

A Review of Philippine Monetary Policy Towards An Alternative Monetary Policy

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Abstract

The Philippines' shift in monetary policy from 'monetary targeting' in the 1980s and 1990s to 'inflation targeting' in 2002 -- wherein policy interest rates replaced stringent monetary targets as the key monetary instrument -- has so far brought in a more 'benign' monetary policy that is more sensitive to output objectives. But this result is mainly due to the fact that inflation targeting was implemented when inflation rates in the Philippines followed the downward trend of world inflation especially after the Asian crisis. Whether this 'benign' policy will continue faces a critical test if inflationary pressures were to return. The problem is that both the monetary and inflation targeting regimes are based on a demand explanation of inflation that blames inflation on overexpansion of money and credit. The evidence for the Philippines shows otherwise -- the inflation experience through the decades has been mostly a supply-led and cost-push phenomenon.

As the paper shows, even with a laxer monetary policy the macroeconomy is still not able to adequately increase investment rate, employment rate and lending to the private sector amidst fiscal difficulties. It is clear that monetary policy is not independent from the other macro sectors as well as the real and external sectors of the economy. This paper therefore proposes alternative monetary policies to inflation targeting that takes into consideration the bigger and more complex role of monetary policy in an economy that requires a more development-promoting program.

1. Introduction

The modern macroeconomic history of the Philippines, especially in the 1980s and 1990s, has been marked by periodic balance of payment crises which are accompanied by massive devaluations that result in high inflation. These crises were followed by drastic monetary and fiscal austerity programs implemented by the IMF, as a precondition for the release of emergency funds. These caused severe recessions.

Monetary targeting was implemented in the Philippines from the 1980s to the 1990s under IMF sponsorship.

Since monetary targeting – employing a hard-line monetarist philosophy backed by IMF conditionalities – is generally accepted as contributing to the depth of recessions in the Philippines in the last 25 years, and since it was replaced by inflation targeting only in 2002, it is difficult not to include in this paper a discussion of the experience with monetary targeting.

The next section describes monetary targeting as a contractionary macro response during periods of high inflation and balance of payment crises.

The third section discusses the shift from the monetary targeting regime to the inflation targeting regime starting 2002 and explains why it is more ‘benign’ than what was originally feared.

The fourth section places monetary policy in the context of the complex macro situation and development needs of the Philippines.

The last section gives detailed recommendations for an alternative monetary policy.

2. Monetarist Targeting and Policy in the Philippines: Criticizing the Demand-Side Cure for Inflation and Current Account Deficits

The economic crises which occurred in the late 1940s, the late 1950s and early 1960s, the early 1970s, the mid-1980s, the early 1990s and the Asian crisis in 1997-8 had been connected with balance of payment and foreign exchange crises. These have led to some very sharp recessions – especially the economic collapse in 1984-85 – that destroyed any chance of the Philippines becoming an East Asian success story.

Monetary policy in response to these balance of payment crises involve damaging procyclical monetary and fiscal austerity that deepens and aggravates the crisis and recession.

These policies were more intensely implemented when monetarist targeting became part and parcel of IMF conditionalities in the 1980s. Starting in the early 1960s the IMF had become the standard funder of last resort during crises. In the early 1980s, quarterly monetary targeting became the norm. These monetary targets became very tight every time balance of payments deteriorated and inflation increased. Monetary targets were based on targets on the monetary base and achieved through: a) high required reserve ratio; b) high policy rates of the Central Bank; and c) open market sale of Central Bank bills and government securities in order to reduce the monetary base. It was the use of the third instrument that was most damaging as it directly reduced liquidity and credit in the financial sector.

Monetarist policies assume that the cause or persistence of inflation and ‘overspending’ (causing large current account deficits) is due to increases in aggregate demand because of too much increases in money supply. This assumption is contradicted below.

2.1. *Supply Side Causes of Inflation*

Fig. 1 gives a picture of inflation rate based on the consumer price index (CPI) and GDP growth rate. The graph shows that high inflation usually happens simultaneous with lower growth or recessions, rather than during periods of high growth and high aggregate demand.

(Fig. 1)

This is particularly true for the periods 1984-85 (economic collapse), 1990-91 (another recession) and 1998 (Asian crisis period). This is because these periods are periods of significant currency devaluations due to balance of payment crises. This brings about stagflation that explains the high inflation and recession.

In fact, the role of currency devaluations and oil price shocks in explaining periods of high inflation in the Philippines is very clearly illustrated in Fig. 2.

(Fig. 2)

It can be seen that the devaluation in 1970 brought high inflation in 1970-71. The first oil price shock in 1973-74 brought about high inflation in 1973 and, especially in 1974. Again, the second oil price shock and worldwide inflation in 1979-81 brought about the high

inflation during the same years. The significant devaluations in 1983 and 1984 led to high inflation in the economic collapse period of 1984-85. The moderate devaluation in 1990-91, plus oil price shock due to the first Gulf War crisis brought about the inflation in 1990 and 1991. The significant devaluation during the Asian crisis in 1998 brought a slight uptick in inflation, but nowhere near the high inflation that occurred in previous devaluations.

Thus, by just using two types of supply-side shocks – currency depreciation and oil price shock – one can explain practically all the above-10% inflation in modern Philippine history. High inflation periods are not triggered by high domestic demand but by supply side shocks.

