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DOF Economic Bulletin on Building Strong Macroeconomic Fundamentals

The Philippine economy used to be the sick man in Asia, with its growth at the bottom of the heap in ASEAN. It was the only ASEAN country to be classified by the World Bank as highly indebted economy in the '80s and '90s. It was the only country in ASEAN to join Latin America excluding Chile in the debt crisis that crippled a group emerging economies in the early '80s.

In response to economic crises, the Philippines has been adopting policies to build stronger macroeconomic fundamentals. Economic, fiscal and financial reforms have made the economy more resilient to economic shocks.

The country has undergone severe economic crises, namely: the debt crisis in 1984-1985; the Asian financial crisis in 1998-1999 and the COVID-19 health crisis in 2020 and is still ongoing. The country has adopted various economic reforms when a crisis strikes. Strong fundamentals enabled the country to avoid the global financial crisis in 2008-2009 which crippled US and Europe.

Debt crisis of 1984-1985

The debt crisis in 1984-1985 started out as a fiscal crisis which progressed to a BOP crisis. It was induced by both political uncertainty and unmanageable fiscal deficits which was further worsened by the assassination of Senator Benigno Aquino. A political unrest emerged, revealing the weaknesses in the economy.

While National Government (NG) deficits remained low during the decade preceding the crisis, the consolidated public sector deficits were huge---averaging 9.15% of GDP from 1975 to 1980.^{1/} During that period, the country borrowed heavily from abroad, pushing external debt ratio to 67.75% in 1984-1985. The proceeds from external borrowing were used to invest in GOCCs and GFIs that were unable to repay these debts. Due to the absence of project evaluation, borrowed funds were invested in projects that generated rates of return significantly lower than interest rates. A study made by DOF in 1980 showed that interest rates of borrowed funds (in Philippine peso terms) averaged 11.65% while the average ROI of projects financed were at a low 0.26%.^{2/} Likewise, the economy focused on import substitution. As the economy grew, import requirements grew faster than exports, resulting in external imbalance.

Thus, the BOP deficit rose to -5.2% of GDP in 1984-1985 with the current account deficit reaching 5.75% of GDP. The severe lack of foreign exchange led the Philippine peso to depreciate by 61.6% in 1984-1985. Thus, the economy contracted by 7.31% for two straight years.

To avoid a deeper crisis, the country negotiated a new economic program with the IMF, a standstill arrangement on debts to allow the economy to recover, a debt rescheduling program with the Paris Club, and a Brady Plan type of debt reduction with commercial creditors.

Response to the debt crisis

The Philippines adopted economic reforms, including:

- a. Shift starting 1980 from import substitution to greater export orientation through tariffication of quantitative restrictions, gradual lowering of tariffs over a 10-year period from a maximum of 100% to 10% except for sensitive items, and a more flexible exchange rate;
- b. Dismantling of state monopolies including coconut, sugar, airline services, petroleum importation, etc., privatization of government owned and controlled corporations (GOCCs) and closer monitoring of their financial condition; and formulation of corporate plans and programs under the Government Corporate Monitoring and Coordinating Committee (GCMCC);
- c. Rationalization of undue tax and borrowing privileges granted to GOCCs and reprioritization of borrowing proceeds, and periodic evaluation of their financial performance;
- d. Establishment of public investment management thru project appraisal and prioritization and monitoring by the Investment Coordination Committee (ICC);

- e. Tax reforms including shift to Value Added Tax (VAT) in 1988 and adjustments in sin tax, raising the tax effort from 10.56% in 1975-1980 to 14.78% in 1993-1997;
- f. Rebuilding of the capitalization of adversely affected financial institutions and encouraging mergers;
- g. Rehabilitation of the Central Bank of the Philippines (CBP) to form an independent monetary authority named Bangko Sentral ng Pilipinas (BSP) with a new charter and capitalization; and
- h. Liberalization of foreign ownership in banking institutions in 1994.

Asian crisis of 1997-1998

The Asian crisis started out as a BOP crisis in Thailand and contagion spilled over to ASEAN and the rest of Asia.

Unlike the 1980s debt crisis which affected mainly Latin American economies and the Philippines and was triggered by public sector excessive external borrowing, the Asian crisis was precipitated by private borrowing and investment.

