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Economic Reform and Macroeconomic Stability: A Delicate Balance*

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The Philippines escaped the worst of the Asian crisis. Now it needs to ensure that reforms don't require too many trade-offs

Just five years ago, the World Bank published a book on the phenomenal success of the economies of East Asia. The volume analyzed the various factors that led to sustained economic growth of the so-called High Powered Asian Economies (HPAEs): Japan, Korea, Taiwan, Singapore, Hong Kong, Malaysia, Indonesia and Thailand. Strangely enough, the absence of some of these factors is now cited as the explanation for the financial crisis presently gripping most of these economies. For example, promoting competition, especially through export-oriented policies, was hailed as one of the key ingredients of their rapid growth. Yet lack of competition in the business conglomerates is seen as one of the critical failings; and what were previously viewed as strong financial markets that were able to mobilize huge flows of savings and allocate them efficiently, have transformed into weak financial markets which sparked the economic debacle (Stiglitz 1998). One factor that remains undisputed, however, is macroeconomic stability. Many analysts (e.g., Montes 1997) cite the sound macroeconomic fundamentals in the region as one of the reasons the economies should be able to weather the crisis and also one of the reasons why the extent of the currency depreciations was unwarranted.

The Philippines was pointedly left out of the list of the HPAEs. Its economic performance over the past forty years has been punctuated by boom-bust episodes, effectively removing any semblance of sustainable growth. The incoming president, as a matter of fact, will be in a curiously similar position as his two immediate post-Marcos predecessors: he will be inheriting an economy reeling from a crisis. Macroeconomic stability has always been an elusive goal.

To catch up with its neighbors, the Philippines has implemented a number of structural reforms, especially during the past twelve years. The more optimistic pundits even say that these reforms were the reason why the Philippines was the least affected by the regional financial crisis. While this position may be true to a limited extent, these same reforms have had some adverse effects. The trade-offs involved in the various reform measures should be considered very carefully. These trade-

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offs may be the reason why policy contradictions seemed to exist in the East Asian economies at the onset of the crisis.

Trade liberalization and macroeconomic stability

The performance of the Philippine economy has been incessantly linked to the fortunes of its industry sector. The orthodox view of the problems plaguing the latter, particularly the manufacturing sector, has come up with the following major conclusions (Medalla et al. 1995):

- More than three decades of protection has been very costly in terms of its inherent penalty on exports, its seriously adverse impact on resource allocation and dynamic efficiency losses arising from lack of competition;
- Reform toward a more liberal, and neutral trade policy is necessary to propel the economy to a higher level of industrialization.

Along these lines, the government embarked on an ambitious trade liberalization program beginning in 1981 consisting of tariff reform and the steady elimination of quantitative restrictions and other nontariff barriers. This was interrupted by the economic crisis in 1984-85 but was pursued in earnest from 1986 onward. As a result of the trade reform package, the average nominal tariff rate fell from 28 percent in 1990 to 13 percent in 1997. The behavior of an average effective tariff is shown in Figure 1. Quantitative import restrictions were lifted on all agricultural imports (except rice) in March 1996, and were accompanied by their tariffication as stipulated under the World Trade Organization (WTO). Trade liberalization will continue beyond 1997. The average nominal tariff will be reduced gradually until a uniform rate of five percent will be imposed in the year 2004.

The arguments for liberalizing the trade regime have been largely confined in the microeconomic sphere with efficiency considerations being the primary focus. Comprehensive discussions on the potential macroeconomic effects are limited. One such approach (Yap 1997) uses a three-gap model to show that a reduction in the tariff level will lead to an unambiguous decline in the GDP growth rate if lower tariffs result in a reduction of the surplus in the government's primary account. Lower government saving leads to tighter overall investment constraints. The actual impact of a tariff reduction depends on, among other things, the import income elasticity. Empirical results indicate that the condition of a contraction in the government primary surplus is satisfied in the Philippine case.