If one uses monthly or quarterly data on inflation, one will also see that agricultural price shocks also make their impact on price inflation. The Philippines is a victim of several typhoons every year and is susceptible to droughts. Both bring about periodic agricultural shortages and agricultural price increases. Furthermore, the Philippines has inferior rural infrastructure (irrigation, farm to market roads, electrification) compared to its more successful neighbors. This makes its inflation rates higher on a long-term basis.

2.2. *Monetary Contraction and Impact on GDP and Unemployment*

Thus, using monetary contraction to fight inflation causes significant recessions (and increased unemployment), since the original supply shocks (devaluation or oil price shocks or adverse agricultural shortages) already have recessionary impact. It is important to point out that the serious stagflationary periods 1984-5, 1991 and 1998 were all periods when the Philippines was employing monetary targeting.

Figure 3 shows the relationship of lending rate and GDP growth rate. Lending rates rise during crises because of the higher inflation, but credit and monetary contraction goes beyond this since the authorities specifically contracts the monetary base and increases required reserves and the Central Bank policy rate. As expected, one sees a strong inverse relationship between the lending rate and GDP growth rate, especially again during the recession periods of 1984-85, 1991 and 1998.

(Fig. 3)

The lending rates in Fig. 3 actually underestimate the costs of borrowing since during periods of monetary contraction, many firms are credit-rationed. Fig. 4 shows the relationship between growth of real money and GDP growth rate. Declines in real money are associated with declines in GDP growth in 1960, 1964, 1974, 1984-85, 1991 and 1998.

(Fig. 4)

Fig. 5 shows that the recessions of 1984-85, 1991 and 1998 created significant upticks in the unemployment rate.

(Fig. 5)

2.3. *Monetary Contraction and External Deficits*

But of course the story is not just between inflation, monetary policy and output/employment effects. Much of the demand-suppressing austerity programs – of which monetary contraction effected through monetary targeting is an integral part – were

implemented at the same time that there were balance of payment crises. Thus, these policies were implemented not only to reduce inflation but to reduce aggregate demand to ensure that current account deficits were also reduced. And it is often overdone to produce current account surpluses.

Figure 6 shows a graph of the current account deficit (as % of GDP) and GDP per capita growth rate over the years. Concentrating on three recession periods – 1984-85, 1991 and 1998 – it is clear that every crisis was preceded by a year or two of very significant current account deficits. This is because import demand grows during boom years as Third World countries are dependent on imported raw materials and capital goods. It is also clear that after every recession, the current account deficit improved, and in the case of the crisis in the mid-1980s and the Asian crisis, the current account turned positive after the recession. It should be emphasized that the improvement in the current account balance was caused partly by the massive devaluation and partly by the recession which had been aggravated by the monetary contraction dictated by monetarist policy. Monetarist theory and the IMF interpret large trade deficits as ‘overspending’ and require monetary and fiscal tightness. Thus, although monetary targeting is supposed to target only one variable – inflation – it is also affected by foreign exchange depletion and capital outflows during crises.

(Fig. 6)

Finally the last possible reason for monetary tightening during balance of payment crises is to stem the flight of capital and attract them back into the country, and at the same time

off the damaging exchange rate collapse. This was mainly the excuse in the 1984-85 debt crisis and the 1998 Asian crisis. However, in both cases it was not the high interest rates that stopped the currency depreciation and balance of payments outflow but mainly the devaluation-cum-recession which improved the current account by improving the trade accounts. Fig. 7 tracks the current account and balance of payment balances. It can be seen in the graph that the balance of payments improvement from 1984 to 1987 following the 1984-85 collapse was mainly due to very significant improvements in the current account. In the 1998 Asian crisis even the improvement of the balance of payments in 1998 was less than the current account improvements, indicating net capital outflows in a period of high interest rates. But in subsequent years, the positive balances in the current account exceeded that of the balance of payments, which meant that there was continuing net capital outflow in the BOP account from 1999 to 2002 (most likely due to the lackluster performance of the Philippine economy and the political troubles of the Estrada and Arroyo governments). In the crises of 1984-85 and 1998, the current account went into significant positive territory because of the joint effects of devaluation and output and demand contraction. This proves that monetarist aggregate demand suppression is successful in stopping foreign exchange outflows and current account deficits – not by stemming capital outflows and encouraging return of foreign exchange due to high interest rates but, as previous graphs prove, by creating sharp recessions and severe unemployment, which reduce trade and current account deficits. Inflation rates are also lowered because recessions kill consumer and investment demand.

(Fig. 7)

An important lesson from the discussion above is that the roles of the current account, the exchange rate regime and issues concerning how to stem capital flight should be incorporated in any alternative to the current monetary policies.

It is also the aim of this section to demonstrate that the Philippines followed monetarist prescriptions very closely from the 1980s to 2000. This made fighting ‘overspending’ that had ‘caused’ current account deficits and high inflation the sole purpose of monetary policy. It ensured that monetary policy could not be used for countercyclical and growth purposes. The adoption of financial liberalization policies starting in the 1980s also ensured that monetary policy could not be used to finance targeted or prioritized sectors of the economy. This complemented the prescription of the multilateral agencies for the country to abandon industrial policy and undertake trade liberalization.

At the same time the policy is not matched by a confirmation of the theory behind the demand theory of inflation and ‘overspending’. Fig. 8 graphs the inflation rate on the y-axis and unemployment rate on the x-axis for the years from 1959 to 2004 to find out any trace of a Phillips curve. One can see there is nothing that looks like it in the picture in any sub-period. This is because inflation is caused by supply shocks and not demand-led. (The graph looks like it is producing ‘natural rates of inflation’ rather than ‘natural rates of unemployment’.)

