

What's Inside

SPECIAL ARTICLE!!

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Editor's Notes

It has been our tradition in the past years to come out with an expert's forecast for the Philippine economy for the year. It is no different this time.

As the country faces new challenges after all the political hoopla which ended in January 2001, the Institute once again contributes to the restructuring of the nation through this economic forecast written by Dr. Josef T. Yap, PIDS senior research fellow.

This piece provides a balanced and independent analysis on what the country had achieved in terms of economic (mis)management and how these had affected the overall performance of the economy, taking into consideration the impact of other external factors. Dr. Yap also focuses on various issues which need to be addressed so as to facilitate growth in the economic sector.

In conclusion, Dr. Yap puts forward several possible scenarios for the Philippines this year. Are they positive? Are they attainable? If the

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The Philippine economy: What lies ahead in 2001

Josef T. Yap*

The swift unfolding of events between October 2000 and January 2001, the heightened emotions, and ensuing euphoria may have clouded the analyses of several pundits. In the aftermath of the downfall of President Joseph Ejercito Estrada's administration, a bleak picture of the economy was generally painted. Moreover, the blame for the poor state of the economy was laid squarely on the ineptitude and corruption surrounding the Estrada government. An excerpt from an article in the *International Herald Tribune* epitomizes this view:

Mr. Estrada, a hard-living former movie actor, was ruined by accusations that he had taken \$11 million in bribes. He left behind a nation staggering under a greater burden: spiraling budget deficits, a battered stock market, a devalued currency, and a new reputation for chicanery that sent even the most loyal investors packing.... What makes the collapse all the more painful is that the Philippines had emerged from the Asian economic crisis in better shape than most others in the region. In part that was because it never experienced the vertiginous growth or asset inflation of countries like Thailand and South Korea. But it was also a result of Manila's fiscal discipline, which produced budget surpluses from 1994 to 1997.¹

While the political crisis that developed out of the so-called "Juetenggate" controversy did affect its performance, the Philippine economy was far from a prostrate position when President Estrada stepped down. The gross domestic product (GDP) grew by 3.9 percent in 2000, narrowly missing the government target of 4 percent but still higher than the 3.3 percent recorded in 1999. Meanwhile, private consumption expanded by 3.9 percent in the fourth

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* Senior Research Fellow, Philippine Institute for Development Studies (PIDS). The author acknowledges the excellent research assistance provided by Merle G. Galvan. The usual disclaimer applies.

¹ M. Landler. 2001. Daunting Task for Manila's New Finance Chief. *International Herald Tribune*. 10-11 February.

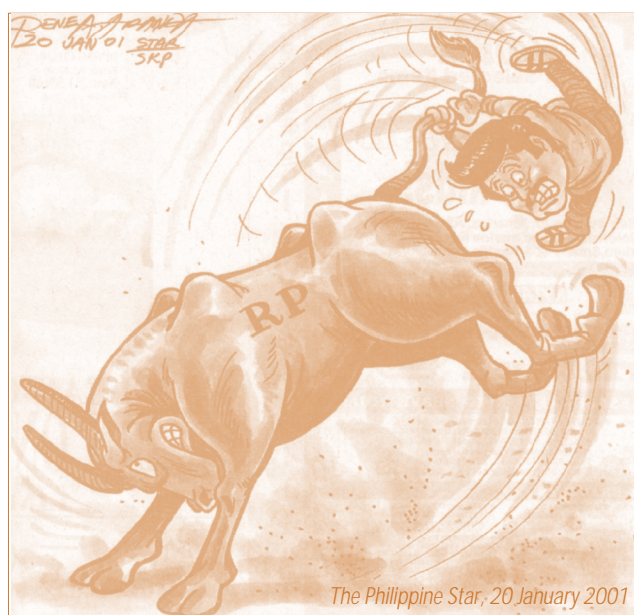
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quarter of 2000, which was the highest among the four quarters of that year, and even higher than the 2.9 percent growth in the last quarter of 1999. This is hardly the performance to be expected from an economy paralyzed by a political crisis.

The scathing attacks on the Estrada administration also obfuscate the less-than-sterling track record of the Ramos government. Despite the loud praises heaped upon the Ramos administration's economic programs by international and domestic investors—and more by the economic managers themselves—the highest GDP growth that was achieved was 5.9 percent in 1996, which was the second lowest in Southeast Asia that year. Income distribution deteriorated sharply between 1994 and 1997 with the Gini ratio approaching Latin American levels. The fiscal surpluses that were achieved during the Ramos administration were more a result of proceeds from privatization of state-owned assets rather than a significant improvement in tax effort. And—at the risk of sounding like a broken record—it should be pointed out that the manufacturing sector decelerated for 15 consecutive quarters over the period 1995Q4 to 1999Q2. The slowdown after 1997Q2 could well be explained by the East Asian financial crisis but the slide in manufacturing output prior to the crisis could be attributed to shortcomings in economic policy.

This sobering view should not be interpreted as a vindication of the previous administration. Indeed, it was

obvious to any fairly rational person that Mr. Estrada did not have the necessary qualifications to effectively perform the role of President of the Philippines. The intention is to remind the present team of economic managers that any mess that has to be cleaned up was partly caused by gaps in policy initiatives of both the Ramos and Aquino administrations.² Since many of the present cabinet members played principal roles in these two stages of Philippine politics, they should be wary



of committing the same mistakes. In addition, the higher-than-expected GDP growth in 2000 serves as a reminder that some policies followed by the Estrada government provided a stimulus to economic activity. Meanwhile, the analysis emphasizes that there are deep-rooted institutional and structural problems that have never been addressed effectively by any of the past governments, including Estrada's.

However, the peso slide was brought about by a combination of external and domestic events. Most currencies in the region had experienced a depreciation of their currencies last year (Table 1). The primary reason, particularly for Australia and New Zealand, was a hike in US interest rates. Indonesia, the Philippines, and Thailand also experienced large net capital outflows related to repayment of external debt. Korea was a net recipient of capital flows and hence the depreciation of the *won* was merely to contain changes in the real exchange rate.

The variation in exchange rate changes can be attributed to domestic factors. A greater degree of political uncertainty resulted in a higher depreciation rate in Indonesia and the Philippines compared to Thailand. The importance of the political risk factor was evident when the peso appreciated and stabilized after the peaceful transition of power in the Philippines in January 2001.

