Institutions and Economies
Vol. 5, No. 2, July 2013, pp. 69-100

The Impact of the Global Financial Meltdown and New Growth Strategies for the Philippines

Joseph Lim
Department of Economics
Ateneo de Manila University
Email: josephanthony_lim@yahoo.com
jlim@ateneo.edu

Abstract: This paper discusses the impact of the global financial meltdown on the Philippines. To cushion future capital flow, exchange rate volatilities and export collapse, new growth strategies for the Philippines should include on the financial and capital account fronts: a) controls on short-term capital flows; b) a BBC (basket, band, crawl) system to replace the free floating exchange rate regime; and c) a bigger reliance on domestic debt financing and a shift away from external debt financing of growth to avoid external debt crises due to external shocks. In developing a vibrant domestic internal demand in order to reduce over-dependence on exports, the following will be vital: a) a strong move to correct income and regional inequalities and disparities, including strong anti-poverty policies; b) an industrial policy to make stronger linkages and productive capacity in the economy; c) fiscal reforms (especially tax) in order to generate sufficient funds to finance much needed infrastructure and human capital, and to address the grave problems of poverty across the country; d) enlightened and independent governance by a pro-poor and democratic state; and e) an end to pro-cyclical fiscal and monetary policies and a strong adoption of counter-cyclical policies.

Keywords: growth strategy, Philippines, global financial crash

JEL classifications: F43

1. Introduction

The global financial meltdown, which reached epic proportions from September 2008 to the first quarter of 2009, had caused tremendous economic havoc worldwide. Many open East Asian countries, particularly the Philippines, which had been following an export-led strategy and liberalised their capital accounts, suddenly became big victims of the massive contraction in global export demand and capital flight from 'risk' as the developed world reeled from the worst recession and financial crisis since the Great Depression.

Countries like China, India, Vietnam and Indonesia fared better than the others because of strong domestic demands and the capability and political will

to use large fiscal stimuli to strengthen internal demand and boost domestic confidence. The Philippines, unlike these countries, was unprepared in terms of lacking a sizeable domestic economy and also failing to have a quick and effective fiscal response to boost internal demand and confidence. The unpopular Arroyo government was unable to use its fiscal stimulus to boost domestic confidence. Although not hit as hard as the very open economies of Singapore, Hong Kong and Malaysia, Philippine GDP growth rates fell from a high of 5.2 per cent and 6.6 per cent in 2006 and 2007 respectively, to 4.2 per cent and 1.1 per cent in 2008 and 2009 respectively. In 2009, gross capital formation and exports fell 8.7 per cent and 11.2 per cent respectively. It was only the big remittances of Philippine overseas workers that kept consumption growing (but at a slower rate) and saved GDP growth from turning negative. This paper aims to assess and evaluate the entire framework of the ongoing globalization processes.

The rest of this paper is organised as follows. Section 2 discusses dissatisfaction with mainstream economics due to global crises caused by market openness. Section 3 describes the Philippines before the global financial crash. Section 4 describes the negative shock experienced by the Philippines due to the global financial crash – the capital flows and exchange rate volatilities, the collapse of the equities and sovereign bond markets, the negative impact on the real sector, especially investments and exports; and the negative effect on the financial sector and credit. Section 5 gives a new growth strategy for the Philippines, including improving inequalities to create a vibrant domestic demand (and less dependence on export demand); an industrial policy to revive domestic industries; progressive fiscal reforms to finance the economic development and capital controls to avoid volatilities of external 'hot money'. In conclusion, section 6 discusses the improvements and reforms in the international financial, trade and economic architecture and arrangements that should be undertaken to support developing economies.

2. Global Crises and Dissatisfaction with the Mainstream Economies

Global crises had been blamed on too much market openness in all sectors and had led to much dissatisfaction with the mainstream economics. Thus, questioning of the Washington Consensus main pillars of trade, financial and capital account liberalisation is heightened in this severe global crisis. External financial and capital account liberalisation it seems had caused severe adverse impacts again (after the Asian crisis) including crashes in the equities and sovereign bond markets, capital flight and sharp exchange rate depreciation that probably adversely affected economic confidence and investments. The sharp fall in exports mirrored the collapse of global trade in late 2008 and

throughout most of 2009. The entire framework of the ongoing globalisation processes requires re-assessment and re-evaluation.

2.1 Questioning Financial and Capital Account Liberalisation due to the Asian Crisis

During and after the Asian crisis, many mainstream economists (Krugman, 1998; Stiglitz, 1998; Rodrik, 1998; Feldstein, 1998; and Bhagwati, 1998) already questioned capital account liberalisation and the traditional IMF (pro-cyclical) demand contraction approach to solving balance of payment and external debt crises. This is because the cause of the Asian crisis was not overspending but strong market failures in the external financial markets that led to 'herd' behaviour and systemic risks. Some proposed exchange and capital controls.

But little known are the papers of Palley (2002) and Blecker (2002, 2003) which blamed the Asian crisis also on the export-led strategy. Recall that the Asian crisis was preceded by and was simultaneous with a cyclical downturn in global electronics demand that contributed to current account deficits within the hard-hit countries in East Asia right on the eve of the Asian crisis. Palley (2002) claims that simultaneous trade liberalisation among developing countries leads to a 'race to the bottom' and over-dependence on foreign (especially developed countries') demand. This 'race to the bottom' leads to continuing deterioration in the terms of trade of the developing countries. All the above, plus slower than world-average growth and *recessions* in developed countries, does not make the export-led strategy an optimal one. Blecker (2002, 2003) agrees with Palley (2002) in claiming that export-led growth, especially in electronics, leads to excess capacity, competitive pressures and eventually lower growth performance. Kaplinsky (2000) and Ertuk (2001/02) also talked about *immiserising growth* as a result of the creation of excess capacity in export-oriented manufacturing industries. During the 1990s, too many developing countries entered the more advanced product categories thus creating excess capacity and fostering falling prices. This issue was also raised by Palley (2002) and Blecker (2002, 2003).

2.2 Non-Mainstream Criticism of Global Trade Openness before the Global Crash

With the then current global financial crash, Blecker and Razmi (2009) added that the export-led strategy for developing countries cannot work without: 1) continuing growth and the absence of sharp recessions from developing countries; 2) greater South-South trade; 3) a 'flying geese' model wherein

some countries specialise in high-tech products and give up the lower end export products to other less developed countries. Furthermore, their paper finds negative effects on currency devaluations of developing countries as they engage in exchange rate competition over the global export market. The devaluation hurts most developing countries, especially those who compete with each other via exchange rate depreciation. Although this might have positive short-run export and GDP growth effects, the currency devaluation vis-à-vis developed countries' currencies have offsetting long-run contractionary effects through more costly imports and higher foreign debt payments. Blecker and Razmi (2009) conclude that because 1) developed economies' export demand is not reliable as the current global meltdown showed, and 2) an internally flawed development strategy wherein many developing economies are forced to compete destructively for the global export market including destructive competitive currency devaluations, the best strategy is still to have a strong internal market and domestic demand. Hundreds of developing countries cannot be expected to compete with one another and replicate the export-led success of East Asian economies. Similarly, the East Asian economies cannot all expect to continue their success with unreliable global export markets and with too many countries – especially China – going into all export sectors including the electronics and other high-tech sectors.

Questioning of the export-led strategy leads us to go back to the old but more comprehensive and (for many) more useful development theories such as Nurkse's Balanced Growth theory and Big Push theories such as those of Rosenstein-Rodan (1943) and Hirschman (1968). Long before endogenous growth theories proclaimed increasing returns to scale as crucial to sustained economic growth and development, Kaldor had analysed increasing returns in manufacturing as crucial to economic development. These theories emphasised the need to develop key domestic industries that are necessary for development and crucial to achieve increasing returns to scale. Exports are supplements and necessities to finance the import and financing needs of any developing economy. The endogenous growth models are actually almost the same theories, employing more 'modern' parlance such as human capital, positive externalities, coordination failures and information spillover (Romer, 1994; Lucas, 1988; Murphy *et al.*, 1989; Hausmann and Rodrik, 2006). But the main difference between the two sets of theories is that the original development theories assumed implicitly or explicitly that a strong and vibrant domestic demand is a necessary ingredient of the theory as export demands of developing and poor countries are weak and made up of primary and agricultural products.