(Fig. 8)

3. From Monetary Targeting to Inflation Targeting

3.1. *A Switch in Regime: From Monetary Targeting to Inflation Targeting*

In the Philippines, research work in the Central Bank itself pointed to the ‘overkill’ created by monetarist policy in trying to tame inflation. This is mainly because the quantity theory of money equation assumes a unitary coefficient of money to prices with output holding steady, despite massive monetary contraction. The use of a single estimated inflation equation assumes all explanatory variables (exchange rate movements, output growth, etc.) to be exogenous and that only the monetary variable will decrease inflation. A study by a staff member of the Central Bank (Dakila (2001)) shows that with a simultaneous equation system where exchange rate movements and output movements are endogenized, the degree of monetary tightening required to achieve a stipulated reduction of inflation is lessened. This is because monetary tightening cum recessionary policies tends to eventually cause some appreciation of the currency and a fall in output growth (both of which tend to be deflationary).

When single-digit inflation rates were achieved in the mid-1990s under the Ramos administration, the Central Bank relaxed monetary targeting to what was called the ‘modified monetary targeting’ policy. This allowed the monetary targets to be exceeded as long as inflation targets were being met. This was the start of a hybrid system of inflation and monetary targeting. The official reason given was that, because of financial liberalization, the link between quantitative monetary targets and inflation had weakened due to ‘structural breaks’ in the income velocity of money and volatilities and instabilities in the money multiplier. Thus the high liquidity and large monetary expansion in the mid-

1990s failed to have any impact on inflation as it remained below double-digit and continued to decline until the Asian crisis (see Guinigundo (2005)).

The laxer monetary policy in the mid-1990s of course was shattered by the ‘contagion’ effects of massive depreciation pressures during the Asian crisis. The major ways used to stave off the depreciation (and indirectly avoid inflationary pressures) were constant and periodic raising of the reverse repurchase rate (overnight lending rate or what we call the policy rate) and the raising of liquidity reserve ratios.ⁱ

However, the massive currency depreciation (around 40%) during the Asian crisis had a very low ‘pass-thru’ to inflation (see Fig. 2). It did not even lead to (and only approached) double-digit inflation. This easily allowed inflation rates to fall after the crisis (with a temporary uptick in 2001 due to another spate of currency depreciation brought about by domestic and international political instability, and also due to weather disturbances). Inflation rates reached a very low 3% in 2002 and 2003, replicating the inflation rates in the developed world.

By January 2000, monetary authorities were already studying the alleged successes of developed and developing countries that had adopted inflation targeting (from a prior regime of exchange rate pegging or monetary targeting). The decision was to make the big switch to inflation targeting starting January 2002. The switch entailed the following elements: 1) continuation of the announcement of inflation targets based on a band over a two-year time period, 2) adoption of a more passive monetary quantitative policy, and employing more the repurchase and reverse repurchase rates (policy rates) as the monetary instrument, 3) continued use of liquidity reserve ratios and policy rates to stave off

currency depreciation inasmuch as exchange rate is a key determinant of inflation, 4) increased sophistication in inflation rate estimation and in using single and multi-equation models to forecast inflation and setting of inflation targets, 5) the use of forward-looking models with monetary instruments reacting to and aiming to influence inflationary expectations rather than actual inflation; 6) creation of an Advisory Committee to recommend monetary policies based on the new inflation targeting regime; 7) the issuance of a quarterly inflation report explaining the Central Bank's policies and achievement or non-achievement of the inflation targets.

But the most important elements are: 8) the stipulation of escape clauses that exempts the Central Bank from achieving the inflation targets. This means that if the inflation target is not achieved, the Central Bank can opt to *not* do anything if the reasons are: a) sudden changes in prices of agricultural commodities and products; b) natural calamities or catastrophic events; c) volatility in oil prices; and d) sudden changes in government policies, such as tax structures.

Another important element is: 9) the setting up of a 'core' inflation rate, as opposed to the overall CPI or 'headline' inflation rate. The core takes out oil and agricultural products whose prices are easily affected by external shocks and weather disturbances. This is an important element since even if overall 'headline' inflation rate is not achieved, as long as the 'core' inflation rate is within the inflation target, the Central Bank can also opt not to do anything.

A Central Bank report (Guingundo (2005)) mentions two important things: 1) the current inflation targeting method allows for 'ample room for judgment and discretion of policy

makers’; and 2) in explaining why overshooting of the inflation target in the fourth quarter of 2004 did not lead to increases in policy rates by the Central Bank, the paper gives the following explanation: a) the inflationary pressures caused by supply-side shocks (oil price increase) were not susceptible to monetary action, since the latter would work on the demand side; b) the Central Bank forecasts indicated that the pressures would subside in 2006; and c) there were downside risks to the overall strength of economic activity. The last point is extremely important as it proves that current Central Bank policy does put weight on the strength or weakness of ‘economic activity.’

3.2. *A More ‘Benign’ Policy?*

So far ‘inflation targeting’ in the Philippines from 2002 to 2006 has not led to very drastic monetary tightening unlike ‘monetary targeting.’