The higher exchange rate was partly responsible for the low growth of imports in 2000 (Table 2). Along with higher fuel prices, the weak peso also sparked an acceleration of inflation in the second half of the year. Nevertheless, inflation averaged only 4.3 percent, much lower than the original government target of 6 to 7 percent. Apart from stable food prices, low inflation also resulted from the continued sluggishness of domestic demand. The latter also contributed to the slowdown of imports.

Recent Economic Performance

Two prominent developments in 2000 were the sharp depreciation of the peso and the hike in fuel prices. The latter was clearly a result of exter-

² An assessment of the state of the economy and policy agenda is summarized in J. T. Yap. 1998. Beyond 2000: Assessment of Economic Performance and an Agenda for Sustainable Growth. PIDS Discussion Paper 98-28.

Table 1. Exchange Rate Movements in Selected Asia-Pacific Countries
(In percent, end-1999 to end-2000)

	Nominal Exchange Rate	Real Exchange Rate
Indonesia	-26.6	-13.9
Korea	-9.9	0.3
Malaysia	0.0	7.9
Philippines	-19.5	-10.4
Thailand	-13.6	-2.1
Australia	-14.9	-7.6
New Zealand	-14.9	-6.3

Note: A [-] indicates a depreciation.

Sources: Bloomberg for nominal exchange rate and JP Morgan for real exchange rate

In anticipation of a less benign international environment, the prognosis last year centered on the role of domestic economic activity to prop up the economy.³ Four factors were identified that would work against the restoration of consumer and investor confidence:

- * the lack of resources for pump-priming;
- * the slow progress of legislation needed to implement economic reforms;
- * the erratic performance of the manufacturing sector; and
- * the proclivity of the Estrada administration for generating controversy.

Indeed, notwithstanding the impact of higher fuel prices and a weaker peso, these factors exerted a major influence on the pace of economic growth in 2000.

By the second quarter of 2000, the *Consensus* forecast for the Philippines for that year had fallen to 3.4 percent (although it rose to 3.6 percent in

September).⁴ Hence, while the GDP growth of 3.9 percent in 2000 was below the government target of 4 to 4.5 percent, it represented an improvement over prevailing expectations.

Moreover, economic growth was broad-based. This is largely due to the healthy performance of the manufacturing sector, which defied earlier predictions and expanded by 5.6 percent (Table 2). A weak peso provided protection to domestic manufacturers and a low interest rate regime supported both local demand and access to working capital. Meanwhile, a stronger-than-expected US economy provided a market for manufactured exports.

The manufacturing sector mirrored the broad-based growth of the aggregate economy. The balanced output is evident in the food manufactures sector, which has the highest share in manufacturing (35.6% in 2000) but grew by only 1.9 percent. The electron-

ics sector (electrical machinery) had the most significant contribution although it comprises only 12 percent of the manufacturing sector. Value added in electronics has been expanding rapidly due to the elevation of local firms from the simple contract assembly process to elements of design. Their contribution to the electronic manufacturing service and semiconductor manufacturing service has been increasing.

The service sector also registered higher growth in 2000, fueled by the transport, communication and storage sector. The completion of the Metro Rail Transit (MRT) may have contributed to the performance of this sector but it was mainly the surge in the purchase of cellular telephones that led to the 9.9 percent growth in 2000. As expected, the agriculture sector decelerated in 2000 but its 3.4 growth rate was still higher than the historical trend of 2-2.5 percent.

Despite improved economic performance, the three sectors hardest hit by the crisis—construction, financial services, and real estate—continued to falter. The contraction in the construction sector was even more pronounced in 2000 as government construction declined by 8.7 percent compared to an increase of 14.9 percent in 1999. This is clear evidence of the inability of the government to conduct pump-priming activities. As a result, private construction continued its decline, which, in turn, contributed to a near-zero growth in the real estate sector.

The financial sector continued to reel from the 1997 crisis. The nonperforming loan (NPL) ratio of commercial banks even increased to 16.2 as of November 2000. This is the highest level since the onset of the crisis. Initially, the rise in the NPL ratio was attributed to technicalities, namely, the reclassification of certain loans after the merger of two +4

³ *Development Research News*, January-February 2000.

⁴ This is the forecast published by Consensus Economics, Inc. The consensus forecast is the median of a survey of over 130 prominent financial and economic forecasters.

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large banks, and the fall in interbank loans, which caused total gross loans—the denominator—to decline. However, with the resumption of growth in commercial bank loans, an increasing NPL ratio should be a source of concern. Meanwhile, the capital adequacy ratio of the banks fell to 15.6 percent in October 2000, which is lower than the 17.2 percent achieved early last year but higher than the international norm of 8 percent.⁵ The banking sector was also affected by the political crisis, as rumors on secret bank accounts triggered minor bank runs.

The general investment climate was boosted with the enactment of two economic laws, the General Banking Law of 2000 and the Securities Regulation code. These laws are expected to raise the regulatory standards of the banking sector and securities market and bring them closer to internationally acceptable norms. Other economic laws enacted last year include the Retail Trade Liberalization Act, which opens retail trade to foreign investment; the E-commerce law, which provides basis for transactions conducted over the Internet; and the Regional Headquarters law, which grants additional incentives to multinational corporations establishing regional headquarters in the Philippines. The incentives provided by these laws may have contributed to the turnaround in investment in durable equipment, which grew by 2.6 percent last year after declining by 5

percent in 1999. However, gross domestic capital formation hardly changed, with a 0.8 percent growth rate in 2000.

The positive developments in the manufacturing sector and the enactment of new laws indeed helped mitigate the negative impact of higher fuel prices, an undervalued peso and the loss of investor confidence following the political crisis. The higher-than-expected growth of the US economy

Sale, sale everywhere but not a drop of money to spare.



eased the burden on domestic demand. Nevertheless, the higher economic growth rate did not lead to the expected increase in revenues, which was 11 percent off-target. Meanwhile, expenditures exceeded programmed levels by 2 percent. The net result was an estimated P136 billion deficit, equivalent to 3.9 percent of GNP.

The last of the aforementioned factors affecting consumer and investor confidence was the proclivity of the Estrada government to generate controversy. Apart from the slide of the peso and fall in stock market activity—part of which is attributable to external factors—there is apparently no other concrete evidence of the impact of the political crisis, especially in the

real sector. As mentioned earlier, consumption spending did not show signs of a slowdown, particularly in the last quarter of 2000. Investment in durable equipment also posted its highest growth rate in the last quarter. Net inflows of foreign direct investment actually had a modest gain—from \$753 million to \$1.04 billion—in the first 10 months of 2000 compared to the same period in 1999.