A decade before, private sector investments using both external borrowing and foreign investment expanded vigorously, pushing ASEAN economies to grow by 6.4% annually from 1976 to 1990. The investment-GDP ratio of ASEAN economies averaged 29.7% during the period funded mainly by private equity flows and to a lesser extent, external borrowing by the private sector.

Unfortunately, some of these investments went into projects with dubious viability. When many ASEAN corporates started to default on their debts, foreign investors started withdrawing their funds from emerging economies. This led to unmanageable BOP deficits and subsequent huge borrowing from multilaterals.

The Philippines was among the less affected in ASEAN because the extent of private sector borrowing from external sources was just starting when the crisis erupted. However, it was also badly affected by risk avoidance and the corresponding rise in global interest rates.

In the Philippines, the BOP position reversed from a 1.59% surplus in 1993-1997 to a small deficit of -0.34% of GDP in 1997-1998. Unfortunately, the external debt-GDP ratio was still high despite fiscal reforms at 49.97% in 1993-1997. This rose to 51.53% as the crisis bit with global interest rates rising. The country was still able to borrow from external sources with a

premium of 420 bps. However, due to contagion and risk aversion, the peso depreciated by a cumulative 51.2% as interest rates on Philippine peso debts remained at double digit levels.

Thus, in 1998 and 1999, the Philippines' real GDP contracted by a smaller -0.29% compared with pre-crisis 5-year annual GDP growth of 4.44% and the -7.3% annual contraction in 1984-1985.

Response to the Asian crisis and thereafter

Asian countries responded with regional economic programs to avoid future crises. These include:

1. Establishment of peer surveillance under ASEAN+3 thru ASEAN Macroeconomic Research Office (AMRO) along with development of economic benchmarks that will trigger assistance to affected countries;
2. Acceleration of trade liberalization under ASEAN Preferential Trading Arrangements to pave the way for an ASEAN Trade in Goods Agreement (ATIGA) under the ASEAN Economic Community;
3. The multilateralization of ASEAN bilateral swap arrangements into an ASEAN Chiangmai Multilateral Initiative Mechanism (CMIM) that pools reserve funds and enable member-economies to assist each other during emergencies; and
4. Establishment of the 10-nation Asia-Pacific Economic Cooperation (APEC) to exchange information and views on programs to transform the region to a rapidly growing and economically resilient area of development.

The Philippines also adopted:

1. Tax reforms including expanded value added tax (VAT) and increase in the rate to 12% in 2006, the increase and indexation of sin taxes in 2014 and the increase and indexation of petroleum taxes in 2017, the lowering of individual income under the TRAIN (Tax Reform for Acceleration and Inclusion Bill in 2017 and corporate income tax rates, and the rationalization of fiscal incentives under the CREATE Bill in 2020;
2. Liberalization of the energy sector through market-oriented petroleum pricing and private investment in electricity sector;
3. Shift to inflation targeting in 2002; 3/

4. Phased liberalization of foreign exchange transactions including import payments and outward investments
5. Adherence to international norms in banking supervision under Basel 1, Basel 2 and Basel 3 to reduce banking risks; and
6. Reforms in the agriculture sector, including tariffication of quantitative restriction in rice in 2019 and other agricultural products before that.

COVID-19 pandemic

Unlike the previous two crises, the COVID-19 pandemic started out as a health crisis that blew up to an economic crisis. To prevent the spread of the virus, the whole world implemented lockdowns that caused a severe economic contraction and adopted spending programs to curb the virus and push the consolidated public sector deficit to expand to an estimated 6.5% of GDP. Public sector debt rose to 47.48% of GDP in 2020 from an average 34.65% during the 5-year pre-crisis period.

Likewise, unlike in previous crises when the BOP was unstable, the Philippine peso appreciated by 4.1% in 2020 and the BOP surplus surged to 4.4% of GDP. Likewise, nominal lending interest rates remained at single digit level, dropping slightly to 6.0%. This is due to liquidity infusion by the Bangko Sentral ng Pilipinas (BSP) through purchases of Treasury securities and lowering of reserve requirement.

Despite continued low inflation and interest rates,^{4/} the lack of mobility arising from strict lockdowns squeezed GDP growth to -9.6%, its lowest in the postwar period.

The Philippines before the COVID crisis

Economic reforms have transformed the Philippines to a more efficient, competitive and resilient economy.