The improvement in inflation targeting over monetary targeting can be due to a number of factors. First, the nature of the policy tools makes inflation targeting more benign than monetary targeting. To illustrate, maintaining a monetary base target (neither increasing nor decreasing it) will entail credit tightening since it does not allow money supply and domestic credit to grow with the economy. On the other hand, maintaining the policy rate of the Central Bank (i.e., keeping the reverse repurchase rate constant within reasonable limits) does not entail credit tightening and allows money supply and domestic credit to grow moderately. Thus to make monetary targeting and inflation targeting equally restrictive will entail increasing policy rates drastically, which is much more obvious and prone to public criticism compared to reducing the monetary base target. The Philippines, in its inflation targeting history (2002 to 2006), has not increased the policy rate drastically

and so inflation targeting policy in the Philippines has not mimicked monetary targeting by drastically cutting money supply and credit.

More importantly, the adoption of IT was not done as a precondition to IMF conditionality but was a conscious switch decided by the Central Bank. Thus, using policy rates as the key instrument allows the Central Bank to implicitly inject growth objectives in deciding what rates to maintain, even if on paper the main goal of IT is inflation reduction. Second, the escape clauses and the use of ‘core inflation’ allow the Philippines to use similar instruments as the US Fed and to decide on policy rate changes based on the strength of the economy and not only on inflation targets. Most importantly, the policy has been quite lax since world and domestic inflation has not been very high between 2002 and 2006.

Fig. 9 below shows that since 2003, the core inflation has always been below the headline inflation. Inflation targets of the Central Bank were exceeded in periods when oil prices were rising in the world market (2004-2005) – when inflation rates went up beyond 6% and 7%. But policy rates were raised only infrequently (the last one in October 2005) since inflation targeting was implemented in 2002. The justifications were: a) Core inflation was below the headline inflation; and b) Overshooting of the inflation target was due to the oil price shock – a supply rather than a demand factor. Between 2002 and 2006, the Central Bank raised policy rates by only 75 basis points (due to the higher inflation led by rising oil prices in 2005 and 2006) compared to the more than 400 basis points done by the US Fed in the same period. Of course, the Philippine policy rate started at a higher level of 9% compared to the US Fed rate of 1%.

(Fig. 9)

In late 2006, with world oil prices and Philippine inflation falling, the Central Bank further relaxed its overnight deposit rates using a three-tiered system wherein commercial banks' deposits with the Central Bank of up to P5 billion per bank are given the official overnight borrowing (deposit) rate of 7.5%. The rate goes down to 5% for deposits between P5 billion to P10 billion, and to 3.5% for more than P10 billion. This policy encourages bank to reduce their excess reserves and do more bank lending.

3.3. *Tightening in 2007?*

However in early 2007, the Central Bank started to change tactics. As inflation in the first quarter fell to 3% or below on an annualized basis, the Central Bank refused to reduce policy rates (see Fig. 10).

(Fig. 10)

Furthermore, the Central Bank is trying to mop up liquidity by:

- encouraging the transfer of deposits of government pension funds and public corporations out of commercial banks to the Central Bank; and
- allowing special Central Bank deposits for trust funds of commercial banks at better than t-bill and bank rates.

Officially, this more conservative policy is due to the fear that the high inflow of remittances of workers which has significantly increased liquidity will trigger inflation.

But in fact, the high inflow of remittances of workers contributed to the strong appreciation of the peso, which actually reduced inflation from the supply side.

What is left unsaid, however, is that the real danger of the high liquidity is that, coupled with little credit going to private businesses, the high liquidity could possibly lead to the creation of bubbles in the fast rising equities and real property markets.

However, as demonstrated by a more complex monetary and financial system not considered by the monetarist demand theory of inflation, the restrictive measures of the Central Bank had no effect at all on interest rates as the financial sector's huge appetite for government securities compared to private loan assets kept treasury bill and bank rates low. Whether the Central Bank succeeds in reducing liquidity remains to be seen.

4. The Need for a Holistic View and an Alternative Monetary Policy

The lax overall monetary policy in the last four years is clear proof of the very strong desire of the present government to achieve higher economic growth rates. But as explained in this section, the laxer monetary policy has not led to adequate credit expansion for investment needs, better employment prospects and a more stable external financial sector. The 'alternative' demands much more than just a move from monetary targeting to inflation targeting. It is clear that the financial, monetary, fiscal, external and real sectors are strongly linked and affect one another critically. These links in the Philippine context are detailed in the next sections.

4.1. *The Recent Fiscal Crisis*

From the mainstream point of view, the biggest challenge to the current Philippine macroeconomy after the Asian crisis is the large fiscal deficits and public debt burden that grew uncontrollably starting 1998 and peaked in 2002, but continuing up to the present.

Fiscal surplus had been achieved by the Ramos administration before the Asian crisis. The Asian crisis, however, brought back fiscal deficits. Table 1 shows fiscal deficits worsening after the crisis, with the national government deficit reaching more than 5% of GDP in 2002. Public sector borrowing requirements reached more than 6% in the same year as the deficit of government corporations, especially that of the National Power Corporation, became larger.

(Table 1)

The gravity of the fiscal problem is due to the fact that the post-Asian crisis economic recovery from 1999 to 2005 had failed to improve tax effort. The tax effort peaked at more than 17% of GDP in 1996 and 1997 consistently fell after that and bottomed at 12.5% in 2004 (Table 1). The falling tax effort despite significant GDP growth forced the government to undertake substantial tax reforms to respond to downgrades by the rating agencies of the sovereign debt. The tax effort improved to around 14.3% in 2006 mainly due to the expanded coverage and higher value-added taxation (raised from 10% to 12%).

