dependence on exports of low-skilled workers. South Korea progressively reduced its dependence on foreign aid and workers' remittances by building first-class infrastructure. Closing the infrastructure gap is the true measure of long-term sustainable growth, and by this metric the Philippines has failed and continues to fail. Giving away our meager advantages is a prescription for "sustainable poverty", not for sustainable growth.

## 7. Where do we go from here?: a modest proposal

Reckless though the appreciation of the past three years has been, it would be equally reckless to try to recover lost ground in the next three. A more realistic goal is the following: Aim for at most a *6 percent per year average appreciation* for the period 2007-2010 by allowing *at most 2 percent appreciation per year for the next three years*. This would allow us to recover ground lost to our competitors by 2010 (granting that they continue their usual 10 percent appreciation trajectory).

Since the recession in the USA and a slowdown in the European Union are now near-certainties, the demand-pull pressure on oil prices will surely ease. The upward pressure on the price of staples, however, will linger for a while longer, perhaps peaking in 2008. But on the whole, the inflation outlook for the next three years appears promising in that it should allow more attention to be paid to output growth and the exchange rate. The credit squeeze will also result in less inward traffic of portfolio flows. Bearish prospects in the Organisation for Economic Co-operation and Development (OECD) and in the Organization of the Petroleum Exporting Countries (OPEC) countries will combine to slow down hiring and remittances. The goal of at most 2 percent appreciation per year till 2010 appears doable. Indeed, the peso has in the last few weeks begun to reverse course to reflect global turmoil and uncertainty. However, it is not wise to leave our fate to the vagaries of the global market. We must do much better in the following areas:

*a) Customization and flexibility*

The enabling law (RA 7653) of the BSP enjoins it "to promote price stability conducive to balanced and sustainable growth". Price stability for its own sake is not the sense of RA 7653. Our contention is that rapid appreciation and the resulting loss of competitiveness militate against long-term "balanced and sustainable growth". Its negative impact on tradeables, employment, and output; its stoking of appreciation expectations; and its seeding of potential asset-price bubbles are like plaque building up in the economy's arteries. Warning signals tend to be ignored until it's too late. The inflation-targeting policy posture adopted by the BSP since 2002 has enough flexibility to accommodate other—if soft—goals or what Bernanke and Mishkin [1997] called "constrained discretion". In the more volatile environment of catch-up economies, one cannot afford to indulge in what Bank of England (BOE) Governor Mervyn King calls "inflation nutting" (i.e., the catatonic subservience of central banks to consumer price index [CPI] numbers). In their authoritative study of inflation-targeting experience in the last decade and a half, Roger and Stone [2005] batted forcefully for "customization": the choice of inflation targeting must be informed by local circumstances, especially vulnerability to exchange rate shocks. Such vulnerability is precisely the fate of a remittance-driven economy.

*b) Rhetoric of endearment*

It is generally accepted that the portfolio flows in first semester of 2007 boosted the pressure for appreciation. Portfolio flows are driven by arbitrage expectations, which in turn hang partly on the rhetoric of the monetary authority. And peso appreciation is, more often than not, accorded a "rhetoric of endearment" by the BSP: it typically defends the peso appreciation as benefiting the nation, even as it insists that it is doing everything to stem the appreciation. The impression it gives is that its heart is really for appreciation. The signal to portfolio managers is "The downside risk to arbitrage-seeking placements is zero". No purpose is served by this apparent inconsistency between rhetoric and action. Credibility would be better served by the "rhetoric of discomfort": by recognizing that appreciation is *not* conducive to sustainable growth.

### *c) Rereading the evidence*

(a) When BSP spokespersons defend the appreciation by claiming that it is governance that matters for competitiveness and not the exchange rate, they misread the "institutions-matter" orthodoxy and buy into a very limited if spicy *Easterly mantra* that "policies do not matter". Indeed, governance does matter most, but if you do not have it, you can still use changes in policy to reduce the ravages of the lack of governance. This is the interpretation Rodrik [2007] prefers for the increasing raft of evidence that "undervaluation of the currency" robustly improves economic growth of least developed countries (LDCs) (Bhalla [2007]; Easterly [2005]; Johnson, Ostry, and Subramanian [2007]; Rodrik and Rigodon [2005]). Weak governance is the fate of most LDCs and its downsides are most felt in the more competitive traded goods sector, which is why undervaluation is what he calls a "second best" solution. In this view, the country with the highest cost of power (e.g., the Philippines) should have the weakest currency. We did the very opposite in 2007.

(b) When the BSP spokespersons defend the appreciation for its disinflationary and therefore poverty-reducing effects, they need to specify exactly what inflation level is poverty reducing. Some inflation may actually be beneficial for development and growth [Barro [1995]; Judson and Orphanides [1998]; Khan and Senhadji [2000]). Our own research shows the poverty-reducing inflationary level to be anywhere between 5 percent and 10 percent [Fabella and Fabella 2007].

### *d) Demand and supply of dollars*

(a) *Borrowing mix*. Consistent with the rhetoric of discomfort is a more aggressive borrowing mix in favor of pesos. The government can and should announce a borrowing mix of 95-5: only 5 percent borrowing is to be sourced from abroad and only to provide the benchmark for *private* foreign borrowing. The decision of the Department of Finance to lower its first dollar bond issuance of the year by half is a good start for reducing the supply of dollars. But a consistent follow-through is called for.

(b) *Foreign debt pre-payment*. While this is already being done, it should be pursued with greater urgency and purpose. Government should buy dollars locally to finance the retirement of its dollar debt.

## 8. Summary

While the prospect of another drastic stumble remains remote for now, its seeds may already have been sown by the rapid peso appreciation. Although more distant than in 1996, we do not know when and how the enemy will strike. In the near-term it may manifest itself simply as foregone growth in output and employment. As it is, the turmoil in the world economy is creating a minefield of dangerous possibilities. Prudence dictates that we resupply rather than fritter away our meager arsenal. Andy Grove's well-known advice to firms in the market ("Only the paranoid survive") also applies to economies afloat in the high seas of globalization.

If we must summarize the message from the appreciation bug, it is this: *Cuidao!*

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