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The Peso Appreciation and the Sustainability of Philippine Growth: Need We Worry?

by
Raul V. Fabella*

* Professor, School of Economics
University of the Philippines



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by *Dr. Raul V. Fabella*
UP ECONOMICS PROFESSOR

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by

Raul V. Fabela

School of Economics
University of the Philippines

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. This runs counter to the Development Orthodoxy of the 4 decades after the Second World War: Have capital will travel. 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 NAIA Terminal 3 fiasco! The list is endless. It is scary how as a nation, we have managed to transform the opportunities imbedded in available resources into a litany of “miseries.” This it seems goes deeper 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 tech to the bone, unfazed by competition and ready to pounce on every opportunity. It will be a most congenial home for dollar earners for the country. But alas, even before the first locator has moved in, its potential revenue in peso terms has already been slashed by 19% in 2007 alone! This, in my humble opinion, is immensely discomfitting.

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

The Philippine economy roared in 2007. The 7.2% growth of real GNP is without precedence. There are questions surrounding the quality of that growth and questions surrounding the validity of that growth. The most salient challenge comes from the current rice and staples crisis which contradicts the reported bumper growth in agriculture (5%). Another question naturally suggests itself to dismal scientists: Is current growth sustainable? The devil, they say, is in the details and while 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.

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 BSP were singing paeans to peso-appreciation (from 27 pesos to 24 pesos 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 IPP-BOT approach. Portfolio investment brokers were then applauding and deviously talking the peso even higher. “We are awash with dollars” was the BSP spokesman's repeated refrain. Exporters who groaned under the burden and burned the effigy of the BSP governor in Cebu 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. It’s different this time, we were assured: We have entered a “new economy”: Is it not the private sector bringing in the dollars? Is it 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 UP School of Economics, proposed an aggressive exchange rate adjustment to 35 pesos from 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 lovers.

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 eighties had given the Mexican economy its first shot of adrenalin. When this was followed by the good news of 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% to 30% between 1992 and 1994. But inflation fell from 18% to 7% in those years. Mexico experienced the highest GDP

growth in 1993, accompanied by a rare fiscal surplus and a record level forex reserves. *Los 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 towards 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, 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.

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% 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 braintrusts 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 a summer make?

China is hardly a lone swallow in Capistrano. It was not 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 80’s and the decade-long Japanese recession coming in its wake. This was a powerful object lesson that China took to heart but we still have to learn.

The weak yen remains to this day the anchor of China’s monetary posture and was 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 (Bloomberg News, 24 March 2008)), a 7% 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, it 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.

Some painful but oft-ignored lessons of catch-up in economic history are the following (1) fighting inflation by currency appreciation may not by itself bring about a financial storm; rather it “seeds” that storm making it more likely (whether the storm materializes depends on other ingredients); (2) raising red flags after the storm has gathered steam is too late; (3) sentiments can change very quickly and, in a culture of very short time horizons and quick profit, the other ingredients, e.g., 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 cleared the way for what we now know as the “subprime lending crisis”.

The Philippines in 2008

“We are awash with dollars”, again declares the BSP, as it did in 1996. 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 Targetting” (IT). Dollar inflows today consist much less of foreign borrowing and portfolio flow than in Argentina and the Philippines in the 90’s. Rather they consist predominantly of overseas Filipino workers’ (OFW) remittances, which won’t hotfoot on you even if you treat it shabbily. But it seems there is a fixed point that won’t budge.

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 (75) small and medium firms have folded up last year alone (BW, 2007). Toshiba’s laptop unit has seen the light and has wisely migrated to friendlier

climes. Jobs are being lost. Intel's well reported (e.g., Business World, 4 April 2008) 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% 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. A fifth of the firms in the industry may already have been rendered uncompetitive and a fifth have already postponed or scaled down investment. Tourism, another promising cog in this exit project, is being pounded. We are frittering away our meager supply of advantages.

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% GNP growth in 2007) – so who cares?

We have obviously seen all this 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” (BW, 5 Feb 2007). Sounds too much like the high priest Caiaphas declaring the “expediency” of *one man* dying for the rest of the nation!

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 which we refer to as the “Latin American Syndrome” (LAS). LAS is rooted in the idea that a strong currency is the proper gauge and motive force 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 goes deeper than the prosaic “Dutch Disease” which happens and discomfit the unwary. LAS 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 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.

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 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 penury” not for sustainable growth.

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% per year average appreciation* for the period 2007-2010 by allowing *at most 2% 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% appreciation trajectory). A net depreciation in the next three years is not incompatible with this goal.

Since the recession in the USA and a slowdown in the EU 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 OECD and in the OPEC countries will combine to slow down hiring and remittances. The goal of at most 2% 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:

1. 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 cardiac 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 Mishkin and Bernanke (1997) called “constrained discretion.” In the more volatile environment of catch-up economies, one cannot afford to indulge in what BOE governor Myrvin King calls “inflation nutting” (i.e., the catatonic subservience of central banks to 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.

2. 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.

3. Rereading of the Evidence

(a) When BSP spokesmen 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, it is empty rhetoric to counsel that you should acquire it! But you can 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 LDCs (Bhalla, 2007; Easterly, 2005; Simon, Ostry and Subramanian, 2007; Rodrik and Rigodon, 2005). Weak governance is the fate of most LDCs and its downsides (like the high cost of power and security) are most felt in the traded goods sector which has to compete with the rest of the world. Undervaluation plays the role of 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.

(a) When the BSP spokesmen defend the appreciation for its disinflationary and therefore poverty-reducing effects, it seems obvious. But nothing is that obvious in the real economy. Some inflation may actually be beneficial for development and growth (Barro, 1995; Judson and Orphanides, 1998; Khan and Sendhaji, 2000). Our own research shows that the poverty-reducing inflationary level to be anywhere between 5 and 12% (Fabella and Fabella, 2007).

4. 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 five 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.

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 re-supply 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: *Cuidao!*

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