The falling tax effort and rising public debt burden after the Asian crisis brought about a serious situation wherein public debt service – principal and interest debt payments – made up 85% of government revenues in 2005 and 87% in 2006ⁱⁱ (see Table 1). The improving fiscal deficits from 2003 to 2006 were brought about only because total non-debt

expenditures of the government (as percentages of GDP) – especially social and economic services – were cut drastically as interest payments increased. Table 1 shows total national government expenditures falling to 17.4% of GDP in 2006 from more than 19% in 1998. Fig. 11 shows the gravity of the situation as economic and social services as percentages of GDP continuously fell in recent years while the share of interest payments went up.

(Fig. 11)

Despite improvements in the tax effort in 2006, the high public debt burden is expected to continue for some more time as Table 1 indicates. Public investment (and other economic and social spending) has yet to recover from cutbacks, while private investments remain low despite high economic growth. In the first quarter of 2007, despite a whopping 6.9% GDP growth, the tax effort fell to 12.2% (from 13% in the same period of 2006). The inability of revenue generation to keep pace with economic growth does not bode well for public investment and the infrastructure needs of the country, which have been neglected in recent years due to fiscal tightness. This is why S & P and Moody's refused to upgrade the Philippine sovereign debt in May and June 2007 despite decreased fiscal deficits and higher economic growth.

During this period, the high issuance of government securities to finance the deficit did not bring about a significant rise in treasury-bill rates since the financial and private sectors had a huge craving for government securities. This enabled the Treasury to issue treasury bonds at ever lower rates. As will be explained later, the aftermath of the Asian crisis reduced the financial institutions' appetite for private loan assets.

4.2. *More Open Capital Accounts and More Volatile Exchange Rate Movements*

Fig. 2 shows that since the 1980s, the exchange rate has been very volatile. This has been aggravated from the mid-1990s up to the present. The current floating exchange rate regime promises more volatility. Obviously the exposure to financial and capital account liberalization has created a Pandora's box of dangerous short-term capital flows and volatile movements.

Even the years following the Asian crisis – from 1999 to 2005 – have been periods of volatile short-term portfolio flows with international capital shunning the country due to political instability and fiscal problems. Starting 2005, short-term capital came into the country due to the increases in VAT and expectations of the narrowing of the fiscal deficits. But they intermittently flowed out also due to political instability and increases in the US interest rates in 2005 and early 2006.

In late 2006 and early 2007, the strong appreciation of the peso due to remittances of overseas workers, short-term capital inflows and a generally weak dollar internationally is causing major concerns among exporters and overseas workers. On the other hand domestically-oriented sectors are happy as inflationary pressures are stemmed and economic growth is stimulated. Trade deficits may be expected to deteriorate (although this has not happened very significantly yet). But the latest picture of the Philippines has changed from one of high current account deficits during periods of high growth (see Fig. 6) to consistently positive current account balances (despite trade deficits) because of the massive influx of foreign exchange earnings of the overseas workers.

4.3. *Low Financial Confidence and Credit to the Private Sector*

The post-Asian crisis period has been marked by low financial confidence due to the trauma of non-performing assets suddenly increasing and due to stringent financial supervision to achieve higher capital adequacy ratios and loan loss provisions. Fig. 12 shows M2 (money plus quasi-money) and domestic credit as percentages of GDP.

(Fig. 12)

It is clear that the Philippines has not achieved substantial financial deepening as M2 and domestic credit fell drastically from its 1997 peak. The lack of financial deepening is partly caused by the various recession and monetary tightening periods. Another big reason is the decline in financial confidence due to the financial crises. This is very clear in the decline of domestic credit (as percent of GDP) from the mid-1980s until 1992 due to the financial and economic collapse of 1984-85. It is happening again in the post-Asian crisis period as both domestic credit and M2 as percentages of GDP declined from 1998 until 2004. Domestic credit remains in the doldrums in the latest 2005 and 2006 data.

The Asian crisis increased financial regulations on banks. The Basel international standard for minimum capital adequacy (net worth to risk asset) ratios of banks is currently at 8%. The Philippines has been more stringent and imposed a minimum capital adequacy ratio of 10% starting 2001. The actual current average capital adequacy ratio for Philippine banks ran to a high 15% to 16% in 2005. But the IMF still thinks that this, and the loan-loss provision (which already is a high 72% in 2005), are too low due to underestimation of the risk assets of the banks and the existence of some non-performing assets not yet disposed.

This situation, together with the perennial political crisis, has so far discouraged banks from aggressively lending to the private sector. The banking system is awash with liquidity with a strong appetite for government securities – whether peso or dollar denominated – rather than private lending. This will constrain investments and employment generation in an economy with still underdeveloped long-term capital markets.

Thus the lax monetary policy from 2002 to 2006 and the subsequent monetary tightening in May 2007 by the Central Bank did not have a significant impact on interest rates and bank lending. Bank interest rates follow the treasury-bill rates after every auction. This reduces the power of the Central Bank to guide interest rate and credit movements as the Bureau of Treasury and commercial banks' behavior define more the outcome of market interest rates and domestic lending.

4.4. *Persistently High Unemployment and Low Investment Rates*

Fig. 4 shows persistently high unemployment in the latest economic recovery period of 2000-2004 despite positive economic growth. Fig. 13 gives more detail on the employment picture.