A more comprehensive discussion of the demand side from the older development economics tradition is provided by Ragnar Nurkse (see Deardoff and Stern, 2007) who talked about the need for both domestic demand and export

demand. The latter is necessary to have enough markets for manufacturing products – what the endogenous growth economists would call manufactures with increasing returns to scale. At the same time domestic demand will have to be shored up for the more labour-intensive products which may face trade barriers abroad, or in Blecker and Razmi's thesis, face too much competition from other countries. A balanced growth strategy based on a good mix of domestic and external demand will be optimal. In the modern context, a strong and growing domestic market (based on increasing purchasing power) can substitute for the global market, for those products with increasing returns to scale.

Bigger countries with large populations such as China, India and Indonesia will have more advantages here (and these are the countries actually doing well in the current global meltdown), but middle sized countries with more than 70 million people (the Philippines, Vietnam and Thailand) will also benefit from a fast-growing internal demand as a buffer to overdependence on external demand as long as income distribution is rather equitable to provide enough purchasing power to the population. Hirschman (1968) even made it a requirement that a successful import substitution stage is needed before coming up with industries that will exploit increasing returns to scale toward a bigger export market.

Endogenous growth theories, on the other hand, try to explain the success of East Asian 'miracles' and implicitly assume strong export demand can be the source of increasing returns to scale in the economy. The endogenous growth literature emphasises good human capital and increasing returns to scale (rather than export-led growth) as the reasons for East Asia's success. However, these papers assume that the increasing returns to scale are feasible because of a huge market made up of the global export market.

2.4 First Movers, Coordination and Market Failures

Hausmann and Rodrik (2006) went a step further, claiming that part of the East Asian success is a strong industrial policy that achieved increasing returns to scale by solving the market failures of: 1) information spillover, or 'first mover' problem – a positive externality problem wherein the technological and skill-intensive firm will undersupply innovation and inventions due to bearing the entire risk of innovating and other firms 'free riding' if they succeed; and 2) coordination, wherein inputs and institutions needed for a progressive (increasing returns to scale) sector had to be simultaneously set up and developed outside the market. Gill and Kharas (2006) assert that this interpretation is most consistent with the Schumpeterian idea of the aggressive drive toward innovation by entrepreneurs because of the strong economic incentive of deriving economic rents. The problem with these endogenous

growth models is that they are concentrated on the supply side and assume enough demand because of a global export market.

Now this assumption is placed in question as all multilateral institutions are calling for 'rebalancing' of demand in the national economies of both developing and emerging markets in the aftermath of the recent deep global financial and economic crisis and recession. The reason obviously is globalisation's penchant for creating volatilities and shocks and a strong domestic demand is now vital as a key element to reduce the impact of world recession and export collapse. This is an additional reason to those given by Blecker, (2002, 2003) Palley (2002) and Blecker and Razmi (2009).

Any new growth strategy will have to address and reverse the above Washington Consensus programmes and policies which have been in place for decades. Thus such a strategy for the Philippines includes on the financial and capital account fronts: a) controls on short-term capital flows; b) a BBC (basket, band, crawl) system to replace the free floating exchange rate regime; and c) a bigger reliance on domestic debt financing and a shift away from external debt financing of growth to avoid external debt crises due to external shocks. All these may need cooperation and coordinated action with Asian neighbours and other developing nations in changing the international financial architecture and to break the stranglehold on the Philippines of foreign short-term capital, international credit rating agencies and the multilateral agencies.

Toward the longer-run goal of developing a vibrant domestic internal demand, the following will be vital: a) a strong move to correct income and regional inequalities and disparities, including strong anti-poverty policies; b) an industrial policy to make stronger linkages and productive capacity in the economy; c) fiscal, especially tax reforms in order to generate sufficient funds to finance much needed infrastructure and human capital, and to address the grave problems of poverty across the country; d) enlightened and independent governance by a pro-poor and democratic state, and e) an end to pro-cyclical fiscal and monetary policies and a strong adoption of counter-cyclical policies. The last also requires some work on international cooperation and coordination to fight the possibly harmful responses of credit rating agencies, multilateral agencies and predatory foreign investors, on policies that run against the Washington Consensus.

3. Before the Global Financial Crash

Like many developing countries, the Philippines implemented an import substitution strategy starting from the 1950s, bringing high growth for most of the decade. With the rise of the Washington Consensus and under the supervision of the IMF, the Philippines incurred a lot of foreign public and commercial debts (together with many countries in Latin America and other middle-level

developing countries) in the 1970s, from 'petro dollars' accumulated by Western multinational banks. This was partly one aspect of the opening up scheme toward export-oriented growth (away from the import substitution strategy) being pushed by the multilateral institutions.

In the early 1980s, the Philippines further undertook financial liberalisation – lifting interest rate ceilings and relaxing restrictions on the banking sector. The Philippines was about to undertake trade liberalisation earnestly when it was hit by the Latin American debt crisis that occurred simultaneously with the uprising against the Marcos government, creating the deepest recession the country ever experienced in 1983-85. Governments that followed Marcos pursued trade, financial and capital account liberalisation with even greater fervour. Import restrictions were dismantled in the second half of the 1980s. Significant tariff reduction was implemented in the early 1990s simultaneous with setting up of the ASEAN Free Trade Area (AFTA) and the Philippines' entry into the World Trade Organisation (WTO) in the 1990s.

In 1992, the Philippine government started liberalising the capital account allowing foreigners free access to the equities and bond markets as well as short-term loans to the public and private (banking and non-banking) sectors. 'Hot money' started pouring into the Philippines in mid-1990s, and together with the very open economy, allowed the Asian crisis to hit the country quite significantly. As the Asian crisis and the global financial crash in 2008-9 showed, this extreme opening up in the trade, financial and capital account sectors open developing countries and emerging markets like the Philippines to unnecessary volatilities, external shocks, recessions, financial crises and losses of confidence that provide big obstacles to continuing and healthy growth and development. The picture of the Philippines before and during the global financial crash in 2008-9 below will demonstrate this.

Tables 1a and 1b illustrate growth rates of the demand and supply (economic sectors) components respectively, of GDP from 1997 to the second quarter of 2009. One can see that private consumption contributed significantly to growth from 1997 to 2007. Investments grew anaemically except in 1997, 2000 and 2007 (high confidence years).

From Table 1a, it can be seen that in the latest growth period of 2004 to 2007, net exports became a large source of growth from the demand side.[1] Thus right before the sharp world trade and economic contraction, the Philippines became partly dependent on net exports for its growth. Table 1a also shows that income sent by overseas workers (overseas remittances) – comprising almost all of net factor income from abroad (NFIA) – significantly boosted the gross national product, especially from 2000 onwards. The big injections from overseas workers partly explain why private consumption is the main contributor to growth in GDP, as overseas remittances are used by the families

Table 1a: Growth Rates of GDP and Expenditure Items: 1997 to 2nd Quarter of 2009 (base year used is 1985)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	1st Q 2009	2nd Q 2009
Personal Consumption Expenditure	4.99	3.45	2.64	3.51	3.58	4.08	5.28	5.88	4.83	5.51	5.85	4.67	0.81	2.25
Government Consumption	4.63	-1.95	6.73	6.15	-5.32	-3.83	2.61	1.39	2.31	10.38	6.58	3.23	3.78	9.08
Capital Formation	11.70	-16.28	-1.98	23.93	-7.29	-4.30	2.99	7.17	-8.80	4.98	12.46	1.68	-16.49	-9.84
1. Fixed Capital	11.47	-11.17	-2.27	19.92	-13.03	2.15	3.76	1.31	-6.62	3.81	10.95	2.90	-5.67	-1.94
2. Changes in Stocks	24.46	-280.04	-9.41	-86.23	-1380.8	-109.3	141.73	-444.2	-58.1	64.08	60.46	-25.3	-186.9	-194.2
Exports	17.15	-21.03	3.62	17.05	-3.44	4.03	4.88	15.00	4.78	13.40	5.38	-1.89	-18.18	-15.99
Less: Imports	13.49	-14.70	-2.80	4.27	3.52	5.61	10.82	5.77	2.37	1.89	-4.19	2.39	-19.15	-2.67
Statistical discrepancy	-79.26	572.35	-54.44	-488.46	-84.26	-432.0	131.24	-53.04	71.71	-134.5	363.08	-28.9	-81.30	-63.50
G D P	5.19	-0.58	3.40	5.97	1.76	4.45	4.93	6.38	4.95	5.40	7.02	3.84	0.45	1.45
Net factor income from abroad	6.84	23.92	10.10	26.82	9.78	0.50	20.61	13.52	10.72	6.07	12.13	30.79	40.80	29.67
G N P	5.25	0.41	3.73	7.07	2.26	4.18	5.95	6.91	5.40	5.45	7.44	6.17	4.44	4.42