First, the GDP growth accelerated, averaging 6.6% five years before the COVID crisis compared to an 70-year average growth of 4.6% since 1950;

Second, the inflation rate and interest rate were at their lowest levels, implying stable internal and external position. Inflation averaged 2.76% from 2105 to 2019 while nominal lending rates averaged 6.05%;

Third, the external debt ratio dropped its lowest in 2015-2019 at 23.19% of GDP, the general government debt ratio at 34.65% and the National Government debt ratio at 39.6%.

Fourth, the country's BOP position was on balance from 2015 to 2019 with the GIR rising to 8.2 months of imports of goods and services (MIGS). During the crisis, in 2020, the BOP surplus swelled to 4% of GDP, further boosting GIR to 10.2 MIGS. This is due to confidence by market that the Philippines will recover lost ground when the lockdowns are taken down.

Fifth, the economy has become outward-oriented with exports of goods and services and primary and secondary income rising above 40% of GDP.

Lessons from the crises

The country is best able to hurdle external and internal shocks by maintaining strong macroeconomic fundamentals. The lessons from these three crises reflect the same ones taught by grade school teachers.

First, save money for the rainy years. During good years when GDP is growing rapidly and interest rates are low, debts and fiscal deficits should be kept to the minimum to accumulate reserve funds for rainy days.

Second, conserve resources and make efficient use of them. Even in the worst of crises, revenues should be conserved because this is the fund that will save the country during difficulties. A country needs revenues not only to fund social programs but to also ensure building and maintenance of efficient infrastructure. Due to low tax effort, the country scrimped on infrastructure spending for many years, averaging only 2.0% of GDP from 1946 to 2000 while those of neighboring ASEAN countries averaged 5.0% of GDP. Thus, under the Duterte administration, a comprehensive tax reform program pushed the tax effort to its highest level in 32 years. This enabled the country to embark on infrastructure spending equivalent to 6.2% of GDP in 2016-2020. At the same time, it was able to raise sin taxes to fund the universal health care, the anti-COVID health programs and consumption subsidies to families and workers affected by the lockdowns.

Conservation of resources requires a prudent investment management policy. The establishment of the ICC in 1983 enabled fiscal authorities to appraise government projects and choose to implement those with highest economic rate of return. The establishment of the GCMCC and later, the Commission on Government Owned and Controlled Corporations (CGC), enabled the government to tame the elephants in the room, e.g., convert the GOCCs from loss-makers incurring huge deficits to money-makers, contributing P160.6 billion to fund anti-COVID programs in 2020.

Conservation policies require transparent and prudent deficit and debt management. The comprehensive consolidated public sector, aside from the NG departments and agencies, should form part of the budget. Debt benchmarks should be put in place to avoid overborrowing. Project economic returns should be higher than project costs to ensure that debts can be repaid. Public

sector borrowings need to be approved by the independent monetary authority (the BSP) to ensure compliance with this good practice.

Third, aim to be the best and the brightest. Allow competition, both local and foreign, to enable market players to improve their goods and services and offer the cheapest prices to consumers. Allow competition to tame the inflation tiger, unleash its potential to drive innovation. Inflation reveals a problem, either supply or demand, and the problem cannot be solved by just imposing band-aid measures like quantitative restrictions, safeguard measures and price controls. Solve the root of the problem thru a productivity program. Allowing inefficiencies to persist and shoving them under the dustbin of neglect will just enable them to fester and come back to haunt the economy years later.

Crises are the symptoms of economic problems; they are signals for the necessity of reform. As Churchill said, “Let’s not allow a good crisis to go to waste”.

Table 1. Growth and Investment, ASEAN			
GDP GROWTH	1976-1990	1991-2020	2015-2019
AVERAGE ASEAN 5/6)	6.44%	5.1%	5.2%
Philippines	3.30%	3.8%	6.5%
Indonesia	6.81%	5.6%	5.0%
Malaysia	6.94%	5.8%	5.0%
Singapore	7.93%	5.9%	2.6%
Thailand	7.50%	5.0%	3.5%
Vietnam	..	6.5%	6.8%
INVESTMENT/GDP	1976-1990	1991-2020	2015-2019
AVERAGE ASEAN 5/6)	29.25%	27.3%	26.6%
Philippines	22.35%	21.3%	24.8%
Indonesia	24.48%	27.9%	34.4%
Malaysia	27.45%	28.0%	25.1%
Singapore	40.12%	29.1%	25.8%
Thailand	29.47%	28.4%	23.0%
Vietnam	14.61%	29.4%	26.6%
Sources: IMF and NEDA			

