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The Economic Choices We Face

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Abstract

We examine the three options at the policymakers' disposal to pull the Philippine economy out of the currency crisis and propel it to a sustainable growth orbit: the BSP option, the incentives restructuring option, and the protectionist option. In a situation of financial panic and the resulting liquidity crunch, the BSP option is hastening a recession while the protectionist option will sacrifice the future for the present. The incentives restructuring option seeks to nurture the gains already paid for before and during the crisis in the interest of quick recovery and future growth.

I. The Problem

1. The Philippine peso has lost 40% of its value in dollar terms ($0.037 in June 1997 and $0.022 on January 14, 1998). Per capita income today is $750, exactly where it was 6 years ago when Pres. Ramos came to power.
2. The Philippine polity is faced with severe financial uncertainty and racked with a mounting "crisis of confidence" which has virtually frozen economic activity.
3. The prime lending rate is upwards of 25% and firms are postponing planned projects, abandoning ongoing projects, retrenching, dehiring or closing down even as we are endlessly bombarded by the mantra of "sound economic fundamentals" and "short-term measures."
4. Households anticipating a rough near-term are still poised to hoard both pesos and dollars at the first sign of trouble even as firms in an attempt to become liquid in preparation for the same turbulence are forced to maintain or even lower some prices.

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5. Exporters are reluctant to convert their dollar earnings into pesos in the fear that dollar needs in the near future will go unmet or met at very high cost.
6. Firms and banks that incurred heavy and unhedged dollar exposures on the strength of BSP assurance on the exchange rate (ER) have scampered to convert dollar liabilities into peso liabilities bidding the dollar price higher in the spot market.
7. OCWs in East Asia stand to be repatriated in increasing numbers in 1998 reducing the flow of OCW remittance -- the lifeblood of the economy and threatening a higher current account deficit.
8. The market in 1997 has virtually ignored all attempts by the BSP to put a lid on the peso's downward spiral overwhelming BSP-inspired psychological barriers (P30, P35, P40). In a state of panic, the rules of the game are different.
9. The market has also ignored a number of encouraging news: a) inflation remains single-digit partly due to the considerable openness of the economy and the considerable devaluation in some source countries (Japan, Malaysia, Indonesia, Taiwan, and S. Korea), b) the bulk of labor and labor unions have opted for moderation and employment maintenance (e.g., the P16 wage suggested wage adjustment for Metro Manila), c) export revenues continue to grow at a healthy pace although it is increasingly threatened by the high interest rate and is concentrated on fewer and fewer goods, d) the current account deficit is falling as imports tumble.
10. "El Niño" is compounding the problem by threatening agricultural production especially of staples which will need dollars to replenish.
11. With GDP growth in 1998 feared to hover around 2.0% if not lower, the Philippines is now in a recession mode.

II. The Sense of Malaise

A. Economic Relations under Panic

The Philippine economy is in the grip of panic. In a state of panic, well-known textbook economic relationships appear suspended. Increments in the interest rate fail to halt the upward march of the exchange rate. Neither does a falling current account deficit. In the face of large unpredictable swings in either direction, calibrated countermeasures are irrelevant. The Bank of England observed correctly during the September 1992 ERM crisis that higher interest rates no longer made an impression on the pace of the exchange rate. Wisely, it let go and cleanly. The British economy, absent the burden of costly liquidity, recovered from the clean price shock with dispatch and vengeance.

Economic decision makers begin to behave differently in the confusion. Instead of closely following the evolving fundamentals, they begin to closely watch other decision makers who themselves are watching still other decision makers whose actions they assume are motivated by access to more solid information they do not have. Keynes' description of the situation is peerless: "We have reached the third degree where we devote our intelligence to anticipating what average person expects the average opinion to be." (quoted in *Business Week*, November 17, 1997) This is a perfect brew for a self-feeding downward spiral when every bad news is a disaster and every good news is a smokescreen for bad.

At the heart of this panic is *first* the precipitous fall in the value of the peso and *second* the uncertainty about where it will eventually settle. Each taken by itself is bad enough but the two together is paralyzing. One must, therefore, make the distinction. A once and for all drop in the value of the peso of 40% requires a lot of painful adjustment. But this adjustment can start immediately and the pain though real is calculable. One can, for example, bring monetary instruments to levels consistent growth. Such was the 40% Chinese devaluation on 1 January 1994. Such as well was the 20% depreciation of the British pound in September 1992. A 40% fall to a wobbly level encourages wait-and-see, prolongs the sense of malaise and geometrically raises the cost of the crisis. Monetary policy, when employed to husband the ER, becomes a hostage and cannot begin to target other goals.