However, private construction did contract in the second half of 2000 after eking out small positive growth rates in the first half. The slowdown from 4.9 percent GDP growth in the fourth quarter of 1999 to 3.6 percent in 2000 is also a possible indication of the adverse impact of the political problems. But this could be largely attributed to the hike in interest rates and the rise in fuel prices.

On the whole, domestic demand, especially investment, was sluggish last year. Fixed investment actually declined in 2000. It has been three years since the Asian financial crisis and private investment has not recovered. The only remarkable category in the expenditure sector was exports, which grew by 16.4 percent in real peso terms. Hence, the political crisis in the last quarter of 2000 was a manifestation of the general lack of domestic investor confidence since the beginning of the Estrada administration.

Another indication of the impasse between the government and the local business sector was the softer rebound of the Philippine economy between 1998 and 2000 compared to other economies in the region (Table 3). In stark contrast to the Philippines, Indonesia, Korea, Malaysia and Thailand experienced a surge in private investment last year. Perhaps the difference between 4.5 percent—the upper limit of the government GDP target—

⁵The Philippines is not yet following the Bank for International Settlements (BIS) capital adequacy standards wherein the weights of different categories of capital are risk-based. However, even if the capital adequacy ratio were adjusted for risk, it would remain above the international norm of 8 percent.

Table 2. Selected Macroeconomic Indicators, Philippines, 1992-2000, Forecasts for 2001
(Annual growth rates and share to GDP, with the latter in italics)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001 Forecast
Gross national product	1.7	2.8	4.6	4.9	7.3	5.2	0.1	3.7	4.2	3.8
Gross domestic product	0.4	2.1	4.4	4.7	5.9	5.2	-0.5	3.3	3.9	3.3
Agriculture, fishery and forestry	0.1	2.0	3.4	1.2	3.9	2.8	-6.6	6.0	3.4	1.5
	<i>22.75</i>	<i>22.75</i>	<i>22.36</i>	<i>21.55</i>	<i>21.13</i>	<i>20.71</i>	<i>19.50</i>	<i>19.99</i>	<i>19.89</i>	
Agriculture and fishery	0.4	2.5	3.8	1.9	3.9	3.3	-6.5	6.4	3.5	
	<i>22.17</i>	<i>22.28</i>	<i>21.98</i>	<i>21.32</i>	<i>20.91</i>	<i>20.56</i>	<i>19.34</i>	<i>19.91</i>	<i>19.83</i>	
Forestry	-12.0	-15.7	-16.3	-37.1	7.7	-39.0	-21.0	-45.5	-16.8	
	<i>0.58</i>	<i>0.48</i>	<i>0.39</i>	<i>0.22</i>	<i>0.22</i>	<i>0.15</i>	<i>0.15</i>	<i>0.08</i>	<i>0.07</i>	
Industry sector	-0.3	1.6	5.8	6.8	6.4	6.2	-1.8	0.9	3.6	3.3
	<i>34.41</i>	<i>34.25</i>	<i>34.71</i>	<i>35.38</i>	<i>35.58</i>	<i>35.91</i>	<i>35.35</i>	<i>34.52</i>	<i>34.41</i>	
Mining and quarrying	8.1	1.1	-7.2	-5.6	1.4	2.9	3.3	-8.4	8.7	0.0
	<i>1.60</i>	<i>1.58</i>	<i>1.40</i>	<i>1.25</i>	<i>1.20</i>	<i>1.16</i>	<i>1.20</i>	<i>1.06</i>	<i>1.11</i>	
Manufacturing	-1.7	0.7	5.0	6.8	5.6	4.2	-1.0	1.6	5.6	3.0
	<i>25.03</i>	<i>24.69</i>	<i>24.84</i>	<i>25.34</i>	<i>25.27</i>	<i>25.04</i>	<i>24.91</i>	<i>24.49</i>	<i>24.88</i>	
Construction	6.1	5.7	9.4	6.6	10.9	16.4	-8.5	-1.6	-6.0	5.0
	<i>5.04</i>	<i>5.22</i>	<i>5.45</i>	<i>5.55</i>	<i>5.81</i>	<i>6.42</i>	<i>5.83</i>	<i>5.56</i>	<i>5.03</i>	
Electricity, gas and water	0.7	2.8	13.9	13.0	7.6	4.8	3.4	3.1	3.7	4.0
	<i>2.74</i>	<i>2.76</i>	<i>3.01</i>	<i>3.25</i>	<i>3.30</i>	<i>3.29</i>	<i>3.41</i>	<i>3.41</i>	<i>3.40</i>	
Service sector	1.0	2.5	4.3	5.0	6.4	5.5	3.5	4.1	4.4	4.0
	<i>42.84</i>	<i>42.99</i>	<i>42.93</i>	<i>43.07</i>	<i>43.29</i>	<i>43.38</i>	<i>45.15</i>	<i>45.49</i>	<i>45.70</i>	
Transport, communication and storage	1.4	2.5	4.2	5.8	7.4	8.2	6.5	5.3	9.9	
	<i>5.82</i>	<i>5.85</i>	<i>5.84</i>	<i>5.90</i>	<i>5.99</i>	<i>6.17</i>	<i>6.60</i>	<i>6.73</i>	<i>7.12</i>	
Trade	1.6	2.4	4.0	5.6	5.5	4.0	2.5	4.9	5.6	
	<i>15.27</i>	<i>15.32</i>	<i>15.26</i>	<i>15.39</i>	<i>15.34</i>	<i>15.15</i>	<i>15.61</i>	<i>15.85</i>	<i>16.10</i>	
Finance	0.4	2.4	5.5	7.3	13.7	13.0	4.5	1.9	0.9	
	<i>4.06</i>	<i>4.07</i>	<i>4.12</i>	<i>4.22</i>	<i>4.54</i>	<i>4.87</i>	<i>5.12</i>	<i>5.05</i>	<i>4.90</i>	
Ownership of dwellings and real estate	0.7	1.8	2.9	3.1	4.2	3.8	1.6	0.6	0.3	
	<i>5.64</i>	<i>5.62</i>	<i>5.54</i>	<i>5.46</i>	<i>5.37</i>	<i>5.30</i>	<i>5.41</i>	<i>5.27</i>	<i>5.09</i>	
Private services	0.6	2.9	4.3	4.3	5.0	4.9	4.7	5.8	4.7	
	<i>6.89</i>	<i>6.94</i>	<i>6.94</i>	<i>6.91</i>	<i>6.86</i>	<i>6.83</i>	<i>7.19</i>	<i>7.37</i>	<i>7.42</i>	
Government services	0.2	2.9	5.5	3.8	5.9	2.6	2.6	3.7	0.9	
	<i>5.15</i>	<i>5.18</i>	<i>5.24</i>	<i>5.19</i>	<i>5.19</i>	<i>5.06</i>	<i>5.21</i>	<i>5.23</i>	<i>5.07</i>	
Personal consumption expenditure	3.3	3.0	3.7	3.8	4.6	5.0	3.5	2.6	3.5	3.2
	<i>78.10</i>	<i>78.81</i>	<i>78.31</i>	<i>77.66</i>	<i>76.76</i>	<i>76.62</i>	<i>79.73</i>	<i>79.20</i>	<i>78.85</i>	
Government consumption	-0.9	6.2	6.1	5.6	4.1	4.6	-2.1	5.3	0.2	0.0
	<i>7.70</i>	<i>8.00</i>	<i>8.13</i>	<i>8.20</i>	<i>8.07</i>	<i>8.03</i>	<i>7.92</i>	<i>8.07</i>	<i>7.78</i>	
Capital formation	8.5	7.9	9.0	3.7	13.3	11.6	-16.4	-1.7	0.8	5.0
	<i>21.46</i>	<i>22.67</i>	<i>23.59</i>	<i>23.33</i>	<i>24.78</i>	<i>26.32</i>	<i>22.16</i>	<i>21.08</i>	<i>20.44</i>	
Exports (nominal \$)*	11.1	15.8	18.5	29.4	17.7	22.8	16.9	18.8	8.7	6.2
Imports (nominal \$)*	20.5	21.2	21.2	23.7	20.8	14.0	-18.8	4.1	2.1	10.0
Inflation (average)	8.6	7.0	8.3	8.0	9.1	5.9	9.8	6.6	4.3	6.5
91-Day Treasury bill rate (average)	16.0	12.4	12.7	11.8	12.3	12.9	15.0	10.0	9.6	10.5
Nominal exchange rate (average)	25.3	27.2	26.3	25.8	26.2	30.1	40.8	39.3	44.2	48.7

