

The Global Recession and the Philippine Economy: Impact and Policy Responses from a Macro Perspective Executive Summary

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The global economic turmoil would have direct and indirect effects on the Philippine economy.

The direct effects would come from the exposure of the Philippine financial system to the toxic assets that are at the roots of the global meltdown. This is not expected to be significant given the limited exposure of Philippine financial institutions on these assets.

What could be more worrying would be the indirect effects which could result from the drying up of the financial flows from the big economies as well as the weakening of the demand for goods and services that the Philippine sell to these big economies.

How vulnerable is the economy?

Three key indicators of the nation's macroeconomic health suggest that the Philippines is in a better state to absorb the impact of the global meltdown:

- a. The nation's is spending less that what it is earning. In technical terms, the nation's current account is in surplus. This was the result of the more prudent income and spending behavior of both the public and private sectors. This is in sharp contrast to the nation's situation during the big three crisis that the country confronted in the past, namely: the closing years of the Marcos regime, the aftermath of the big coup attempt during the Aquino administration and the Asian Financial turmoil in 1997. In contrast to all of those instances which hit the economy at a time when the country suffered serious current account deficits, the present global meltdown is occurring when the Philippines is posting surpluses.
- b. The nation's cash position is relatively healthy. Indicator: The gross and net international reserves can finance about six months worth of imports. Two things are important to note:
 - a. First: Gross reserves are practically equal to net reserves reflecting that the economy is relatively free from the choking effects of short-term debt obligations.
 - b. Second: Both the gross and the net reserves are at relatively comfortable levels. They are not as high as the more conservative Asian economies keep but they contrast sharply with the tight situations that we faced during the past crises.

- c. Given the good cash position and healthy income and spending balance, lenders and investors are starting to look more favorably at the Philippines. If we play our cards right, we could take advantage of the diminished attractions of the previous destinations of foreign savings.

Can the economy sustain financial health in the midst of the global crisis?

Three things need to be asked to gauge whether the global crisis can undermine the nation's present financial strength:

- a. Will financial meltdown cause the incomes to dramatically drop,
- b. Will it trigger uncontrollable increases spending? and
- c. Will the financial sources to severely dry up?

Threats to Sources of Income

There are three sources of income that will be threatened by the slowdown in production activities in big economies: export revenues, OFW remittances and revenues from BPO services. There are signs that two of these will remain strong.

- a. The BPO industry is just at the initial phase of its rapid growth and the potential activities that firms in the US can outsource is still large.
- b. OFWs are also geographically dispersed. Thus, the impact of the slowdown in big economies can be mitigated by the continued growth in the others.

The one that seems to have been severely affected are export revenues which showed dramatic drops starting December of last year. Fortunately (or perhaps unfortunately), the contribution of exports to the nation's total income has been declining. In gross terms, the share of exports to the nation's income down to about 30%. Netting out the imported raw materials that the economy uses, this goes down further to around 10%. In terms of net revenues, therefore, OFWs contribute even more than the exports of goods. Furthermore, the slowdown in export earnings is probably more a problem of lack of competitiveness rather than a result of the slowdown in our big market. The Philippines is a small player in this big market. Thus, as long as it can sell what it produces at the prevailing dollar price and at the quality required by the market, it should be able to sell all that it produces.

Will expenditures balloon?

If the global crisis will not cause severe problems in the income side, will it trigger pressures on the spending side? This does not seem to be the case either. Even before the onset of the global crisis, the nation's spending as a proportion of the nation's income has been on the decline. Most notable are the declines in the shares of personal and government consumption expenditures. Result: Gross savings rates have moved up. Consequently, interest rates have moved down.

These trends have not been reversed. What is in fact worrisome is that despite the increased availability and lower cost of funds, the proportion of the nation's income spent on investment goods by the private sector has been on the decline. The only one that has slightly recovered is the proportion of the nation's income that is invested by the government on public construction. Nevertheless, even this is still below what we have posted in previous years.

Given these trends severe imbalances between income and spending seem unlikely to result from the ongoing crisis. This gets even reinforced when one considers the two key accounts that make up the nation: private and public sectors. The private sector seems to have sufficient elbow room in keeping a healthy surplus in its financial records. The public sector could face some challenges. Since the growth in the nation's income seems to be originating from the sectors that enjoy some tax breaks (OFWs and BPOs), the proportion of income that would go to the government coffers is likely to be threatened. The collections of BIR during the first two months of this year are highly suggestive of this emerging problem: the agency's collections during the year would likely be fall short of what could have been expected from the underlying trends.

Do these mean that the public sector's deficits would balloon to unsustainable levels? Not necessarily. This administration has established a sufficiently long track record of prudent fiscal management and there seems to be no reason to break that trend in the next two years.

Will we have access to foreign funds?

With the expected strength of the nation's income-spending position, the anticipated drying up of funds from foreign investors and lenders would unlikely pose a big problem to the nation. Again, the nation's track records during the past six years are instructive. We have lived with severely limited inflows of funds from foreigners because we have learned to manage our finances better. In fact, it is even possible that we could face a better situation for the next two years. Given the troubles that Thailand, India and Vietnam are going through, more foreign funds might find their way to the Philippines for the lack of better alternatives for investors and lenders on where to place their money.