Source: National Statistics Coordination Board (2009)

Table 1b: Growth Rate of GDP by Economic Sectors: 1997 to 2nd Quarter of 2009

Economic Sectors	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	1st Q 2009	2nd Q 2009
AGRI. FISHERY, FORESTRY	3.09	-6.38	6.52	4.31	3.71	3.95	3.76	5.18	2.00	3.70	4.93	3.22	2.15	0.33
INDUSTRY SECTOR	6.14	-2.12	0.90	8.95	-2.48	3.87	4.00	5.21	3.78	4.81	6.51	4.95	-2.12	-0.33
a. Mining & Quarrying	1.69	2.77	-8.70	11.68	-6.54	50.96	16.82	2.63	9.31	-6.08	26.04	1.87	16.07	21.43
b. Manufacturing	4.22	-1.13	1.60	5.59	2.87	3.47	4.24	5.84	5.28	4.60	2.89	4.31	-7.32	-7.19
c. Construction	16.18	-9.65	-1.53	26.23	-23.13	-4.02	-0.81	3.41	-5.88	9.63	21.15	7.84	16.74	16.94
d. Elect, Gas and Water	4.82	3.26	3.25	4.03	0.67	4.26	3.19	4.23	2.48	6.38	6.68	7.31	1.04	2.90
SERVICE SECTOR	5.42	3.47	4.02	4.42	4.25	5.09	6.12	7.73	7.00	6.47	8.16	3.34	1.41	3.06
a. Trans., Comm. & Stor.	8.23	6.49	5.22	10.49	8.81	8.93	8.59	11.23	7.34	6.34	8.33	4.24	4.11	1.74
b. Trade	3.90	2.45	4.88	5.16	5.61	5.76	5.66	6.78	5.64	6.10	8.29	1.22	-0.25	3.02
c. Finance	12.97	4.45	1.88	0.90	1.23	3.44	5.88	9.89	13.49	11.29	13.10	2.52	0.16	1.79
d. O. Dwellings & R. Estate	3.78	1.62	0.59	-0.02	-0.45	1.82	4.00	5.30	5.32	5.71	5.84	5.74	1.81	3.37
e. Private Services	4.82	4.66	5.79	4.84	4.40	5.49	8.12	10.65	7.52	6.92	8.44	4.86	2.90	2.83
f. Government Services	2.54	2.27	3.15	1.62	0.94	1.29	2.87	0.49	5.04	2.33	2.85	5.53	1.69	7.74
GROSS DOMESTIC PRODUCT	5.19	-0.58	3.40	5.97	1.76	4.45	4.93	6.38	4.95	5.40	7.02	3.84	0.45	1.45

Source: National Statistics Coordination Board (2009)

to expand their consumption. Without much government pump-priming (to be explained later), the main injection to growth is the high overseas remittances. Secondarily in 2004 to 2007, net exports contributed to the growth of the economy, since although still incurring trade deficits before the crisis, there was a sharp reduction in trade deficits (higher growth of exports compared to imports).

The big overseas remittances in the 2000s outweighed the trade deficits and made current account deficits positive starting in 2003. This made gross national savings bigger than gross capital formation. But investments continued to grow slowly during the good years despite a bigger financing capacity as national savings grew because of the overseas workers' remittances.

On the supply side, Table 1b clearly shows that the service sector was the main driver of growth from that side in the past decade. In the growth years 2004 to 2007, service was the lead driver of growth while industry was just secondary. It must be pointed out that the service-led growth is consistent with the consumption-led growth, much having to do with consumption of services (dwellings and real estate, finance, wholesale and retail trade, and private services). But the fastest rising service sector is comprised of the business process outsourcing (BPO) firms – mostly call centres – which are essentially exports of services and strongly part of the export-led growth as well as the export most promoted by the government. The Philippines is second only to India in the BPO export of services globally.

Just like other East Asian countries that wanted to avoid a repeat of the Asian crisis, the Philippines, spurred primarily by large overseas workers' remittances and secondarily by 'hot money' inflows during the 'good' years of 2004 to 2007, began to accumulate international reserves way beyond its needs for import financing. This is shown in Table 2.

The large international reserves saved the Philippines and other East Asian countries from balance of payment problems due to foreign investors' flight from 'risk' (which hit Pakistan, Hungary, Serbia, Kazakhstan and other emerging markets). But this was at the expense of creating dynamic domestic demand through over-saving of the national income. A growing current account surplus contributing to high international reserves means high national savings which do not go to investments. As seen in Table 1a, investments had been rather anaemic so that the high international reserves are at the expense of physical and human capital.

During the good times (2005-2007) the currency appreciated significantly compared to the US dollar and the euro. This tamed the export-growth period since the main Philippine final good export markets (like most developing countries) are mainly the US and Europe, and currency appreciation made its exports relatively expensive.

Table 2: International Reserves, in millions and number of months of imports

Year	$US millions	No. of months imports of goods
1993	5921	4.0
1994	7142	4.0
1995	7799	3.5
1996	11773	4.4
1997	8769	2.9
1998	10829	4.4
1999	15052	4.5
2000	15063	4.2
2001	15692	5.0
2002	16365	4.9
2003	17063	5.0
2004	16228	4.4
2005	18494	4.6
2006	22967	5.2
2007	33751	7.0
2008	37551	7.4
2009	44243	11.4
2010	62373	12.3

Source: ADB, 2011.

To summarise, the growth experience of the Philippines before the current global crash had been one spurred by overseas workers' remittances in the midst of strong trade and financial liberalisation, resulting in a consumption and service-led growth. Investments were lacklustre while net exports also contributed to growth in 2004 to 2007. Foreign capital inflows came in quite late, mostly in 2006 and 2007 (because of a fiscal crisis to be discussed below), which together with high overseas workers' remittances led to a strong peso appreciation and reserves accumulation. This paved the way for and increased the country's vulnerability in the face of the impending global export collapse and capital flight from emerging markets during the global financial crash.

4. The Impact of the Global Crash on the Philippines and Asian Countries

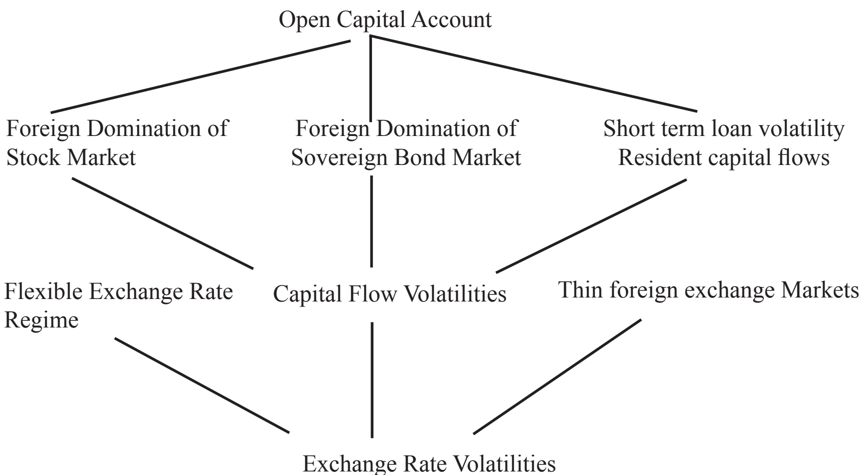
The global financial crash caused serious damages in the Philippine economy through the sudden outflows of capital and exchange rate volatilities; collapse of the stock market sovereign bond markets; decline in exports and investments as

global markets and economic confidence, respectively, collapsed. The financial sector however remained relatively unscathed.