(Fig. 13)

It shows that a major trend in the employment picture is the downward employment absorption capacity of agriculture and the low and stagnant employment absorption capacity of industry (mainly manufacturing and construction). The only sector adequately absorbing the growing labor force is the service sector.

It must be pointed out that the industrial and agricultural sectors are the main tradable sectors. With increased trade liberalization, globalization and competition among countries, these sectors are now exhibiting increasing output-employment ratios as output increases are not matched by equivalent employment increases. This means labor shedding and labor-cost cutting in areas whose products are facing stiff competition from imports. Thus, services, which is largely a non-tradeable sector, becomes the biggest absorber of employment. But this is not enough to absorb the expelled labor from the tradable sector, and the new labor force entrants (see Lim and Bautista (2006)) Of course the result is that unemployment remains persistently high, hovering at 10% and 11%.

Apart from trade liberalization and globalization, the lack of financial lending to the private sector and the political instabilities may have contributed to lower employment demand.

This situation leads us to explore whether a more employment-sensitive monetary policy can help alleviate unemployment and underemployment through an integrated scheme of credit allocation to labor-intensive and employment-generating activities.

Related to this is the fact that investment rates have fallen since the Asian crisis (as is true for most of the East Asian economies). Investments as a share of GDP fell from above 24% before the Asian crisis in 1997 to 21% in 2000 to 14.8% in 2006. The steady and continuous fall of the investment rate does not bode well for future supply capacity and productivity improvements in the economy, even as the GDP growth rate has improved considerably. This is another area where monetary policy may play a more active role.

4.5. *External Shocks and High Oil Prices*

The volatile world oil price movements starting in the second half of 2004 has increased the average inflation rate in the Philippines from a low of 3% in 2002 and 2003 to more than double in 2005 and 2006. The continuing threat of higher oil prices may lead to tighter monetary policies at home and abroad. There were pressures to increase the policy rate in 2005 and 2006 because of the continued raising of the dollar interest rate by the US Federal Reserve Bank in a capital-liberalized setting. The volatility of world interest rates will also determine whether domestic monetary policy will be tightened or relaxed.

Thus, a policy to respond to increasing world oil prices and return to higher world inflation and interest rate regimes is now an urgent task. Inflation has already been aggravated in 2006 by the imposition of a 12% value-added tax on all goods and additional coverage of oil, gas, electricity and services. If this supply-led inflation leads to a policy of fighting inflation through demand-suppressing methods of increasing interest rates, recessionary pressures may again become a major monetary policy.

5. Components of an Alternative Monetary and Financial Policies

5.1. *An Undervalued Currency and Tax-Based Capital Controls on Inflows*

The first component of the recommended alternative scheme is a reasonably pegged exchange rate regime, targeted at a value that will undervalue the peso. The models for this component would be China and Malaysia, which have set their exchange rate at an undervalued level despite high trade and current account surpluses. Other East Asian

economies, such as South Korea, Thailand and Taiwan Province of China have a more floating exchange rate regime but are biased in keeping their currencies undervalued vis-à-vis the US dollar. (This recommendation is consistent with the policy prescriptions of Frenkel and Taylor in this volume.)

The best time to undervalue the currency is now, when there are pressures for the peso to appreciate. This can be easily done by allowing the peso to move only in a small band and putting counter-pressures to its appreciation. This will mean providing the desired pesos to exchange for dollars. This is easier than resisting devaluations since resisting devaluations would require the Central Bank to provide (possibly) scarce dollars to prevent devaluations. Providing the desired pesos to stem strong appreciation trends of the currency will also be consistent with a more expansionary stance on monetary policy to spur development. Furthermore reducing the appreciation movements of the peso to achieve undervaluation, compared to outright devaluation, will mean that inflation will not worsen.

To achieve a stable currency hovering in an undervalued level, the proposal suggests working within a specified band determined by the Central Bank to be an undervalued measure of the currency. To keep some stability within the band, it would be practical to propose tax-based (or market-based) capital controls on inflows a la Chile or Malaysia, which will implement a graduated (exit) tax rate on capital outflows as the duration of foreign capital in the country is reduced. Complementing this will be stronger financial supervision (part of which is already in place) on short-term dollar loans, discouraging currency and term mismatches similar to those that occurred before the Asian crisis. These capital and financial controls will attempt to control the capital volatilities and help reduce

both volatilities in the exchange rate and strong pressures for appreciation. This is important since there are already strong inflows from overseas workers' remittances.

The undervalued currency will provide a price-based incentive for exports and disincentive for imports to counteract the negative employment and output effects on tradable goods brought about by import liberalization and tariff reduction. Furthermore, the combination of undervalued currency and market-based capital control will leave some independence in monetary policy, which hopefully will be more biased towards an accommodating monetary policy rather than on monetary contraction. The possible tendencies towards higher inflation and current account deficit implied by monetary expansion will be offset by the stable exchange rate pegged at an undervalued measure of the currency. Possible risks of capital flight due to lower domestic interest rates are offset by the undervalued pegging of the currency. Finally, the stronger purchasing power of overseas workers due to the undervalued currency will ensure that any recessionary tendency brought about by an undervalued currency will be offset.

Most likely, the current Central Bank and the IMF will view a fixed exchange regime as unacceptable since floating exchange rates are very much in fashion with mainstream organizations, especially after the Asian crisis. International finance may want to punish a country pursuing such a scheme. Thus the policy requires strong political will but it can be sustained as long as the current account surplus continues and the fiscal deficit kept manageable. This will reduce the foreign financing needs of the economy.