Where the ER settles determines the level of price adjustments to be made and the extent of normally adverse social response. The social adversity will itself contribute to the general sense of malaise. Two concurrent factors will soften the adverse social response to the currency collapse. One, the currency crisis is regional and plenty of company is an excellent social shock absorber. Second, we are facing a presidential election which, in the grand Jeffersonian tradition, always acts as a social depressurizer.

Where the ER settles also determines the fate of an influential segment of the economy--the private companies and banks that borrowed dollars heavily in the last three years. Some of these may, at current ER, be already virtually bankrupt and are pinning their survival hopes on where the BSP will force the ER to settle. In an attempt to avoid paying even higher for future dollars, they bid up the dollar price now.

B. The Liquidity Crunch

Meanwhile the fear of impending bad times is inducing households and firms to becom and stay liquid. They hoard pesos, dollars and what-not, postponing purchases with the excuse "Sumasama ang timpla ng panahon." Legitimate businesses can pry credit from banks only a suicidal rates. Banks fearing a rise in bad loans and in need of liquidity for loan loss reserve and anticipating increased reserve requirements of BSP are prying pesos from households a suicidal rates. The BSP in pursuit of the galloping ER maintains a tight monetary policy in keeping with the ceilings committed to the IMF which the BSP believes it cannot afford to defy in view of the 3 billion dollars IMF standby credit and the "exit" good marks it needs. This is the face of the liquidity crunch.

The challenge at hand is a) to break the liquidity crunch for legitimate business before it breaks the economy, b) to attain stability soonest in a way that facilitates future rapid growth, i.e., without throwing the baby out with the bathwater.

III. The Options

Option 1: BSP Strategy

The BSP's strategy has been to fashion a floor on the value of peso by a combination of tight monetary policy via increased required reserves and higher OBRs, spot sale of dollar from its forex reserves, selling of covered forward dollars, strict adherence to the IMF conditionalities, the IMF standby credit of $3 billion, and a continuous babble of idle talk.

While some monetary tightening is healthy in order to convert the nominal devaluation into a real devaluation, this is not an excuse for strangling the economy to death by prohibitive access to liquidity. There are, in fact, two types of monetary tightening: one that softens the inflationary pressure but allows growth in output -- prime interest rate in the teens, and another that forces the economy to shrink to accommodate a national ER. The term "interest rate cure" which was coined in 1985 by UPSE faculty to describe the ravages of the "Jobo Bills," applies to the latter type of monetary policy. This is the phrase that still aptly describes the BSP's monetary policy. At 25% interest or over, if you can get credit at all, only drug pushers and jueteng lords will make any money. The BSP for a while floated the idea of reviving the "Jobo Bills" which shows its predilection for interest rate cure. It was the "Jobo Bills" that killed the Philippine economy in 1984-85. We literally threw the baby out with the bathwater. Although the polity rejected the "Jobo Bills" overture this time, the tendencies of the BSP is shown very clearly. Old dogs hue closely to old tricks. The prohibitive cost of liquidity is doing the same thing in 1998.

Drawing down of forex reserves for spotsales to influence the ER level is not sensible. The BSP should shore up its reserves where dollars have a more calming effect than when sold in the market. The BSP must be buying dollars! All other measures to raise supply of $ (IMF standby credit) and lower spot demand (selling covered forward dollars) are commendable.

The interest rate cure component of the BSP option is the most insidious. Because the BSP persists in containing the peso plunge via tight money, it in effect forces the whole economy to absorb any shock that comes from outside the country. The series of bad news from the outside (Thailand, Indonesia, Malaysia, S. Korea) rattles the foreign exchange market pushing the ER higher. By itself, this generates a "price shock" entailing changes in absolute and relative prices. Some industries suffer; others benefit and, if stabilized, will begin to rechannel investment toward the benefited activities. If the interest rate, however, pursues the ER to prohibitive levels, no sector will benefit. The "interest rate cure" does not distinguish between good and bad firms. The domestic real sector and employment become the shock absorber of outside disturbances. We stand to squander all the pain and the encouraging news that has come our way so far.

But the "interest rate cure" is destabilizing in another way. It introduces additional uncertainty into a confused market. The series of BSP-inspired notional Maginot lines for the ER collapsed in disgrace. Some people are still awaiting the promised resignations. Everyone is guessing whether the BSP is bent on forcing the ER back to pre-crisis level, an exercise which by our experience with "Jobo Bills" in 1984-85, will kill the economy. The floating of the idea by the BSP was extremely destabilizing. If the near-term augurs a dead economy, everyone will freeze -- no investments, unbounded liquidity preference (to take advantage of the "Jobo Bills" money machines as in 1985 when liquid banks became very rich on 40% interest rate even as the economy lay wasted), halted projects, etc. The latest destabilizing babble came from the BSP governor as late as January 15, 1998 who made an idle speculation on the value of the peso. This is no way for the BSP head, who has the power to employ "Jobo Bills," to behave. The BSP leadership seems to be already part of the problem and some people would argue that changes here will improve credibility and go some ways to calm the market.