4.1 Capital Flow and Exchange Rate Volatilities

The years before and during the Asian crisis and the current global meltdown illustrate the very unstable and volatile pro-cyclical capital flows hitting many developing and emerging economies that opened up their external capital account. Open capital accounts have caused tremendous pro-cyclical volatilities during the 'good' times and during crisis periods. Diagram 1 illustrates this. An open capital account leads to foreigners entering the stock and sovereign bond markets. Being strong institutional investors, local stock and bond market players look to these foreign institutional investors as lead investors (even if they are a minority), and just follow them in a 'herd behaviour' mode. During 'good' times, there is massive buying of equities and sovereign bonds leading to a certain degree of bubble, especially in the stock market. During the crisis period, there is much foreign capital flight and local players' withdrawal from the stock and sovereign bond markets leading to their strong asset price collapse. During good times, short term foreign loans also tend to pour into the banking and private sectors, but quickly flow out in times of national, regional or global turmoil. These capital flow volatilities and the flexible exchange rate regime lead to significant appreciation during 'good' times jeopardising the export-led strategy. During bad times, capital flight and thin foreign exchange markets

Diagram 1: Volatilities in the Capital Account and Exchange Rate Movements



(with people holding on to hard foreign currencies amidst massive demand to abandon the domestic currency and capital flight by foreign investors) create strong pressures for massive currency depreciation. Harmful exchange rate volatilities ensue.

As exports contracted and 'hot money' flowed out of portfolio investments and short-term loans in the last quarter of 2008 and first half of 2009, the peso depreciated sharply (despite healthy inflows of overseas workers' and strong international reserves) as corporations and individuals abandoned the peso for hard currencies (especially the US dollar). The peso exchange rate went from more than P50 per dollar in 2006 to almost P40 per dollar right before the financial crash in the period of 'irrational exuberance'. This collapsed to more than P48 per dollar. The peso stabilised in 2009 as it became clear the US was bailing out its financial institutions and was going to undertake a big fiscal stimulus. The exchange rate's wild swings reflect the uncertain times and the foreign exchange market's volatilities in a floating rate regime, despite a strong international reserves position.

4.2 Stock Market Crash and Increases in Sovereign Bond Spreads

As mentioned earlier, foreign investors withdrew right away from emerging markets' financial sectors due to 'flight from risks' and cashing in on profits to compensate for the big losses in the developed economies' derivative markets. This withdrawal had two major consequences.

First, it led to the stock market bubble bursting. The stock market index almost doubled between 2006 and 2007, creating a bubble very much like during the Asian crisis. The index reached a high of 3835 on 10 October 2007. The bubble began to burst in late 2007, triggering an accelerating stock price collapse throughout 2008. It bottomed out one year later (28 October 2007) when the index hit 1704. This was more than a 50 per cent decline. By February 2009, the stock market price index was below that in early 2006. The stock market collapse had led to strong capital outflows and strong currency depreciation. It had also contributed to losses in confidence leading to declines in real investments and slowdown in the growth of private consumption. However in the 2010 recovery period, the stock market again hit a new high of 4400 index through massive capital inflows.

The second consequence of the 'flight-from-risk' of foreign investors and lenders was higher spreads for emerging market sovereign bonds. This made it more difficult for the Asian countries to borrow commercially from abroad, especially to fund the fiscal stimuli they were all undertaking. The emerging market sovereign bond spread[2] of selected countries – including the Philippines – had increased from the second half of 2007, but began accelerating in the last quarter of 2008.

4.3 The Impact on the Real Sector

The economic slowdown in 2008 and the 1.1 per cent growth in 2009 are direct consequences of the global financial meltdown that started in the US subprime market. The slowdown and near-recession[3] were evidenced by specific trends as can be seen in Table 1a. A sharp decline in both exports and imports occurred. In the first quarter of 2009, the year-to-year movements show in fact a stronger import decline than export decline. This reversed in the second quarter. The near-recession is clearly a case of strong loss in confidence in the economy. Diagrams 2a and 2b show the fall in domestic confidence in investment and consumption brought about by the global recession and its accompanying volatilities. The strong export decline, steep stock market crash, currency depreciation, consistent bad news regarding developed countries' economies globally, and the threat of unemployment to overseas workers – who had been a strong driver of growth – made a direct hit on "animal spirit" bringing down investments and stemming the growth of consumption. Both investor and consumer confidence fell strongly as in any recessionary event. Thus, we see investments fall in the first and second quarters of 2009 (falling 17 per cent year-to-year, see Table 1a). Personal consumption was flat with a 0.8 per cent real growth in the first quarter and 2.25 per cent growth in the second quarter (compared to 4 to 6 per cent growth in the previous years).

On the supply side, it can be seen that the 2009 bleak performance was a fall in the growth rates of all sectors – agriculture, industry and service, especially industry and manufacturing, which posted negative growth rates. Industry declined mainly because of a more than 7 per cent (year-to-year) fall in manufacturing in the first two quarters of 2009 (see Table 1b). It is again due to the service sector that GDP remained positive (1.1 per cent) in 2009. However, agriculture and industry both ended in negative territory for 2009 as agricultural growth ended slightly negative in the second half due to extremely damaging storms and typhoons.

Now we can explain why imports fell more than exports in the first quarter of 2009. First, two-thirds of Philippine exports are made up of semiconductors and electronic parts. Most of the electronic inputs are imported chips and other high-tech inputs which are assembled in the country. Thus export decline also led to import decline. But, more importantly, imports fell more than exports because: a) durable equipment fell significantly and most durable equipment is imported; b) manufacturing fell significantly, and a majority of the inputs to manufacturing are imported. The fall in investments and manufacturing reflect both the slowdown in consumption growth and a massive decline in exports. A loss in confidence could have contributed also to the decline in investments.

The low GDP growth in early 2009 was completely unexpected by all, especially in the beginning. Everybody thought the Philippines, together with

Diagram 2a: Contagion of Open Trade and Capital Account Leading to Losses in Investor Confidence

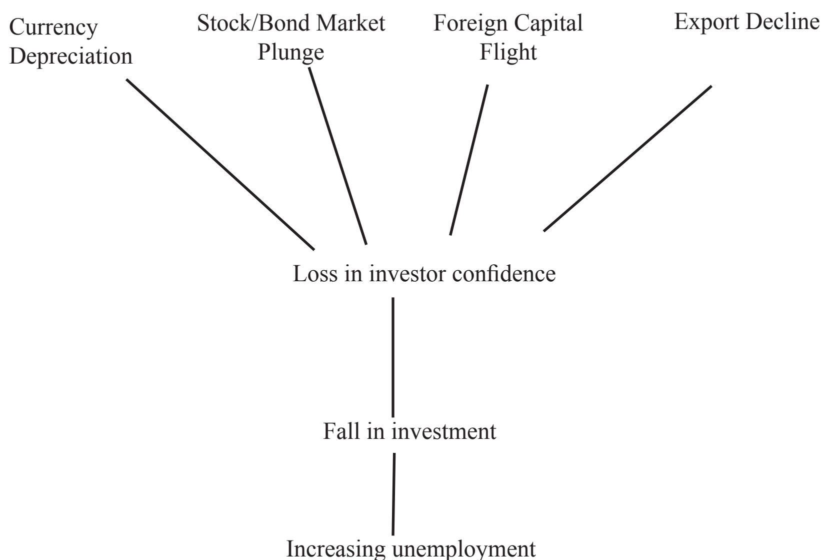
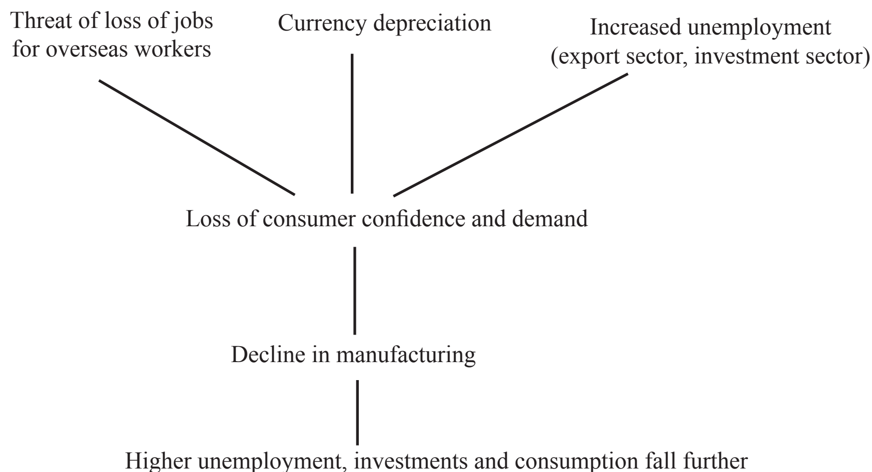


Diagram 2b: Explaining Losses in Consumer Confidence



China, India, Indonesia and Vietnam would be major Asian countries that would register more than 2 per cent growth rates. On the eve of the first quarter report in late May, Moody's predicted a positive 2.9 per cent first quarter year-to-year

growth for the Philippines. The government predicted a growth somewhere between 1.8 to 2.8 per cent. It was the IMF prediction that was most accurate, predicting 0 per cent in early 2009, but based on a wrong assumption that overseas remittances would fall significantly. In November 2008, the IMF in its World Economic Outlook predicted a 2.5 per cent growth rate for the Philippines in 2009. By September 2009 the IMF was predicting only a 1 per cent GDP growth for 2009 (The actual growth ended up being 1.1 per cent). But, on a per capita basis, the growth rate of GDP in 2009 was negative. Fortunately the GNP per capita was positive, thanks to overseas remittances.