TABLE 2. PHILIPPINES: ECONOMIC INDICATORS						
	Debt crisis		Asian crisis		COVID-19 crisis	
ECONOMIC OVERVIEW	1984-1985	1975-1980	1998-1999	1993-1997	2020	2015-2019
REAL GDP GROWTH	-7.31%	4.50%	-0.29%	4.44%	-9.51%	6.56%
INFLATION	36.76%	14.29%	8.27%	9.73%	2.63%	2.76%
INTEREST RATES (LENDING)	28.40%	15.78%	14.28%	15.11%	6.00%	6.05%
FISCAL INDICATORS						
CONSOLIDATED PUBLIC SECTOR DEFICIT, % OF GDP	-3.88%	-9.15%	-2.68%	-0.56%	-7.39%	-0.30%
NATIONAL GOVERNMENT DEFICIT, % OF GDP	-1.81%	-2.29%	-2.33%	0.07%	-7.63%	-2.34%
PUBLIC SECTOR DEBT, % OF GDP	67.75%	34.02%	52.26%	62.51%	47.48%	34.65%
NATIONAL GOVERNMENT DEBT, % OF GDP	9.23%	9.96%	21.43%	19.38%	54.49%	40.52%
REVENUE EFFORT (% OF GDP)	9.22%	8.73%	13.81%	15.20%	15.89%	15.83%
TAX EFFORT (% OF GDP)	7.77%	10.56%	12.45%	14.78%	14.00%	13.66%
EXPENDITURE EFFORT (% OF GDP)	7.25%	10.30%	16.14%	17.04%	23.52%	17.60%
INFRASTRUCTURE SPENDING, % OF GDP	1.98%	3.11%	1.65%	2.66%	6.22%	4.59%
BALANCE OF PAYMENTS INDICATORS						
BOP POSITION, % OF GDP	-5.22%	-0.51%	-0.34%	1.58%	4.42%	0.38%
CURRENT ACCOUNT POSITION, % OF GDP	-5.75%	-3.88%	-2.29%	-2.90%	3.58%	-0.24%
EXTERNAL DEBT, % OF GDP	69.70%	38.89%	51.53%	49.97%	27.19%	23.19%
GIR, US\$B	1.77	1.43	15.44	10.82	110.12	81.56
GIR, MONTHS OF MGS	2.46	1.63	4.25	3.03	11.80	8.20
EXPORTS OF GOODS & SERVICES & PRIMARY INCOME (US\$B)	8.63	8.20	43.40	34.22	150.04	136.96
EXPORTS OF GOODS & SERVICES & PRIMARY INCOME (% OF GDP)	23.2%	15.9%	44.7%	42.3%	41.4%	40.8%
EXCHANGE RATE, PHP/US\$	17.65	8.49	35.18	26.21	49.62	49.58

AVERAGE'						
ANNUAL DEPRECIATION RATE	30.8%	9.1%	25.6%	-0.8%	-4.1%	3.2%
Sources: NEDA, BSP, Department of Finance, & Bureau of the Treasury						

1/ The consolidated public sector deficit (CPSD) was invented by the IMF for the Philippines. Due to restriction imposed on NG deficit levels under IMF programs, fiscal authorities at that time used GOCCs to spend on behalf of the NG to escape the restriction. Thus, the IMF devised a bigger fiscal deficit measure, the CPSD.

2/ “Foreign Borrowing: Blessing or Curse? (The Role of Foreign Borrowing in the Economy)”, by Gil Beltran, Jose Robert Javier, Ma. Teresa Habitan and Joselito ALmario, 1985.

3/ The Philippines formally adopted Inflation Targeting as the framework for Monetary Policy on January 2002. The Philippines’ inflation target is measured through the Consumer Price Index (CPI). For 2009, inflation target has been set to be 3.5 percent, having a 1% tolerance level, and 4.5 percent for 2010, also having 1% tolerance.

4/ Inflation surged for short periods after the Asian crisis due to supply problems. This happened after strong typhoons that batter food producing areas, when the African swine fever dented pork production and set pork prices to spiral, affecting the prices of substitutes, and petroleum market uncertainties that led to petroleum products rising in response to global price conditions.

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