5.2. Incorporate Output and Employment Targets to the Current Inflation Targeting Regime

The less contractionary setting of the ‘inflation targeting’ experience from 2002 to the present is mainly due to the low inflation experienced during this time. As mentioned earlier, this scenario may change in the near future. If one envisions a transition away from the inflation targeting regime, it would be wise to recommend that output and employment goals be explicitly stated as part of the objectives of monetary policy. After all, not adversely affecting economic activity has explicitly been cited by the Central Bank as one of the reasons why policy rates were not increased drastically despite inflationary pressures from world oil prices in 2005 and 2006.

5.3. *A More Active Role in Stimulating the Economy*

The above monetary policy can have some beneficial impact, especially on the current problems of high fiscal deficits, lack of financial confidence and unemployment. The more accommodating monetary policy may be complementary to the moves to improve and increase financial loans in the post-Asian crisis period, and to offset the natural conservative tendencies in credit expansion due to higher capital adequacy ratios and loan-loss provisions. Furthermore, this may create a better atmosphere for involving credit allocation in employment generating activities to be discussed in the next section. Finally, when oil prices have returned to normal levels and world interest rates have stabilized, the more accommodating policy may allow some room for monetizing the fiscal deficits inasmuch as the pass-thru of monetary increases to inflation has been accepted as weak and unstable. Fiscal expansionary policies – especially in social, economic and infrastructure spending – are vital in returning the system to quality and employment-generating growth. And due to the high debt-to-GDP and debt service ratios of the Philippines, it is difficult to

support fiscal expansion with higher public debts. Monetizing the fiscal deficit will be difficult to implement practically since the current authorities and the IMF have succeeded in institutionalizing the non-monetization of fiscal deficits. Strong political will from the national government and monetary authorities will again be required.

5.4. *Credit Allocation to Stimulate Investments in High Value-Added and Employment Generating Sectors*

Inasmuch as unemployment is a major problem in the post-Asian crisis period and investment rates are low particularly in sectors that may have positive externalities for the economy and inasmuch as the financial sector is reluctant to use market mechanisms to lend to the private sector, it is worth considering whether targeted credit programs can help in alleviating the unemployment and low investment problem. However, the Philippines since the 1980s has moved away from subsidized and targeted credit schemes as the financial liberalization school has predicted distortionary and adverse effects from such policies, and because the bad experiences with the Marcos administration has convinced many economists and technocrats that subsidized and targeted credit to potential cronies is detrimental. Relying more on the financial markets and the private sector, they figure, is more beneficial than government interventions. Thus by September 2002, the Central Bank rediscount window has been liberalized to allow a generalized and uniform access to the facility by all sectors of the economy at market rates. The use of the facility has been reoriented for money supply management (complementing open market operations) instead of selective credit allocation (such as to exports and small scale industries) and development financing (Guinigundo (2005)).

There are some targeted credit schemes outside the scope of the Central Bank administered by the Land Bank of the Philippines (LBP) and Development Bank of the Philippines (DBP) targeted at agricultural cooperatives, farmers' groups and small scale industries with funds from the Department of Agriculture (DA), Department of Agrarian Reform (DAR), other agencies and multilateral organizations. The Department of Trade and Industry (DTI) also has some credit lines targeted to small and medium enterprises. The current system has become rather schizophrenic as the formal system and the big government agencies such as the National Economic Development Authority (NEDA) and the Central Bank promote financial liberalization and reduction of targeted credit in the formal sector. But the Arroyo government currently promotes microfinance lending by government-supported agencies as one of its key anti-poverty strategy.

Although there are some striking successes by some rural banks, cooperative banks and other microfinance units in providing credit to develop local economies and some economic sectors, this is not being mainstreamed. The targeting of small and medium enterprises (SMEs) and micro-enterprises, largely in the informal sector, for microfinance has positive aspects inasmuch as these entities have high employment generating potentials. However, the provision of microfinance has oftentimes been politicized and lacks a holistic approach of providing the SMEs and micro-enterprises access to markets and linkages in the formal sector, access to technology and good management practices, skills development and technical assistance for product development. This, unfortunately, is consistent with the overall trade and industrial policy that the government has been following for several decades, which prohibits 'picking winners' and frowns at promoting priority economic sectors (closely subscribing to the policies of the 'Washington

Consensus' view and WTO rules). Thus credit allocation in this setting becomes directionless and limited to providing small 'livelihood' programs for some targeted poor areas rather than to permanent, productive and growing industries and employment for a vibrant economy to benefit a wider pool of poor and low-income families.

It is therefore recommended that a targeted credit allocation program be set up by the Central Bank and related institutions (such as key state banks) to give prioritized credit to key sectors that satisfy the following:

- a) exhibit strong potential for successful take-off, viability and high repayment but may require lumpy investments and/or suffer the 'first mover'ⁱⁱⁱ problem;
- b) have strong employment generating effects, and/or strong interlinkages with the other sectors of the economy, which will lead to multiplier effects in the economy;
- c) have technology or knowledge spillover effects; and
- d) are part of an integrated set of industries that suffer coordination failure problems

Market failures, endogenous growth and strategic trade theories are now mainstream economic theories that justify the above interventions. It is only the strong resistance of institutions that support the Washington Consensus that prevent developing countries from applying the policy implications of the new economic theories.