Figure 1
Effective Tariff Rate with Respect to Dutiable Imports, 1980-1996

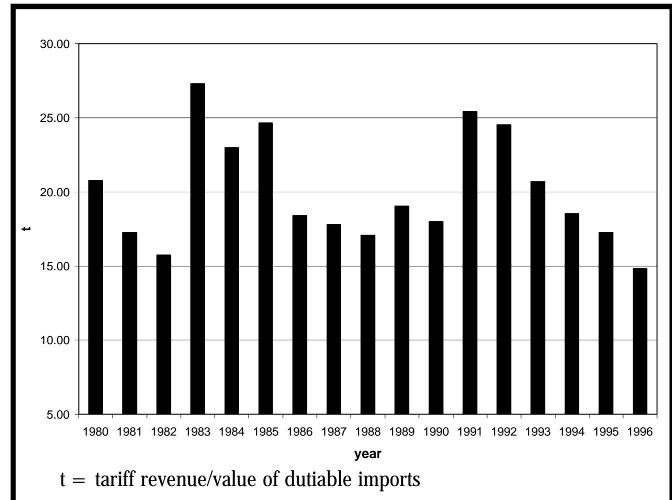

Table 1 shows that government revenue from customs duties has been declining steadily since 1980. Government officials have acknowledged that this has been the main reason why tax revenue performance has leveled off causing actual collections to fall short of targets in 1997. It should come as no surprise, therefore, that while Korea, Thailand and Indonesia consider the financial sector to be a focal point of policy following the 1997 crisis, in the Philippines, the fiscal sector has been identified by the government economic managers and the IMF as the principal concern for 1998 and 1999.

The key message derived from this analysis is that policymakers must be cautious about the impact of economic reform on macroeconomic stability. This is important in the light of the contention of Dani Rodrik (1996), an economics professor at Harvard University, that, in describing the experience of developing countries, it has

become common to lump together a wide range of policies under the label "import substitution policies." Confusion then arises because failures were often misattributed to microeconomic policies (e.g., indiscriminate protection), when their sources lay either with unsustainable macroeconomic policies or bureaucratic and institutional shortcomings.

Nevertheless, estimates of some trade statistics show that there have been efficiency gains from the trade reforms in terms of lowering *effective protection rates* (EPRs)—in absolute terms and in terms of variations among the different sectors of the economy—and lowering of domestic resource costs, i.e., the opportunity cost of protecting specific sectors. But these numbers (the effective protection rate and domestic resource cost) follow the trend in the level of tariffs and taken on their own, can be viewed only as potential efficiency gains. The record shows that despite the reforms, growth in the Philippine manufacturing sector has slowed down for ten consecutive quarters (1995Q4 - 1998Q1). It appears that there may be no trade-off between microeconomic efficiency and macroeconomic stability after all. In fairness to the advocates of trade liberalization, an overvalued currency, poor infrastructure, and low labor productivity—which are persistent problems in the Philippines—may have prevented the potential efficiency gains from being realized.

Financial liberalization and the East Asia crisis

A debate on the causes of the East Asia financial crisis has developed over the past year, sometimes parallel to the debate about the sources of their erstwhile phenomenal growth. The more popular view is that the weaknesses in the financial sector were brought about by the cozy relationship between banks and business conglomerates resulting in loans of dubious quality. The lack of transparency in the banking system and inadequate regulation and supervision led to a number of bad loans which were exposed when the crisis struck.

This sweeping analysis tends to gloss over the fact that similar crises have occurred in countries with sophisticated financial regulation (e.g., the U.S. savings and loan debacle) and in places with high levels of transparency (e.g., Scandinavia) [Stiglitz 1998]. Moreover, two-thirds of external bank lending in Indonesia was to the nonbank private sector, indicating that foreign lenders were willing to extend credit to Indonesian firms. The latter did not have to resort solely on behest loans from "friendly" domestic banks.

Another line of argument lays the blame squarely on the liberalization of the capital account and the liberalization of the banking sector as the cause of the weaknesses in the financial sector (Montes 1997). Ready access to international credit amplified existing market failures leading to the profligacy of the private sector. This led to overinvestment in certain areas (e.g., real estate) reducing the profitability of many projects. The profit squeeze led to bad loans and the subsequent fall in asset prices, triggering the capital outflow that caused sharp depreciations of the domestic currencies. The latter then sparked the downward economic spiral, particularly in Indonesia, as it became more difficult to repay unhedged foreign loans.