Option 2: The Incentive Restructuring Strategy

The option we consider next is an attempt to turn the current crisis into a long term opportunity. This involves a recasting of the "incentive structure." At the heart of the Asean currency crisis is the wrong "incentive structure" channeling too much resources in the wrong places.

The Asean currency crisis can be viewed as a market-induced incentive restructuring program (IRP) which radically recasts the system of incentive away from an unsustainable bias for nontraded goods (property, real estate, banking, stocks, trading) towards the eroding traded goods sector (manufacturing, both export- and domestic-oriented). The breakneck speed of the liberalization of capital account together with the internationalization of fund management shows up this bias in painful relief. The pre-July 11 1997 incentive structure enshrined capital gains and foreign inflows (portfolio and borrowing), as the main source of wealth. By contrast, manufacturing, especially domestic manufacturing, was eroding because traded goods prices were too low relative to nontraded goods prices. Put another way, the peso was too strong having appreciated 40% since 1990. This is the classical "cheap dollar" strategy with manufacturing companies moving out of manufacturing into quick money businesses. The public was soaking up on imports (cars, aircons, french wines) which were "too cheap." The pre-July 11 situation was not sustainable as trade and current account deficits mounted (although the BSP persistently swore by a current account deficit of 4.3% of GNP, it has now recanted reports a deficit of 6.3% of GNP after persistent sniping from critics who are regularly subjected to vicious name-calling in the press.). Red flags were raised but the authorities preferred the soothing reassurances of vestedly interested portfolio managers. The latter promptly packed their bags at the first snuff of danger and were promptly castigated as insidious speculators. The regional currency crisis only hastened what monetary and political authorities opted by default to postpone into the future.

Every true industrial restructuring involves fundamental changes in the incentive structure and this entails real pain. The peso collapse is an occasion for incentives restructuring. We call this "price shock-mediated incentives restructuring program." The IRP of the peso depreciation involves putting the whole nontraded goods sector in a temporary squeeze since its dollar-associated costs rise while its revenues lag. It also puts pressure on domestic market-oriented firms, whose imported input cost rise to transform themselves into dollar earners. The IRP involves a breakout from our age-old and costly liaison with "cheap dollar." While some sectors suffer, some other sectors will grow with the abandoning of "cheap dollar.' It is the silver lining in the currency crisis.

The IRP option recognizes that there is a segment in the economy that has grossly been neglected by the "cheap dollar policy." This segment should be allowed room to grow. But the "interest rate cure" of the BSP ends up killing all economic activity, efficient or otherwise. The tack of IRP is to rechannel resources and investment towards manufacturing and exports. The interest-rate-cure simply blocks all channels. Thus, the IRP option consists of the following:

(i) monetary policy must be completely disengaged from the exchange rate, i.e., the classic float so that the peso seeks its true level after some overshooting. This makes us a "true float" for the duration of the crisis. The exchange rate in effect becomes the true absorber of shocks coming from the outside (say a Chinese devaluation or a Brazilian crisis) and frees monetary policy for pursuing domestic goals such as breaking the liquidity crunch. In a world of large external shocks, a true float insulates the domestic economy from considerable unpredictability. If, as many people believe, the ER is overshooting, the market will eventually pull it down. But it must not be pulled down by a shrinking output as appears now.

(ii) to break the liquidity logjam, monetary policy should aim for prime interest rate in the terms on loans; it must not hesitate to breach IMF ceilings in the pursuit of this. When the economy is going in reverse, and where preference for liquidity is exaggerated, the monetary base ceilings proper for a growing (and overheating) economy do not apply. A larger money supply does not have the same inflationary impact. A prolonged liquidity crunch may itself indeed be inflationary as output falls even faster than demand.

(iii) if the private banks prove poor conduits due to exaggerated liquidity preference, the BSP must open special windows to carry liquidity directly to legitimate business.

(iv) the BSP must stop giving any semblance of defense of the ER and must, instead, raise its forex reserves by open market purchases in anticipation of more normal times. Cozy relationship with entities whose activities the BSP is supposed to monitor does not help BSP credibility.

(v) it must avoid any semblance of trying to bend over backwards for dollar-exposed banks and private companies. It must publicly make it clear that on the principle that private loans are private sector liabilities, the public treasury will not be held hostage to private miscalculation even if such was inspired by wrong monetary policy. Better to be rid of a few bad eggs than to lose the whole house. If the public knows that this is a deliberate BSP strategy, the cost of some bank failures, if it comes to that, will be contained. The BSP will then avoid future moral hazard problems.

(vi) the monetary authority must avoid "idle talk" which eventually has to be swallowed and only contributes to the feeling that it knows no better. It should just say it respects the market.