*Exports and Imports data (January to November 1999) comes from the Bangko Sentral ng Pilipinas (BSP) homepage.

Sources: National Accounts of the Philippines, National Statistical Coordination Board; Selected Philippine Economic Indicators, BSP; and forecasts of J.T. Yap.

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and the 3.9 percent GDP growth in 2000 could be attributed to the anti-Estrada sentiment of majority of the local businessmen.⁶

Key Issues

The deterioration of the fiscal deficit from 3.5 percent of GNP in 1999 to 3.9 percent in 2000 should be a cause for utmost concern. As mentioned in last year's report, slower output growth and the sharp nominal depreciation of the peso constrain fiscal flexibility, as does the high initial level of debt. Nevertheless, for various reasons, cutting expenditures should not be considered as the primary option. First, the deficit is more a result of shortfalls in revenue mobilization rather than expenditure overruns. Second, the Philippines lags behind other East Asian countries in terms of infrastructure development and any further reduction in spending for this purpose will have dire consequences in the medium-term. And third, scaling down government expenditures may reduce the necessary social spending and contribute to the already serious poverty problem in the country.

Hence, the only alternative the new government has is to make a strong push for a substantial improvement in tax administration. This issue has become as important as ever before. The political crisis that engulfed the Philippines centered on the issue of corruption. Together with the need to enhance tax administration, these issues emphasize the need to improve governance in this country. The phenomenon of a "weak state" has to be analyzed carefully and reforms needed to improve the institutional framework

must be implemented effectively. This would encompass the banking sector, particularly the amendment of the Secrecy of Bank Deposits Law.

The privatization programs for both the National Power Corporation and the National Food Authority are still pending. However, these programs must be carried out without putting the government at a due disadvantage. Moreover, the competitive environment that the government should maintain to sustain private sector investment must not be undermined by the process of privatization especially as there are concerns that under the present proposal, monopolies may emerge in the energy sector. If successful, the privatization programs should promote efficiency and boost revenues.

Finally, the issue of competitiveness should be revisited since the entry of China into the WTO and the emergence of India have reduced the attractiveness of Southeast Asia for many traditional industries. Apart from

the need to catch up in terms of infrastructure, the continued stupor of private investment should be a priority consideration. Hopefully, the new administration, which has close ties with the business sector, will be able to uplift investor confidence. Nevertheless, the main focus should still be on addressing the country's low labor productivity. Apart from the usual recommendation to increase the investment rate, measures at the microeconomic level—a well-defined technology policy, measures to improve social cohesion, and the need for better governance—have already been discussed and presented at various fora.

Prospects

A general slowdown is projected for world economic activity in 2001. The main reason for this is the deceleration in the US economy (Table 3). In this context, the relevant question is: To what extent will GDP growth fall in the Philippines? For reasons discussed below, it is virtually impossible for the economy to improve its 3.9 percent performance in 2000. As can be

Table 3. GDP Growth Rates of Selected Countries and Regions (In percent)

	1999	2000	2001	2002
China	7.1	8.0	7.7	8.1
Indonesia	0.3	4.8	3.6	4.3
Korea, Rep. Of	10.7	8.0	4.4	5.3
Malaysia	5.6	7.5	5.2	6.1
Philippines	3.3	3.9	2.7	3.4
Singapore	5.4	10.1	5.3	6.1
Thailand	4.2	4.0 - 4.5	3.5	4.3
Japan	0.8	1.8	1.4	1.8
North America ^a	4.2	5.0	2.1	2.4
Western Europe ^b	2.4	3.3	2.7	2.8

^aUS and Canada

^bGermany, France, UK, Italy, Austria, Belgium, Denmark, Finland, Greece, Ireland, the Netherlands, Norway, Portugal, Spain, Sweden and Switzerland.

Sources: Country sources (for 1999 and 2000 estimates), Asia Pacific Consensus Forecasts (for 2001-2002 forecasts).

⁶ It should be noted that the original target of 4.5 to 5 percent was scaled down to 4 to 4.5 percent in the middle of the year primarily because of the peso depreciation and the rise in fuel prices.

seen from Table 3, the *Consensus* forecast is for a GDP growth of 2.7 percent.