The Philippine capital account was liberalized in September 1992. The financial sector was likewise liberalized in 1994 when ten foreign banks, in addition to the existing four, were allowed to operate in the domestic market. As a result, greater liquidity was introduced in the system as indicated by the rising M3/GNP ratio (Figure 2). Economic data clearly show that the Philippines was on the verge of mimicking the Thai and Indonesian experience beginning in 1996. Value added in the real estate sector surged in that year along

Table 1: Behavior of Tariff Revenue

	1980	*1985*	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*
Tax revenue (% of GNP)	12.6	11.0	14.2	14.5	15.2	15.3	15.6	15.9	16.1	16.1
Tariff revenue (% of GNP)	3.9	2.8	4.3	5.1	5.3	5.5	4.7	5.0	4.6	3.7
Tariff revenue (% of tax revenue)	27.2	22.9	25.4	29.2	30.0	31.5	24.3	27.0	25.5	20.1

with a sharp rise in the share of loans to that sector (Table 2). Consumer loans were also rising rapidly and dollar liabilities of commercial banks increased dramatically. Portfolio investment of nonresidents had accumulated to $5.2 billion by 1996 creating a virtual time bomb in a country where foreign exchange reserves amounted to only $11 billion. In other words, the Philippines was a latecomer to the game and this fortuity—not superior economic policies—explains why it was not as battered by the crisis as Thailand and Indonesia.

No doubt, the real reasons behind the East Asia debacle lie somewhere between the two interpretations cited above. The substance of the arguments should nevertheless buttress the lesson derived from the discussion on trade reform: policymakers must be aware of any potential trade-offs between microeconomic efficiency gains and macroeconomic stability.

Figure 2
M3/GNP, 1975-1997

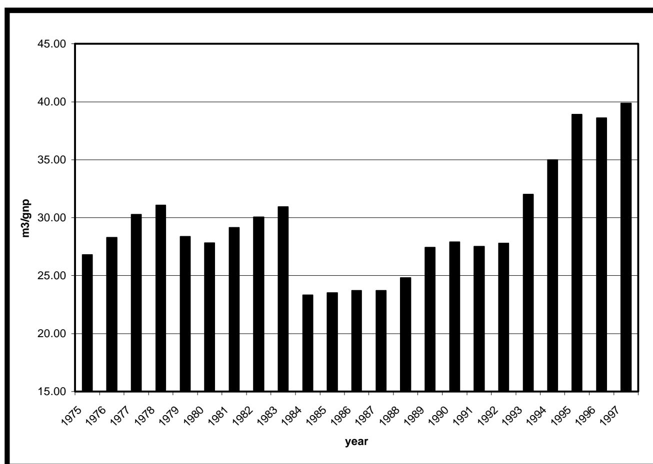

Table 2
Selected Indicators

	1990	1991	1992	1993	1994	1995	1996	1997	1998 Jan	1998 Feb	1998 Mar
Growth rate in value added of real estate	4.1	-0.4	1.5	2.6	3.8	5.9	10.7	6.8			
Growth rate in loans outstanding to real estate	-	19.2	36.1	10.1	37.4	24.6	97.2	42.6	34.3	30.0	27.9
Share in loans outstanding to real estate	16.9	18.3	20.1	16.7	18.3	16.8	21.8	24.6	24.0	25.3	25.7
Dollar liabilities of commercial banks (share to GDP)	1.4	0.1	0.5	-0.5	1.1	2.1	5.0	1.4			

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Creating relevant institutions, establishing appropriate regulatory frameworks, and formulating a strategic technology policy—both in a domestic context and an international setting—should be part of any policy agenda in order to minimize the adverse impact of such policy trade-offs. This may well form the bulk of the work of policymakers into the next century. Otherwise globalization will always be a threat and not what it should be: a challenge and opportunity.

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