(vii) with the float in place, the Government should stick to its globalization, deregulation and privatization programs since, in fact, the very link that was missing since 1992 in that program--a proper ER--is now potentially in place.

(viii) the Government should reduce wasteful expenditures but should raise infrastructure investment to keep liquidity flowing and ease unemployment even if this means breaching another IMF conditionality -- fiscal balance. In these extraordinary times, a 2% fiscal deficit directed at infrastructure spending may help close the fiscal gap if economic activity quickens and raise tax revenues. A fiscal surplus that squeezes liquidity further can lead to even lower growth and subsequent fiscal deficits. Current inflationary expectation is dominated by the falling demand and a 2% deficit replaces demand reductions elsewhere (e.g., from OCW remittance shortfall). A programmed reduction of the fiscal gap to 1% in 1999 and zero percent in 2000 can be adopted to husband inflationary expectation.

(ix) the Government should staunchly avoid price repression mechanisms like the suggested new OPSF subsidy, which only postpone coming to grips with the problem and thus prolong the uncertainty. Normality is best served by letting the price shock take its course.

<u>Option 3: The Protectionist/Regulationist Strategy</u>

There is some clamor from segments of manufacturing for more protection from imports to revitalize domestic production. Specifically an import surcharge of 10% has been bruited about. This has the corollary effect, if imports don't fall precipitously, of improving the fiscal picture which in an economic slowdown tends to deteriorate.

The drawbacks of this option are considerable. First, the fall of the peso already accords domestic manufacturing with considerable protection (the so-called "exchange rate protection" except for goods coming from S. Korea, Indonesia and Thailand). What they need is some quickening in the pulse of demand. Second, the experience in 1990-92 with the 7% surcharge was very unfavorable. The combination of oil price hike, devaluation and 7% surcharge brought the economy to its knees (negative growth in '91 and '97). Third, this represents a retreat from the globalization initiatives of the Philippine government and signals a "fair weather liberalizer" image. Fourth, this surcharge waters down the "price shock mediated incentives restructuring effect" of the peso slump, the real beneficial effect of the crisis. Fifth, this surcharge can take on an aura of permanence which is politically difficult to lift. Import controls have also been suggested but these really do not deserve serious consideration in the 90's.

A policy initiative sometimes floated in connection with this is the "fixing of the ER." While the "fixed ER" has its own attraction, a "fixed ER" in a crisis is just wrong. A very important information "the true value of the peso" is lost. For example, when faced by speculative turmoil in 1992, the Bank of England simply floated the erstwhile (ERM) fixed British pound. The second objection is that by its nature a fixed rate entails a hostage monetary policy. When the outside world is itself a hotbed of bad news, a fixed ER means the domestic economy bounces up and down to absorb the shock. A true float insulates the real economy even as it grants monetary independence. When the world calms down, we may consider a managed exchange rate but not now.

Another policy suggestion is the subsidy to OPSF in order to postpone oil price adjustments. This is just price repression which will prolong the uncertainty and the crisis. Taiwan in the 1973 oil crisis simply allowed the price shock to take its full course and contained the effect to one year. Countries that cushioned the price shock stayed in recession much longer.

Conclusion

As painful as the currency crisis is turning out for the Philippine economy, the opportunity it presents is both rare and precious. It gives the Philippines the chance to reconfigure its incentives structure in a way that will transform independence from political aspiration to economic reality. The incentives structure that we never mustered the political will to completely shed off has always celebrated rents and capital gains over value-added, the instant gratification of the present over the more backbreaking constructure of the future. The privatization, deregulation and globalization initiatives or the last ten years, as subversive as they are of the rent-coddling incentives structure, were always blindsided by the "cheap dollar" policy. This protracted march has finally the summit in sight.

The stakes are high. If we succeed in recasting the incentives package with something to spare, i.e., with a respectable growth accompanied by single digit inflation and a current account balance, we will hold pole position in the race for next wave of beneficial direct foreign investments at the turn of the century. Timing is all important now. Getting our house in attractive appointment ahead of the Asian pack will put us where Thailand, Malaysia, and Indonesia were in mid-1980s -- the darlings of foreign investment. More importantly, we will start the next century with our own investment resources deployed productively.

None of the choices we face are painless. For Option 2, the bulk of the cost has been prepaid. We only need to nurture and let grow. But our chances of a quicker turnaround will only suffer with BSP's deployment of monetary firepower to influence the ER. The BSP response is turning the currency crisis into a full blown recession. The protectionist option will poison the waters and signal a lack of backbone which augurs badly for the future.

The window of this rare and precious opportunity is open only momentarily. In this our centennial year, we can confound history and the world by being for once on the opposite side of "an hour late and a dollar short."