Two key determinants of the 2001 GDP growth would be the rate of deceleration in the US economy and the trend in international fuel prices. The Philippines is one of the more vulnerable, if not the most vulnerable, countries in East Asia to a US slowdown and persistence of high fuel prices. A relatively large proportion of its exports go the US. Meanwhile, the declining energy efficiency and increasing oil import dependence of the Philippines makes it very sensitive to the behavior of oil prices.⁷



Agriculture will be affected anew by the El Niño weather disturbance and should grow by only 1.5 percent. The manufacturing sector would be adversely affected both by the slowdown in the US economy, which would lower demand for manufactured exports, and by the lower growth of agriculture, which would affect the food manufacturing sector. The manufacturing sector is predicted to grow by 3 percent in 2001. The services sector would also experience a lower growth, which would likely be 4 percent this year.

Fortunately, the general consensus is that the US will experience a “soft” landing, where growth will slow in a benign inflationary environment. The scenario where rapid capital outflows and a depreciating dollar would necessitate a sharp increase in interest rates is not probable. The Federal Reserve Bank has actually trimmed key interest rates in an attempt to avoid a recession.

Meanwhile, the projections for international oil prices are not clear. There are indications for an upward movement but pronouncements by the Organisation of Petroleum Exporting Countries (OPEC) that consensus has been reached to cut supply imply stable oil prices. However, the international oil price is currently \$24.83/bbl (February 15) but so long as it does not

break the \$30 threshold, oil importers should not be too adversely affected.

Among the domestic factors that affect prospects, it is the fiscal deficit that stands out. If it is perceived that there is no turnaround in the deterioration of fiscal balances, then interest rates would rise and hamper the recovery of investment. This would then lead to the scenario where GDP growth will fall below 3 percent this year. However, it is likely that the new administration will have success in pushing for legislation bills that would increase revenues, even if it is only a one-time surge. This would then allow the continuation of an accommodating monetary policy, a sufficient reason to expect GDP to grow between 3 to 3.5 percent in 2001.

There should be a relatively strong recovery in construction and investment, something that did not materialize last year. However, both variables will be growing from a low base.

Meanwhile, inflation would continue to accelerate in the first few months of the year before stabilizing toward June. This is because the bulk of the peso depreciation and the rise in fuel prices happened in the second half of 2000. The whole year average would be about 6.5 percent. Higher inflationary expectations should limit the impact of the cut in interest rates of the Bangko Sentral ng Pilipinas. The average of the 91-day Treasury bill rate should be higher in 2001 than the 9.6 percent average in 2000.

Last year’s prediction of the exchange rate was way off. However, few analysts—perhaps even none—predicted that the peso would depreciate that sharply. This year, the exchange rate should hover between P47 and P51. Net capital flows are predicted to turn positive for Indonesia, Korea, Malaysia, the Philippines and Thailand (in aggregate) in 2001 after turning negative in 2000. The average exchange rate would thus be about P48.70. DRN

⁷ For a more comprehensive analysis, refer to the Asia Recovery Report, October 2000 issue (<http://aric.adb.org>).

Dr. Gloria Macapagal Arroyo: The next Philippine President could be an economist*

*Gerardo P. Sicat***

If the current impeachment of President Joseph Estrada succeeds in his removal from office, then Vice-President Gloria Macapagal Arroyo would become President. Her rise as a politician is one of the fastest in Philippine history. There is no doubt that her pedigree, as the daughter of a former President whose name is still revered despite the distant years, helped her a lot.

But who is she, aside from the political persona?

Toward the Ph.D.

It is not as widely known that she is Dr. Gloria Macapagal Arroyo by virtue of a Doctor of Philosophy Degree in Economics that she received from the University of the Philippines in 1985. In her submission to the School, she downplayed her maiden surname to an "M." However, she connected with that surname by dedicating her thesis "to my parents, former President of the Philippines and Mrs. Diosdado Macapagal."

Her academic preparation makes her one of the best-prepared politicians in the country from the standpoint of educational attainment. Her knowledge of economics should be helpful to a leader when presented with complex economic policy options. It would therefore be useful to appreciate this point and discuss its implications.

As the daughter of prominent parents, it is a remarkable achievement that she worked to obtain a Ph.D. degree. Generally, young people who come from families with inherited economic stature or political power often

find it hard to raise their motivation level. So much could be had for the asking and, therefore, their best efforts may not be needed. The high achievement of children of well-to-do parents who work on their own efforts is a favorable reflection on the parents who had reared them.

That Gloria Macapagal took further intensive graduate study is also a tribute to her own search for self-improvement. She initially studied graduate economics at the Ateneo University where she also took a job as a faculty member in its Economics Department.

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* Gloria Macapagal Arroyo became President of the Philippines two and a half weeks after this paper was first publicly released as a Discussion Paper of the University of the Philippines School of Economics on January 2, 2001. After one try to change the subjunctive mood to reflect this reality, the author reverted to the original title, with minor revisions, and decided to retain the speculative nature of the paper.

** Professor of Economics, School of Economics, University of the Philippines. In my own lexicon, this paper was designed as a topical comment on a very important issue—the possibility that a Ph.D. in Economics and a graduate of the U.P. School of Economics could become President of the Philippines. Gloria Macapagal was never my student. I have talked to her only once, in a neighborhood Christmas party just before she became a candidate for Vice President (we happen to live in the same neighborhood). She was a graduate student at the School of Economics when I was still connected with the government. When she finished her doctoral work, I was already working with the World Bank in Washington D.C. and I returned to my post at the School only in 1998. My colleagues at the School remember her as a serious student.

ment. Later, she sought a faculty award from the Ateneo faculty development program to enable her to enroll at the University of the Philippines School of Economics (UPSE).

Ph.D. studies are for those who seek a specialist training. The program at the UPSE is not a mediocre course. Economics has become a specialist subject and at U.P., the work is up to current developments in the discipline. The faculty is varied, some have obtained their degrees from graduate schools in the U.S. and elsewhere. The faculty engages in both research and policy work, and has a professional stature in the Asian region and internationally.

One aspect of Ph.D. study that often defeats many a student who has passed the early hurdles is the research effort that is put in the thesis. The thesis has to be of acceptable quality to the faculty. This means that the student has to aspire to the status of her mentors. The thesis is the final hurdle prior to acceptance within that select group of professionals. To qualify for that stage of research writing, it is important that the student passes comprehensive examinations for the Ph.D. candidacy. This requires written and oral examinations with the faculty. A committee of three faculty members serves a Ph.D. thesis panel, and the research is defended in an oral examination.