The low GDP growth had aggravated an already existing tension between the Bangko Sentral ng Pilipinas (BSP or Central Bank) and the planning agency (the National Economic Development Authority or NEDA) on one hand, and the Department of Finance (DOF) on the other. The BSP had complained that the DOF had been more concerned about keeping the fiscal deficits low (especially after fiscal revenues fell below target) rather than stimulating the economy. It therefore had not spent enough money – especially government investments – to counter the recessionary tendencies. NEDA had more discreetly been backing the BSP stand. In recent months, the DOF, with its conservative head,[4] had publicly agreed to increase the targeted deficit to 3.2 per cent of GDP and had hinted that this may even be exceeded. But the threat of Moody's, S&P and Fitch[5] to downgrade the Philippines' sovereign credit rating due to its fiscal weakness prevented the DOF from spending significantly to stimulate the economy. In the end, the BSP prevailed as government consumption rose 10.9 per cent in 2009 (mostly in the second semester, perhaps a bit too late). This may have helped stave off a recession but was not enough to stir up the economy to at least 4 per cent growth as the stimuli of China, Vietnam, India and Indonesia did.

4.4 The Financial Sector

The banking and financial institutions of Asian countries were largely protected from the financial aspects of the global crisis. This was because, in the first place, the Asian countries improved their financial supervision and regulations after the Asian crisis. This can be seen by the high capital adequacy ratios (around 15 per cent by end of 2008) and low non-performing loan ratios (3.7 per cent by end-April 2009), partly due to low domestic credit increases during the period before the global crash. Furthermore, Philippine banks did not invest heavily on the mortgage-backed securities (MBS) and credit default swaps in US financial institutions. Some banks, though, were hurt since they had some investments in Lehman Brothers.

5. Development Challenges and an Alternative Development Approach with New Growth Strategies

The new growth strategy should be now more conscious of creating a vibrant domestic economy. On the demand side, domestic demand, consumption and investments, must be permanently and continuously increased. To a large extent, this involves tackling the large inequities in the country. On the supply side, the domestic economy must address the important growth and linking of local economies and promoting and supporting industrial sectors to grow and upgrade technologically. Progressive fiscal reforms are needed so that the rich and large conglomerates and individuals can finance the massive needs of economic and social development. Finally, the economy must be insulated from harmful global influences. As a starter, capital controls on short-term portfolio investments, or 'hot money' is an urgent task. This will help stabilize the exchange rates and help the producers to plan and implement their industrial policies.

The development challenges as a result of the global meltdown and recession, whose repercussions (global growth slowdown and European debt crisis) may last several years, have strong and significant implications for drastically improving future growth and development strategies. In 2010, there was a strong recovery in the Philippines (7 per cent growth rate) as global markets made a strong comeback. But the threat of a double-dip in the US and the European debt crisis again brought global turmoil and the Philippines GDP growth rate in 2011 fell to below 4 per cent. Worse, its GNP grew even more slowly than GDP as overseas workers' remittances still grew, but at a much slower rate. However, the capital account and stock market surged to unprecedented heights as 'hot money' flowed into emerging markets again from 2010 to 2011. This reflects the lack of correlation between economic performance and portfolio flow performance, the latter being pushed by global external factors. Bank loans are increasing fast. Over-construction of condominiums is spurring talks of a possible property bubble. The peso has appreciated to almost its strongest level. Is this the start again of bubbles and pro-cyclical movements inevitably bursting and causing another financial crisis and/or recession or economic slowdown? The volatilities and vulnerabilities of a very open account in the trade and capital account sectors again are manifesting themselves strongly.

5.1 The Main Challenge: Creating a Vibrant Domestic Demand – Correcting Income and Regional Disparities

It is clear that the major task in creating a vibrant domestic demand is to ensure strong purchasing power of the population. We had discussed that the

Philippines experienced consumption-led growth in its good years, spurred by overseas workers' remittances. However, this was not enough to create a strong spur to growth because the purchasing power of Philippine households was not growing enough and much of the purchasing power resided in a minority of the population considered as rich. This fact can be seen in the following Tables. Table 3 shows the percentage of the population considered as poor based on the national poverty line set by the country's own government. The data are based on the World Development Indicators of the World Bank and only East Asian countries with data are presented. One can see that among the countries in Table 4, the Philippines, together with Cambodia and Laos, has the highest percentage of poor in the country (28 per cent). If we use the World Bank's measure of $2 (PPP) earnings a day, Table 4 shows that the Philippines is doing better than India, Laos and Cambodia, but together with Indonesia and Vietnam, more than 40 per cent of the population are earning $2 (PPP) a day. Finally as an indicator of income distribution, Table 5 shows that the poorest 20 per cent of the population capture only around 6 per cent of the country's income, the second worst in the set of countries in the Table, next to Malaysia which has a very high income per capita, very little poverty, but is highly unequal due to a sparse population dispersed in a wide area with strong regional disparities.

In the Philippines, wide disparities are very clear in terms of life expectancy, percentage of high school graduates (a proxy of educational attainment) and per capita income. Unfortunately, there is no available provincial breakdown of the unemployment and infrastructure indicators in the Human Development Report, but it is general knowledge that the poorer provinces have very poor infrastructure and high unemployment leading to high migration from these poor provinces to the metropolitan centres or directly to outside the country as overseas workers.

Table 3: Poverty Headcount Ratio at National Poverty Line

Country name	2007	2008	2009	2010
Cambodia	30.1			
Indonesia	16.6	15.4	14.2	13.3
Lao PDR		27.6		
Malaysia	3.6		3.8	
Philippines			26.5	
Thailand	8.5	9	8.1	
Vietnam		14.5		

Source: World Bank, 2012

Table 4: Poverty Headcount Ratio at $2 a Day (PPP)

Country name	2007	2008	2009	2010
Cambodia	60.1	53.3		
China		29.8		
India				68.7
Indonesia	56.1	54.4	52.7	46.1
Lao PDR				
Malaysia	2.9		2.3	
Philippines			41.5	
Thailand		5.0	4.6	
Vietnam		43.4		

Source: World Bank, 2012

Table 5: Income Share Held by Lowest 20%

Country name	2007	2008	2009
Cambodia	6.6	7.5	
Lao PDR		7.6	
Malaysia	4.7		4.5
Philippines			6.0
Thailand		6.6	6.7
Vietnam		7.4	

Source: World Bank, 2012

It is clear that a domestic demand-led strategy requires strong structural changes in wealth and income distribution. The export-led strategy had allowed the current dire situation to continue for a long time and explains the strong Communist and Muslim insurgencies existing in the country. The lowest ranked five provinces in terms of human development indices (Sulu, Tawi-Tawi, Basilan, Maguindanao and Lanao del Sur are all war-torn areas facing strong Muslim insurgencies). A more equal regional income distribution as well as better distribution between urban and rural areas will go a long way toward improving purchasing power of over 90 million Filipinos (close to a 100 million now). Many poor provinces (but not all) are run by powerful politicians (some are warlords, others are landlords and monopoly traders), whose monopoly power over resources will have to be broken.