In short

1. The Philippine economy is in a better financial position to face the global financial slowdown compared to the previous three crises that it faced from the eighties to the present.
2. This relatively healthy financial position is not likely to be seriously undermined by the ongoing difficulties in the world economy.
 - a. Among the vulnerable income drivers (i.e. exports, OFW remittances and BPO earnings), only exports have exhibited dramatic drops. Furthermore, even these drops in export earnings are not probably due to the slowdown in these markets. The slowdown in our exports started way before the onset of the global crisis suggesting that competitiveness is our problem not lack of demand. Furthermore, the

net contribution of exports to the nation's income is smaller compared to other countries.

- b. The nation's spending behavior is also likely to remain prudent given the track records posted in the past years both of the private and public sectors. Furthermore, even if the income and spending balance gets reversed, there is some elbow room provided by the relatively healthy cash position of the nation.
- c. With these, the prospects for access to foreign loans and investments could even be better compared to the past crises we have gone through considering the diminished attractiveness of the alternative destination of these funds due to the political and economic problems these countries are going through.

Implications on Policy Responses

All these are important to keep in mind in crafting the policy responses to the ongoing global slowdown:

- a. Lack of demand in the global market does not seem to our problem. Thus, offsetting the drop in export revenues by stimulating domestic demand through the traditional Keynesian approach does not seem to be the best way to cope with the crisis.
- b. In fact, deliberate increases in the fiscal deficits could potentially spark imbalances in the nation's finances if these stimulate more the demand for imported goods rather than domestically produced goods. True, the present financial conditions allow some elbow room for this strategy. Nevertheless, if not properly calibrated and directed to productive uses, the strategy could eventually undermine the financial muscle that has been built up through the years.
- c. The following bottlenecks appear to require more policy interventions:
 - i. The apparent lack of confidence in the private sector to bet on the nation's economic future. This can be gleaned from the declining proportion of the nation's income spent by the private sector on investment goods. This despite the greater availability of funds due to the increased savings rate and the drop in interest rates due to this improved conditions in the funds market.
 - ii. The deteriorating competitiveness of in the export sector. This is indicated by the sluggish growth of our export revenues in comparison with the records of our neighbors. Two key indicators are worth examining to trace the reasons for this trend: (a) Peso prices of exports have been declining thereby squeezing the profit margins of exporters; and (b) the drop in the peso prices not only of the US dollars but of the other foreign currencies.

- iii. The relatively slow pace of job creation that has accompanied growth in the recent years. The growth of employment in agriculture and industry has decelerated. Unfortunately, the growth in services, though fast, has not completely offset the slowdown in growth of the other sectors.

The government's resiliency plan

The term resiliency plan seems a more appropriate label than a calling the program as a stimulus package. This may sound like an issue of semantics but in truth, a stimulus package may give the impression that the response is inspired by Keynesian economics. The resiliency plan does not seem to be one. From a Keynesian perspective, as stimulus is essentially the deliberate posting of a fiscal deficit in order to offset the shortfall in private demand.

To a developed economy whose currency is acceptable for international transactions, the impact of such stimulus could be predominantly positive. This is what Keynesian economics posits. A fiscal deficit means additional demand which will stimulate additional production. As long as the economy has spare capacity (or it is not at full employment), the stimulus would result in more production and, therefore, more income.

To a small open economy like the Philippines, however, a public sector deficit could have a bad side effect. Excess of spending over income of the public sector if not offset by a surplus in the private sector, would translate to a deficit for the nation as a whole. The problem: the nation's deficit gets reflected as a current account deficit (i.e. an excess of nation's dollar expenses over its dollar income). Obviously, this deficit will have to be financed with foreign currencies. If these foreign currencies cannot be drawn from the reserves or supplied by a surplus in the capital account, tightness in the foreign exchange market would ensue and put pressures on the exchange rate.

Can the government afford to post a deficit now without leading to these bad effects? It seems it can but only to a limited extent. The following indicators suggest that there is a room for some amount of stimulation:

- a. We have a relatively comfortable level of international reserves.
- b. The private sector is in surplus.

Nevertheless, the elbow room seems tight. The levels of our gross and net international reserves are higher than our historical records but they are not extraordinary compared to what our Asian neighbors have. Also, the nation is only in surplus because the remittances of OFWs have, so far, been sufficient to offset the deficit in our trade. The slowdown in the world economy has thus far shrunk our current account balance because our trade deficit has widened and OFW remittances are no longer growing as fast as before.

Thus, ERP should not be looked at from a Keynesian perspective. The ERP is designed not in terms of the deficit the government is going to incur. Rather, the program is presented as one that is primarily meant to make sure that

- a. the amounts budgeted are actually spent,
- b. that the expenditures are on items that would have high impact on growth of output and jobs and on poor families and

- c. that resources tapped are optimized by augmenting them through private-public sector partnerships.

Thus, ERP speaks of a budget (not a fiscal deficit) of P330 billion that would come from three sources:

- a. Increase in the 2009 budget: This amounts to P160 B
- b. Tax cuts for low and middle income earner: This amounts to P40 B
- c. Financing of large infrastructure projects in joint effort with the private sector. This will amount to P 100 B
- d. Additional benefits to members by social security institutions. This is valued at P30 B

Viewed from this perspective, it is difficult to find fault in the approach taken to stimulate the economy. In essence, the focus of the program is simply the make sure that resources are tapped to the fullest, that they are actually spent, and that they go to the proper items. With or without the crisis, this is something that the government should be doing. To the extent that the government has been provoked to do this by the crisis, this is still something that would be worth pursuing.

There is a wide gap between intentions and actual actions. There is a nagging fear that ERP has been formulated with an eye for the 2010 elections. This is a valid concern but this does not diminish the significance of the general directions adopted in the program.