The Ph.D. degree is for the student with high intellectual aspirations. It is professional education of the highest order. Aside from intellectual equipment, it also requires of the student enormous personal discipline. Such a discipline would be most exacting especially in the preparation of the Ph.D. thesis. In that endeavor, the student would be essentially on his own. Many students who have already passed their

comprehensive examinations fail to finish their degree for a number of reasons. Some lack the concentration needed to do the research and finish the thesis. Some get lucrative jobs that get in the way. Others have family obligations to fulfill, especially in the case of married graduate students who are raising children. Still others might have a unique difficulty focusing the research topic as to foment frustration and, later, disappointment.



It helps to be connected with a research project that provides a job as well as stimulus for the intellectual effort. This was what Gloria Macapagal had at the U.P. School of Economics. At the stage when she was about to write a doctoral thesis, she also became a teaching fellow at the School. She also got recruited into a long-term research project. This was the multi-year Economic and Social Impact Analysis Project that had for its objectives the evaluation of the impact of development projects in the government.

This project involved a large team of economists at the School of Economics that was then headed by the late renowned Dean José Encarnación, Jr. Her involvement in this project helped to crystallize her research thesis related to government expenditure on tourism for the doctorate, which was to analyze the impact of tourism expenditures on the economy. Her Ph.D. thesis acknowledges this point.

Gloria Macapagal did manage to finish her Ph.D. course. She took undergraduate studies at Georgetown University, the Jesuit University in Washington D.C. This period of her studies appeared to have coincided with the years when Bill Clinton was also a co-student. She finished her undergraduate education in Assumption College. But her having finished a Ph.D. in Economics at U.P. should be her crowning achievement as a student.

In 1968, she got married to a scion of the Tuason clan and settled in La Vista in Diliman, Quezon City, a community flanked by the campuses of UP and Ateneo and Maryknoll (now Miriam). She was married and with children when she began her graduate studies. Here was how she justified getting a job outside and studying further:

"...When I got married, I lived with my in-laws. I lived with my husband's family, so I didn't really have my own home to run. So in that kind of environment, it's really conducive ... to look for something to do outside."¹

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¹ As I was finishing this paper, a timely interview with Gloria Macapagal Arroyo appeared in the December 24, 2000 issue of the Philippine Daily Inquirer. This and the next paragraph are taken from said interview (Anonymous 2000).

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She wanted to become a teacher. She wanted to become a professional, and finally a technocrat in government. In her application for the Ph.D. course at the UPSE, she said that she wanted to take up a doctorate in economics because she wanted to be a technocrat.

The doctoral thesis

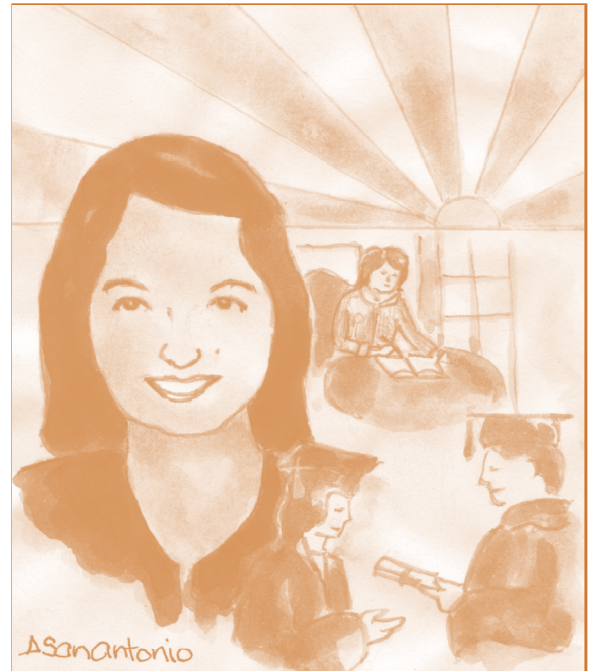
The doctoral thesis that Gloria Macapagal submitted to the School of Economics provides a clue to her competence as an economist. The study was entitled "An Investigation of the Real Effects of Government Expenditures with an Application to Tourism Expenditures." It dealt with issues in public finance and macroeconomics that were current in the profession at the time. In turn, those issues—the real effects of public expenditures on the economy, in particular on the private sector—are at the center of current doctrinal controversy in macroeconomics. This doctrinal controversy flared in the field of economics as a result of the challenge waged against the dominant theory of aggregate demand embodied under Keynesian economics.

The doctrinal debate is in the context of the effectiveness of fiscal policy, trade-offs between inflation and growth, and, in brief, the debate between Keynesian economics, on the one hand, and the revival of the old classical economics through the rational expectations school, on the other. Her study sought to study fiscal expenditure issues in the context of models offered along the new classical lines in contrast to Keynesian.

She wanted to become a teacher. She wanted to become a professional, and finally a technocrat in government.

At the heart of the issue is whether fiscal deficits lead to income expansion or provide competition with private sector activities. The doctrinal issue critical to her question was the effect of government expenditure on output. In particular, is government expenditure likely to lead to an expansion of output, and if so, by what mechanism, if any? This was the topic of lively debate in recent years, a debate in which the major tenets of mainstream Keynesian economics came under attack in doctrinal terms. There were different modes of thinking about the role of government and output, some of them even emanating from older principles. The issue centered on old propositions with new and unexpected twists.

One of these is known as the Ricardian equivalence proposition, an old idea discussed by David Ricardo, a classical economist of the 19th century. This proposition claimed that people reduce their income expectations equivalent to the amount of the repayment of the debt at a future time. In such a world, when a government incurs new debt, households anticipate this by expecting that their future income would be affected by future taxes. In that event, households discount the beneficial output effects of new deficit finance by anticipating the taxes that are due to finance the debt repayment.



The other proposition of economics is that government expenditure competes for the same resources so that government expenditure could crowd out private activity. The conventional view at that time was that in the presence of excess capacity and unemployment of labor, any new expenditure would lead to a multiplier impact that raises output and employment.

The essence of these two propositions—resuscitated by a stream of macroeconomic critics of Keynesian economics—was to put doubts on the effectiveness of fiscal policy. The new school of economists challenging the conventional results of Keynesian economics was called the rational expectations school.