The potential of a vibrant booming domestic demand-led economy is strong, but strong structural and income policies, and dismantling of

monopolies in economic and political power, accompanied by strong political will, are urgently necessary. The current anti-poverty policy of the government is concentrated on conditional cash transfers, which provide cash grants to qualified poor families on condition that the children go to school, are vaccinated, and mothers undertake maternal care in the government hospitals or clinics. There is also a general effort in job creation, but so far this has little direction and impact, being mostly concentrated on urban areas. There is a clear lack of improving economic and social infrastructure and human capital in the poor areas, the majority of which are rural. This will be taken up in the next section.

5.2 Industrial Policy

The Philippines abandoned industrial policy in its slow dismantling of the import substitution process starting in the early 1960s when it became one of the first Asian countries to enter an IMF program (due to a depletion of international reserves as imports outpaced exports). Due to an early end to internal industrialisation, the country failed to develop a steel and metal sector, a petrochemical sector, and equipment and machine sectors, unlike its Asian neighbours. Most of these intermediate products had to be imported, contributing to the import dependence of the economy, and its growing trade deficits. The Philippines reached only the assembly stage of import substitution in motor vehicles, construction of structures, electrical appliances, and many others including its main exports, electronics and semi-conductors (where high-tech chips and other electronic conductors are imported). Even garments, the second top export, depend on imported textiles. Backward linkaging in industries and forward linkaging from the agricultural and primary product sectors are absent.

It is beyond the scope of this paper to come up with an industrial policy and plan for the Philippines. But this is an initiative the Department of Trade and Industry (DTI) and the National Economic Development Authority (NEDA – the economic planning office) should urgently undertake in a major way.

The productivity of the economy will have to be improved. Cororaton (2002) found that total factor productivity (TFP) actually declined for the Philippines from 1967 to 2000. The growth rates of total factor productivity[6] were erratic, going positive and negative randomly during the period. This indicates a lack of direction toward higher productivity in the economy.

The Philippines improved its overall ranking but still had a low ranking of 75 (out of 142 countries), below all of the major East Asian countries. Vietnam ranked 65 and Indonesia ranked 46. The Philippines scored especially badly in basic requirements (rank 100), which includes basic infrastructure (rank 105) and institutions (rank 117). It also ranks low in technology and innovation, ranking 95 in capacity for innovation, 106 in quality of scientific

research institutions and 85 in spending for R&D (only 0.1 per cent of GDP). The Philippines has lagged behind the rest of developing Asia in terms of GDP per capita. The Global Competitiveness Report 2011-12 (WEF 2011) shows that the Philippines was above trend, based on GDP per capita in US dollars purchasing power parity (PPP), from 1986 to 2001, but the gap narrowed and by 2006, the country was left behind by the rest of developing Asia.

In line with the above discussions, the Philippine industrial policy should take into consideration the country's regional and income disparities. Furthermore, establishing all of the following should be undertaken by the central, regional, provincial and local governments: important physical infrastructure (roads, bridges, railways, rural electrification, edifices for market places, irrigation systems, post-harvest and storage facilities); social infrastructure and human capital (schools, hospitals, rural clinics, day care centres, an efficient pool of teachers and health workers); product creation and promotion for the towns, villages and provinces; linking of rural-rural, rural-urban and urban-urban markets. Linked to the dismantling of monopoly by political and economic powers in the countryside, the above are the biggest challenges the current Aquino government – popular with the masses – will have to undertake. Given the current initiatives in peace talks with the Communist and Muslim insurgencies, the above initiatives can be hastened with the support of these movements, which carry with them large mass bases.

In the current Philippines development experience, overseas workers' remittances have led growth for at least a decade now, and the economy is becoming more dependent on these external income flows. A strong industrial policy will have to slowly reverse this and make the economy more dependent on a strongly inter-linked domestic economy with strong domestic demand. This transition should be slow and natural so as not to cause major disruption. As the domestic economy grows and achieves expansion in employment and in physical as well as human capital, the overseas workers, who are the more educated and skilled, will find better-paid and improved working conditions in the Philippines and contribute to improving productivity in the country. Relying on overseas workers' remittances has short- and medium-term benefits of shielding the economy from external shocks and allowing the economy to grow moderately. But effects of 'brain drain' including a slow rise in productivity may be more harmful in the long-run.

5.3 Fiscal Reforms

Fiscal revenue capacity is important in providing financial backing for development and in shoring up the domestic economy by providing infrastructure and technology for undertaking developmental projects and programmes.

The Philippines faced a fiscal crisis from 2002 to 2005 due to deterioration in the tax effort, a sharp increase in the fiscal deficits (close to 5 per cent in 2002 to 2003) and a rise in national government debt. The central government debt peaked at more than 78 per cent of GDP in 2004. Though this was a far cry from the large fiscal deficits and debt suffered by Greece (which was getting high ratings during the same period) the credit rating agencies, multilateral agencies and the Philippines' own conservative economists warned of an Argentinian-sized debt default fiasco. The government had to hurriedly increase the value-added tax to 12 per cent and to include the previously exempted services and professional sectors in the VAT coverage.

True, the country needed tax reforms due to a very regressive tax system, with expenditures that were not sufficiently shared with the poor and backward regions. But this was not the cure imposed. Instead the higher VAT rate and coverage became a very unpopular measure that only the economists and big business praised.

Table 6 shows that the Philippines tax effort (tax revenues as per cent of GDP) is underperforming compared to Korea, Malaysia, Thailand and Singapore. Although it seems to be doing better than countries like China, India and Indonesia, one must bear in mind that these countries are huge with large populations in provinces or states, which have strong local government capacity to generate revenue. This reality is not captured in the Table. Thus, this leaves the Philippines in the company of Cambodia and Laos as countries with weaker tax revenue generation capacity.

Table 6: Tax Effort (% of GDP) of National Government

Country name	2007	2008	2009
Cambodia	9.7	10.6	9.7
China	9.9	10.3	
Hong Kong SAR	14.2	13.0	12.8
India	11.9	11.2	9.8
Indonesia	12.4	13.0	11.4
Korea, Rep	16.6	16.3	15.4
Lao PDR	11.5	12.0	12.6
Malaysia	14.8	15.2	15.7
Philippines	13.5	13.6	12.2
Singapore	13.1	14.1	13.7
Thailand	16.1	16.4	15.2

Source: World Bank, 2012

Table 7: Cash Fiscal Deficit (% of GDP)

Country name	2007	2008	2009	2010
Cambodia	-0.8	-0.3	-2.3	-3.7
Hong Kong SAR China	6.7	0.6	1.1	
India	-0.5	-4.9	-5.2	-3.7
Indonesia	-1.0	-0.3	-1.7	-0.6
Korea, Rep.	2.3	1.6	0.0	1.7
Lao PDR	-2.7	-2.2	-1.6	-0.8
Malaysia	-3.3	-4.6	-6.4	-5.4
Philippines	-1.4	-1.2	-3.8	-3.5
Singapore	11.3	7.8	1.7	8.0
Thailand	0.1	0.5	-3.0	-0.6

Source: World Bank, 2012

Table 7 shows the cash deficits of some East Asian countries. The Philippines was able to emerge from the fiscal crisis of 2002 to 2006 not just by imposing a higher VAT with broader coverage, but more so by reducing its deficits through fiscal austerity. With the global financial crisis, the Philippines had to pump-prime the economy as its tax effort deteriorated (see previous Table) in 2009 due to the recessionary tendencies, thus increasing the fiscal deficits again. Credit rating agencies were hinting that this would hurt the country's sovereign rating. As Table 9 shows, the Philippines' fiscal deficits are better than India's and Malaysia's, but these stronger economies have always defied the credit rating agencies and the multilateral agencies in their fiscal policies and survived by relying mainly on domestic debt financing (just like Japan).

Table 8 shows the central government debt as percentage of GDP, compared with some other Asian countries. Notice that the Philippines' central government debt is still more than 50 per cent, which is considered high by the credit rating agencies. However, the credit rating agencies would prefer the Philippines to be like Indonesia and Thailand, which had substantially reduced their central government debt. The country has similar debt ratios to Malaysia and India. However Malaysia and India, as well as Japan, fund their fiscal deficits mainly via domestic debt. The Philippines has been switching more to domestic debt financing but around 42 per cent of the national government debt is still foreign debt. Again India, Malaysia and Japan had been defying credit rating agencies and multilateral agencies by maintaining high government debts, but had not suffered any consequences due to the high confidence displayed

by both domestic and foreign investors in these economies' capacity to pay their government debt.