5.5. *Heterodox Policies of Income Policies, Price Controls and Price Stabilization*

Since most of the inflationary pressures are from supply-side shocks, other means may be more productive than an immediate monetary demand-reduction response.

In many of the weather and natural calamity shocks, the government has, for practical reasons and with some success, gone into temporary price controls and constant monitoring of basic foodstuffs and imposing heavy penalties on hoarding. Importation of agricultural products is also undertaken during periods of agricultural shortages. These policies should be continued and enhanced. Improvements are especially needed in the area of equitable, transparent and efficient distribution of imported foodstuffs during periods of agricultural shortages. The inefficient distribution system and lack of transparency in many of the sales of the National Food Authority (NFA) during periods of food and agricultural shortages call for an overhaul in the system and more participation of the private sector in the distribution of temporarily imported foodstuffs during periods of shortages.

The oil price shocks have led many in the Philippines to question the deregulated structure of the oil industry. There is a perception that there is an asymmetry of quick price increases during times when world prices are rising, but slow and lagging price decreases when world prices are falling. The question of a domestic oil cartel has arisen (led by Shell, Caltex and a previously government-owned oil company, Petron), as many new players are finding it hard to compete in a setting of rising world prices. It is difficult to handle this problem as the fiscal bind prohibits any temporary support of oil prices, and as cross-subsidies to low-income households in electricity charges have been mostly dismantled in

recent years. Regulatory boards still regulate electricity charges and transportation fares, while the Department of Energy has clout to stop unreasonable price increases in oil and gasoline products. Thus, the importance of regulation in public utilities and oil/gasoline products become crucial in fostering competition and stopping cartel-like pricing. The Philippines also lacks anti-trust legislation that will remove monopoly and predatory pricing in key economic sectors.

If world oil prices increase significantly again, it is recommended that an oil price stabilization fund (used moderately successfully in the 1970s by the Marcos government) be explored to tackle the situation. Equally important is the need to develop, in the medium and long run, alternative fuel sources and to reenact laws giving special tax incentives for firms providing these alternative fuel sources.

The Philippines has an incomes policy that deliberately keeps minimum wages very low and lagging behind price increases even as their monitoring and implementation are grossly inadequate. With labor productivity increasing, this has led to lower inflation but has also led to a long-run decline in real wages, which may have contributed to worsening income distribution and poverty. A more balanced approach that this paper recommends involves the following: 1) depending more on tripartite agreements derived by government, labor and employers to impose agreed-upon ceilings on price and wage increases; 2) enact laws and rules that punish monopoly and cartel-like pricing (especially for the oil and telecommunications industries); and 3) do more monitoring and temporary regulation of key products such as food, oil, telecommunications and rent-control housing especially during periods of price instabilities.

The above set of alternative monetary policies points to a need for a change in mind-set from a dichotomy between the financial and real sectors to a viewpoint wherein the financial sector is integrally linked and supportive of the real sector. The strategy is to coordinate and link the current targeted credit programs in the anti-poverty strategy campaign with the initiatives of the economic departments and agencies in developing and promoting key priority economic sectors that have high value-added, high technology spillover, multiplier effects and employment generating potentials. Successes in this arena will hopefully spill over to the formal and big business sector of the economy.

5.6. *Testing the New Alternative*

Inasmuch as the Central Bank already has a long-term and a short-term macroeconomic model, it is suggested that the new alternative be tested employing similar types of macro model. The new econometric model poses some challenges: 1) How to model a more discretionary monetary policy based on multiple objectives of both output/employment generation and price stability (various simulation scenarios and quadratic loss functions might be used); 2) How to define and model ‘overheating’ and excessive aggregate demand in the model to identify when some monetary contraction or aggregate demand reduction may be beneficial to the economy and to identify when monetary contraction will be unreasonably recessionary; 3) How to model the incomes policies and temporary price controls; 4) How to model increased credit allocation and incorporating its impact on the growth of key economic sectors with high value-added and employment generation. No doubt different scenario simulations are needed (with low, medium, high scenario assumptions) to make the models more useful to policy makers.

5.7. *A Difficult Endeavor*

The above alternative set of policies run counter to the current macro policies of the Philippine government and go beyond policies traditionally reserved to the Central Bank. Thus the adoption of the alternative monetary policy is a formidable endeavor that requires a change, not only in the inflation targeting regime, but also in the current macro framework of the country.

To achieve this, one does not need to drastically change the mandate and autonomy of the Central Bank. What is needed is perhaps a gradual but sure and progressive change in its attitude. The first hurdle of shifting away from over-emphasizing inflation over growth has been achieved. The next step is just to make this more explicit. The hardest part is convincing not only the Central Bank but the entire government, business and financial sectors of the country that high and sustained growth requires an active industrial policy supported by monetary and credit policies. The last hurdle is the most difficult one as it entails a rejection of the Washington Consensus and the adoption of a new and fresh perspective. This is what heterodox economists, including those involved in this special issue, is working and striving for.

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Notes:

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ⁱ These are cash and short-term government securities which a bank is allowed to keep as required reserves.

ⁱⁱ The increase in 2006 was however due more to conscious prepayment of foreign debt (as the peso became strong) and domestic debt (as interest rates started to fall).

ⁱⁱⁱ Haussman and Rodrik refer to the market failure problem of 'information spillover' or 'first mover' problem as the problem wherein the first mover bears all the risks. If he succeeds, others will imitate her/him and reduce her/his market share. If she/he fails, she/he will bear all the losses.