By the 1970s and 1980s, alternative explanations were being sought to account for the failure of fiscal deficits to raise employment rates in industrial economies. This led to the formulation of alternative macroeconomic hypotheses. The debate centered on what was then called the "Phillips curve controversy." The Phillips curve formulation

predicted a trade-off between growth policy (represented by fiscal and growth stimulus following Keynes) and employment rates. Many observed that that trade-off was weak or did not exist, and it was the major point raised by the rational expectations school that began to challenge the macroeconomic mainstream.

The literature on public finance includes a study of Robert Barro (1981), with insights from Martin Baily (1968, 1971), which led to the revival of the Ricardian equivalence proposition. The proposition stirred controversial waters. Empirical validation of the theory became the main issue. The empirical literature tested the effectiveness of government expenditure as an instrument of output change.

At the time of the writing of her thesis, prominent works along the line included investigations of Martin Feldstein (1982) whose work provided a defense of accepted theory of the multiplier impact of government spending. The empirical work of Roger Kormendi (1983), whose investigations provided the grist to the crowding-out effect of government spending on private consumption, supported the points stressed by Baily and Barro.

Dr. Macapagal's study took a part of this tradition to pose questions about public expenditure policy in the Philippines. Using national income and government spending data, she then explored alternative hypotheses with her own econometric investigations, following the lines individually proposed by Feldstein and Kormendi.

The effort meant estimating equations that served as alternative hypotheses for the behavior of private consumption in relation to different streams of output and other forms of expenditure. Her propositions examined consumption expenditure as being dependent on a number of factors

including output (GNP), tax revenues, real transfers, the public debt as proxy for wealth, and corporate retained earnings.

These econometric calculations used statistical techniques of regression, making sure that the accepted regressions met statistical standards of goodness of fit and that the equations defined by the time series data also used satisfied tests of statistical reliability. Her regression estimates found no evidence of the existence of the Ricardian equivalence hypothesis in the Philippine context. There was no evidence to indicate that incurring a fiscal deficit implied a corresponding

The chapter that focused on the expenditures on tourism examined the magnitudes of the public expenditures on tourism and analyzed their impact on output. The period under study covered the 1970s and early 1980s. She found that tourism expenditure on the Folk Arts Theatre, the Miss Universe contest and the Ali-Frazier fight, among others, had some multiplier effect on output. But she examined such positive findings against the alternative of employing the same amount of expenditure on social services. She concluded that the net difference in economic impact would have been higher if the resources were spent on social services rather than on tourism.

She came out with strong conclusions [in her thesis] that social expenditures had a much stronger impact on the economy than the same volume of expenditure on tourism.

anticipation that future taxation would be expected.

The more important finding in her study, however, confirmed that there was strong evidence of crowding out of private expenditure when government expenditure was introduced. Her findings on this score were robust. These findings, as discussed above, formed the article that she published in the *Philippine Review of Economics and Business* in 1987.

But her doctoral thesis covered more ground. The work was extended to two other aspects of the problem that were treated separately in two more chapters. The latter part of the thesis was devoted in particular to public expenditures for the development of tourism.

The last part of her study was far removed from the empirical investigations described above. She followed a different research tradition by using input-output analysis. She verified the direct and indirect inter-industrial impact of expenditures on tourism on the rest of the economy and compared the same with similar expenditures on social services. Using the 1978 input-output model of the Philippine economy, she applied a given final demand projection on the input-output structure. She came out with strong conclusions that social expenditures had a much stronger impact on the economy than the same volume of expenditure on tourism.

Gloria Macapagal's doctoral thesis demonstrates a state-of-the-art effort dealing with an em- +12

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pirical topic. Correctly, she focused on research issues dealing with the country's problems. Her treatment of the subject contained a reasonably brief summary of the relevant theoretical literature to her research agenda. Her research covered three different approaches to the study of the impact of government spending. First, there was an econometric estimation of the determinants of aggregate consumption expenditure when the government's activities are taken into account. Second, she undertook a quantitative assessment of fiscal expenditures in the tourism sector. Finally, she employed input-output analysis to examine the comparative impact of tourism as against social expenditures.

The doctoral thesis showed Gloria Macapagal as an accomplished economist with a good command of the current debates in economic theory. She also knew how to employ up-to-date empirical methods used in economic analysis. She was at home in different modes of economic analysis.

Had she decided to become a researcher rather than a public official and a politician, she would have been properly equipped to contribute to the profession more than adequately.

The post-Estrada scenario and lessons from the past

The most likely scenario of an Estrada conviction, or resignation even if acquitted, is the Constitutional route. This means that Gloria Macapagal Arroyo becomes president. If this specific scenario becomes the flow of history, what economic issues of performance would await the new president?²

Had she decided to become a researcher rather than a public official and a politician, she would have been properly equipped to contribute to the profession more than adequately.

The removal of Estrada does not guarantee better growth and development. The economy, however, stands a much better chance of improving than under Estrada, given his failure to attend to the work of the presidency during the almost three years that he has been in office.³ The easy part is pulling off from the nation's back the negative Estrada factor. In its place, it would be possible to put in place a new start and a restoration of business and investment confidence. The negative

Estrada factor is mainly a perception arising from poor management, erratic style, and lack of credibility of the leadership. That perception discourages any favorable decisions that are beneficial to growth and development from being made. It is a factor that adds to the gloomy forecast of future events and makes decisionmakers postpone their decisions. When the Estrada factor is taken off, a leap in confidence by business and investors would be easier to realize until a new leadership proves its worth through hard work and wise decisions.

Based on the way the economy immediately responded to the accusations of corruption against the President, together with the other reasons that became apparent as he continued in office, the negative Estrada factor could at least be around 20 percent of current indicators.⁴ The impeachment trial of Estrada in the Senate took away part of the volatility of that negative factor. It helped to produce a temporary but relative calmness in expectations. However, that calm presages a big storm, especially if the judgment on the impeachment should fail to become

² There are, of course, countless other scenarios. So long as the new leader faced the economic challenges of the nation squarely, the economic issues would present themselves in whatever scenario. From among the competing scenarios, the Constitutional route appears to hold sway, because it is what the country's political institutions would demand (Fabella 2000).

³ In a moment of candor, perhaps a slip of the tongue, Executive Secretary Ronaldo Zamora was reported to have said in a radio interview that Estrada had the practice of sleeping during what should be his working hours. This "damaged" not only the presidency but also his ability to lead effectively. Zamora said that the economic crisis and the impeachment trial made Estrada realize that he "had to be awake at the right hour... In the morning, there is need for papers to be signed and processed." Secretary Zamora ought to know because as cabinet officer, he manages the office of the President, the center of the cabinet officialdom (Nocum 2000).