Table 8: Central Government Debt (% of GDP)

Country name	2007	2008	2009	2010
Hong Kong SAR China	30.8	30.4	34.0	
India	56.5	56.6	53.7	46.1
Indonesia	35.2	33.1	28.4	26.1
Japan	149.6	157.8	174.4	
Malaysia	41.5	41.3	53.3	53.1
Philippines	55.7	56.3	54.8	52.4
Singapore	78.9	98.6	112.6	109.2
Thailand	24.5	24	28.6	28.8

Source: World Bank, 2012

The important task facing the Philippines is two-pronged. First, it has to drastically improve its current regressive tax system which relies on sales taxes and fixed income rather than on the high profits and income of corporations and rich individuals (such as professional lawyers and medical doctors). Second, the Bureau of Internal Revenue (BIR) is also known for corruption and collusion with rich taxpayers. Although the current government seems to be serious in catching the 'big fish' of tax evasion, much has yet to be done. The most important task is to limit the exemptions and permitted deductions by the corporations and rich individuals with variable income. Hence the eradication of corruption within BIR is of utmost importance. There is still a long way to go to achieve both objectives.

The current government initiative is centred partly on imposing 'sin taxes' on alcohol and cigarettes, a move also in the right direction. This was attempted by the previous government but failed as the resulting legislation was watered down and became inutile with the strong lobby of the cigarette magnates, made up of both multinationals and local conglomerates. The current initiative is a commendable one, but may again face stiff opposition by the powerful tobacco and cigarette corporations as they are quite efficient in lobbying the legislators in Congress.

On the other side of the fiscal picture of the two-pronged approach, the Philippine government has tried to put more expenditure into education and health. But as discussed earlier, infrastructure and social/human development of the poor and backward areas and regions will be vital (requiring a significant

amount of financing) in order to resuscitate the domestic economy and domestic demand. The current Internal Revenue Allocation (IRA), the system of allocating finances to the provinces is based mainly on the size of the population and does not take into consideration the poverty and backwardness of each region. Local taxation will also have to improve the taxation of real estate, which is quite under-priced and deprives local governments of needed revenues. But any improvement in these realms will also have to be accompanied by radical changes in the governance of the provinces and local governments, many of which are under monopolised control by powerful clans and families.

Finally, the government will have to start relying almost exclusively on domestic debt financing to finance its deficits (as tax reforms are still taking place) in order to be more independent from the credit rating agencies and multilateral agencies. So far, the credit rating agencies have been zeroing in on the Philippines fiscal performance to determine its sovereign rating.

5.4 Capital Controls and a More Managed Float Exchange Rate Regime

As discussed in a previous section, the opening of the capital account in the 1990s brought about volatilities and contagion with 'herd behaviour' as short-term foreign capital flowed strongly into the equities, bonds and banking sectors during 'good' times, resulting in strong nominal and real appreciation of the currency. During global or regional crises, panic and capital flight from the same sectors ensued, contributing to sharp depreciation, losses of confidence and recession as in the Asian crisis, and partly in the latest global financial crash.

The aftermath of the Asian crisis allowed strong banking supervision and regulation, which now allows countries to regulate 'hot money' going through banking sectors. But as shown in 2008 and 2009, some of the most harmful capital flight occurs in the equities and sovereign and private bond markets, especially the stock market as it gauges economic and business confidence in the economy.

Capital controls can be comprised of quantitative controls on capital flows or market-based tax on short-term capital flows. For a country that moved from capital controls to capital account opening, this paper would recommend more a market-based capital control mechanism, such as the Chilean tax or what is now called the unremunerated reserve requirement (URR), wherein 20 or 30 per cent of short-term inflows (less than a year) will have to place 20 or 30 per cent as unremunerated reserve requirement. This is to encourage longer term flows and avoid fly-by-night 'hot money' that comes in and flows out immediately after making adequate rates of return. On an aggregate level, such policies will

also discourage unnecessary capital inflows that cause bubbles, which may end up in panic, capital flight, contagion and sharp currency depreciations.

Alternatively, a Tobin tax – or a tax on all foreign exchange transactions – would also be beneficial, but such a policy should be agreed upon by all countries in the world.

This is what makes URR a difficult policy to implement, as the case of Thailand in 2006 showed. Thailand imposed a 30 per cent unremunerated reserve requirement (URR) on foreign inflows that stay less than one year, except those related to trade in goods and services. This led to a stock market collapse, forcing the Monetary Authorities to exempt the stock market from the rule. The URR requirement on other foreign investments was slowly removed starting in 2007.

Thus imposing a Chilean tax or URR may lead to a backlash from foreign investors that dominate much of the equities and sovereign bond markets. To make it easier for countries to implement URR, a go-signal should be given by multilateral agencies, foreign investors and developed countries. Or alternatively, developing countries and emerging markets can agree and cooperatively and simultaneously implement the URR scheme. This shows that going counter to the liberalisation policies may entail potential sabotage from foreign entities, and requires strong political will, cooperation and coordination among developing countries and emerging markets.

Once capital controls are achieved, it would be easier for a country like the Philippines to abandon the full floating exchange rate regime and move further toward a more managed float system based on a basket of international currencies. Akyuz (2009) proposes a BBC (basket, band and crawl) system wherein the country abandons the dollar peg and uses a basket of international currencies (dollar, euro, yen, etc.) to determine their central parities, a crawling peg and a tighter band on the central parity. This system is even more feasible given the growing international reserves of the Philippines, which will allow more room for interventions in the currency market by the Central Bank.

Table 9 shows the coefficient of variation[7] of the real effective exchange rates (REER) of the ASEAN5+3 countries plus Hong Kong and Taiwan using the broad indices of the Bank of International Settlement (BIS). The period covers monthly data from January 1994 to February 2012 in the third column and January 2000 to February 2012 in the fourth column.

In general, countries with more managed floats (Malaysia, China, Singapore, Thailand, Taiwan) have less volatility than free-floating ones (Indonesia, Korea, the Philippines and Japan) or with fixed exchange rate regimes (Hong Kong). Thus to avoid wild volatilities, it would be wise for the Philippines to go to a more managed float and a BBC system.

Table 9: Coefficient of Variation of East Asian Countries

	Exchange Rate Regime	Jan 1994 - Feb 2012	Jan 2000 - Feb 2012
China	Managed float	0.0981	0.0734
Malaysia	Managed float	0.0935	0.0364
Singapore	Managed float	0.0562	0.0493
Thailand	Managed float	0.0990	0.0702
Taiwan	Managed float	0.1181	0.0962
Japan	Free float	0.1366	0.1124
Indonesia	Free float	0.1859	0.1212
Korea	Free float	0.1196	0.1120
Philippines	Free float	0.1141	0.1082
Hong Kong SAR	Currency Board	0.1505	0.1400

Source: Calculated from BIS Broad Indices of Effective Exchange Rate Indices, 2012

6. Conclusion

In conclusion, the new growth strategy for emerging countries requires urgently a new international financial, trade and economic architecture and arrangements so that they can have a healthy global setting for their economic development. Equally important is a good state that is democratic and efficient to undertake the difficult and multi-dimensional task of the new growth strategy.

6.1 The International Trade and Financial Architecture

The discussion on capital controls shows the difficulties faced by a country like the Philippines were it to embrace a development strategy running against the Washington Consensus. On the financial and capital front, not only should a country be allowed to undertake capital controls without any reprisals, but there should be international and regional funds to support a country in need of fiscal or foreign exchange support, given the adverse effects caused by external shocks combined with past policies. There should also be sovereign bankruptcy and restructuring mechanisms for countries facing foreign debt defaults. All these should be provided without 'bleeding a country to death'. The case of Greece (and other peripheral countries in the European Union) reminds one of the harsh conditions and pro-cyclical policies forced on countries facing debt crises such as Argentina and Turkey in the early 2000s, the East Asian countries during the Asian Crisis and the Latin American countries during their debt crisis of the 1980s. Global policies should be reoriented to counter-cyclical policies

to save countries from the tremendous suffering brought about by financial crises, debt defaults or recessions.

On the trade front, the WTO and many free trade agreements will have to be rethought and corrected in order to give countries more room to implement domestic demand-led strategies and industrial policies to energise the domestic economy. They should not be breaking WTO and free trade agreements when they try to 'rebalance' their economy and bring about domestic economic development and industrialisation. Again, solidarity among developing countries probably would be needed to achieve a better international environment for progressive change and advancement of developing economies.

6.2 Democratic and Efficient Governance

Obviously, the above recommendations require a government with integrity and capability from the national to the regional, provincial and village levels. Taxation, implementing infrastructure and development projects in the field cannot afford corruption, inefficiencies and leakages if success is to be achieved. The people should have a voice in preventing government failures, corruption and inefficiencies.

We must be reminded that the *Global Competitiveness Report 2011-12* rates institutions as very low in the Philippines (ranked 117 out of 142). This includes property rights (ranked 105), public trust of politicians (128), corruption and bribes (119), wastefulness of government spending (109), business costs of terrorism (130) and business costs of crime and violence (112).

The current government is popular with the people. Its peace talks with the Communist and Muslim insurgencies, however, had been stalled for various reasons. It is high time that all sides earnestly come together to achieve peace via social, political and economic equity in the country. Genuine development of poor and backward regions as well as structural and institutional policies to deal with poverty will have to be put in place. Again, these require integrity, sincerity and efficiency within the government.

Finally, good, honest, dedicated and very capable technocrats should be tapped to lead the development strategy and the development projects. Thus the new growth strategies we are talking about involve economic, political and social institutions, policies and governance. This is challenging as it entails implementing revolutionary changes in the society.

Notes:

1 It must be pointed out that the value of net exports was still negative during most of the years 2004 to 2007, but the reduction of the trade deficit contributed significantly to the growth in GDP. It is also most obvious from

Table 2a that statistical discrepancy explains a large proportion of the growth rate of GDP in most years. This reveals large statistical errors between the supply side national accounts and the demand side accounts. This is perhaps aggravated by the fact that the base year is 1985 wherein relative prices of sectors are very different from the more current periods.

[2] The spread is the difference between the interest rate paid for the country's sovereign bond and the interest rate paid for US treasury bonds of equal maturity.

[3] GDP per capita is already negative in the first semester of 2009, but GNP per capita is still positive due to the overseas workers' remittances.

[4] Then Department of Finance Secretary Gary Teves was given the best finance minister of Asia for 2008 by the London magazine *The Banker*.

[5] These are some of the rating agencies that gave triple-A rating to the subprime loan assets and derivatives before the US and global financial crisis.

[6] Of course, there are controversies over the calculation of total factor productivity, especially as residual to estimated production functions.

[7] The coefficient of variation is the ratio of the standard deviation of the variable to its mean. It is a standardized measure of the degree of dispersion of the variable.

References

ADB, (2011) Key Indicators 2011, downloaded from http://www.adb.org/key-indicators/2011/country-tables on 1 May 2013

Akyuz, Y. (2009) "Exchange Rate Management, Growth and Stability: National and Regional Policy Options in Asia", Asia Pacific Trade and Investment Initiative, Policy Paper Series, UNDP Regional Centre for Asia Pacific, Colombo.

Bhagwati, J. (1998) "The Capital Myth: The Difference between Trade in Widgets and Dollars", *Foreign Affairs*, 77(3): 7-12.

BIS, (2012) Broad Indices of Effective Exchange Rate, downloaded from http://www.bis.org/statistics/eer/index.htm on Feb. 15 2012

Blecker, R.A. (2002) "The Balance-of-payments-constrained Growth Model and the Limits to Export-led Growth", in Davidson, P. (ed.), *A Post Keynesian Perspective on Twenty-first Century Economic Problems*, Northampton, MA: Edward Elgar, pp. 69-88.

Blecker, R.A. (2003) "The Diminishing Returns to Export-led Growth", in Mead, W.R. and Schwenninger, S.R. (eds), *The Bridge to a Global Middle Class: Development, Trade, and International Finance*, Norwell, MA: Kluwer Academic Publishers, pp. 259-98.

Blecker, R.A. and Razmi, A. (2010) "Export-led Growth, Real Exchange Rates and the Fallacy of Composition", in Setterfield, M. (ed.), *Handbook of*

Alternative Theories of Economic Growth, Northampton, Ma.: Edward Elgar, pp. 379-396.

Cororaton, C. (2002) “Total Factor Productivity in the Philippines”, Discussion Paper Series No. 2002-01, Philippine Institute of Development Studies (PIDS), March.

Deardorff, A. and Stern, R.M. (2007) “Some Reflections on Nurkse’s Patterns of Trade and Development”, Discussion Paper No. 574, Research Seminar in International Economics, Gerald R. Ford School of Public Policy, The University of Michigan, Ann Arbor, Michigan.

Erturk, K. (2001/02) “Overcapacity and the East Asian Crisis”, *Journal of Post Keynesian Economics*, 24(2): 253-276.

Feldstein, M. (1998) “Refocusing the IMF”, *Foreign Affairs*, 77(2): 20-33, March/April.

Gill, I. and Kharas, H. (2007) *An East Asian Renaissance: Ideas for Economic Growth*, World Bank.

Hausmann, R. and Rodrik, D. (2006) “*Doomed to Choose: Industrial Policy as Predicament”,* John F. Kennedy School of Government, Harvard University, Cambridge Ma., downloaded from http://www.hks.harvard.edu/fs/drodrik/Research%20papers/doomed.pdf on 1 May 2013.

Hirschman, A.O. (1968) “The Political Economy of *Import-substituting* Industrialization in Latin America”, *Quarterly Journal of Economics*, 82(1): 1-32.

IMF, (2012) International Financial Statistics, downloaded from http://elibrary-data.imf.org/FindDataReports.aspx?d=33061&e=169393 on Feb. 15, 2012

Kaplinsky, R. (1999) “If You Want to Get Somewhere Else, You Must Run at Least Twice as Fast as That: The Roots of the East Asian Crisis”, *Competition and Change: The Journal of Global Business and Political Economy*, 4(1): 1-30.

Krugman, P. (1998) “Curfews on Capital Flight: What Are the Options?” downloaded from http://web.mit.edu/krugman/www/curfews.html on 12 October, 2012.

Lucas, R.E. (1988) “On the Mechanics of Economic Development”, *Journal of Monetary Economics*, 22(1): 3-42.

Murphy, K.M., Shleifer, A. and Vishny, R.W. (1989) “Industrialization and the Big Push”, *Journal of Political Economy*, 97(5): 1003-1026.

National Statistics Coordination Board (2009), downloaded from http://www.nscb.gov.ph/sna/default.asp on 10 Oct. 2009

Palley, T.I. (2002) “A New Development Paradigm Domestic Demand-led Growth: Why it is Needed and How to Make it Happen”, *Foreign Policy in Focus Discussion Paper*, downloaded from http://www.thomaspalley.

com/docs/articles/economic_development/new_development_paradigm.pdf on September 2012.

Rodrik, D. (1998) "Who Needs Capital-Account Convertibility?" in Kenen, P.B., Riccardi, M.B. and Spais, L. (eds), *Should the IMF Pursue Capital-Account Convertibility?* Essays in International Finance, No. 207, Princeton: Princeton University Press, pp. 55-65.

Romer, P. (1994) "The Origins of Endogenous Growth", *Journal of Economic Perspectives*, 8(1): 3-22.

Rosenstein-Rodan, P. (1943) "Problems of Industrialization of Eastern and South-Eastern Europe", *Economic Journal*, 53(210/211): 202-11.

Stiglitz, J. (1998) "Boats, Planes and Capital Flows", *Financial Times*, 25 March.

United Nations Development Programme (UNDP) (2009) *Institutions, Politics and Human Development in the Philippines*, Philippine Human Development Report, 2008/2009, downloaded from http://hdr. undp.org/en/reports/national/asiathepacific/philippines/Philippines_NHDR_2009_EN.pdf on 1 May, 2013.

WEF (2011) Global Competitiveness Report 2011-12, downloaded from http://www.weforum.org/reports/global-competitiveness-report-2011-2012 on 1 May, 2013

World Bank (2012) World Development Indicators, downloaded from http://data.worldbank.org/data-catalog/world-development-indicators/wdi-2010 on 1 May 2013