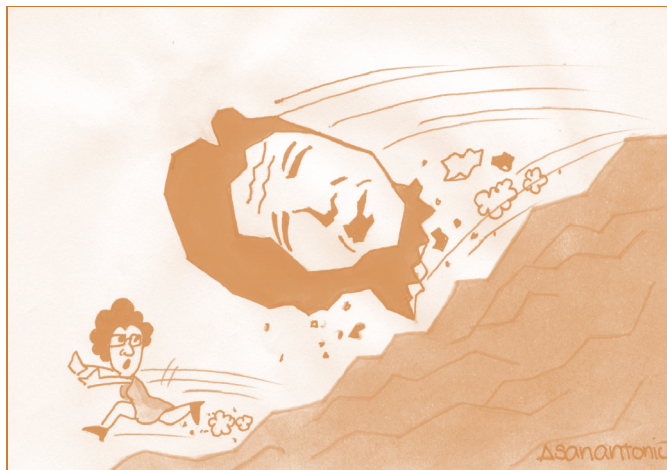
⁴ This negative factor can be measured by using standard indicators. One approach would be to project the performance of the economy if a different leader were in charge of the country by way of some counterfactual hypothesis. Some of the problems related to the stock market scandal and the high level of the fiscal deficit need not have happened. The loss of confidence arising from these events led to the decline of overall economic performance. A more easily calculated alternative approach would be to use the exchange rate as some measure of the negative factor. At year-end (refer to Manila newspaper accounts of December 28, 2000), Governor Buenaventura of the Bangko Sentral ng Pilipinas (BSP) said that the peso should be at around P46 to P47 to the dollar rather than the current rate of P50 to P51 range if there were no political crisis. The impeachment proceeding had actually helped to stabilize the exchange rate and reduced uncertainty. Otherwise, the peso exchange rate could have risen far above the P51 to the dollar rate by now if the impeachment process had not absorbed the shock of uncertain events. It is to be recalled that prior to the Asian crisis, the peso was slightly higher in value than the Thai baht. Today, despite the problems in Thailand, the peso is about 17 percent cheaper than the Thai baht in terms of the US dollar. The current baht is around P41 to P42 to the dollar. It would therefore be justifiable to use the base of P40 to the dollar as the basis of the negative Erap factor.

credible. That appears to be the way in which Estrada has created divisiveness in the social fabric in so short a time.

Lessons from the post-Marcos transition

The circumstances of the succession are in sharp contrast to the succession of Corazon Aquino to Marcos in 1986. The economic crisis of the Marcos period was prolonged. It was an ever-deepening crisis for almost three years. The crisis dated back to August 1983 when Ninoy Aquino was assassinated and it worsened until the EDSA revolt in February 1986. The prolonged economic crisis led to a large external debt, a legacy of economic depression and severe shortages in the economy. The resulting crisis set the country back for almost a decade.

The problems that Mrs. Aquino faced when she took office in 1986 were far more difficult and more frustrating than those that Gloria Macapagal would face in a post-Estrada world, assuming that Estrada's disappearance from the scene would be accomplished by January 2001. The economic disruptions that Mrs. Aquino endured during the transition from the Marcos rule were deep and very challenging. Some of them were psychological. The deep resentments felt by the members of the new government and their zealotness



to correct the mistakes of the Marcos rule made them commit mistakes that could have been avoided.

On the other hand, the discontinuity in some government programs were not necessarily caused by the drastic fall of fiscal resources inherited by the Aquino government during the immediate post-Marcos transition. In fact, there were economic projects and programs during the Marcos rule that were neutral from the contentious political issues that divided the nation at the time. A discontinuity occurred because the turnover at the top of the government echelon encouraged turnover at the senior level of the government service. Although such was not the official policy, there were terminations and forced resignations of critical personnel at the middle and senior levels of the bureaucracy. These personnel were important to project management and

implementation not only for their experience but also for the institutional memory that they embodied. The result was that some important programs suffered disruptions for an unduly long period.

A result of these mistakes was the neglect of some critical sectors by Mrs. Aquino's government. Toward the second half of her term, the neglect of the energy sector caused regular

power shortages to the detriment of both households and business institutions. The energy development program was a major casualty of political wrangling. The nuclear power project itself symbolized the corruption of the Marcos leadership and discontinuing it in turn gave the succeeding leadership problems in searching for energy replacement sources that could meet the growing energy needs of the country.⁵

Faced with the consequences of this neglect toward the end of her term, Mrs. Aquino's presidency was perceived to be weak and she became the target of a constant threat of challenge from the military. (Of course, Mrs. Aquino had a major share of two catastrophic natural disasters that shifted the attention of the national leadership: the earthquake of 1990 and the Mount Pinatubo eruption of 1991, both of which had negative effects on economic performance.)

The post-Estrada transition

Gloria Macapagal's transition into a prospective post-Estrada period is seen to be less filled with problems that Mrs. Aquino had in her time. Although in political terms, it is as sensational because of the impeachment process and the public disemboweling of the accused, the post-Estrada succession does not provide the dra-

⁵ The nuclear project was a flagship economic project of the Marcos government. It was conceived during the energy crisis of the 1970s when the objective was to diversify the dependence of the country on energy sources, including nuclear fuel. The plant was designed to represent a major capacity boost toward meeting the country's energy needs. Even as the project selection was about to be made in favor of General Electric, there was a reversal of the award to Westinghouse Electric, with a change in technical specifications. In later investigations of the project, it became clear that the change in the award was a classic case of corruption through commissions paid indirectly to a crony who was tied to the leadership. The project was almost finished by the time of the EDSA revolt. The alliance between those who criticized the project as an environmental disaster and those who wanted to leave the project as an example of the corruption of the Marcos leadership led to the project being abandoned. But the project had cost the country billions of pesos. It was as if the country, poor in resources, decided to build an aircraft carrier and, during a typhoon while at sea, the aircraft carrier sank. Billions of pesos of business debt therefore sunk with the project, with the country paying for it as part of the external debt.

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matic backdrop on the state of the economy compared to that of the post-Marcos succession. Up to the present, the economy is still holding up. The main problem today is how to prevent the economy from further deteriorating, and to restore the momentum that was available to the leadership when political power was transferred from Ramos to Estrada. The Asian crisis provided a new dimension to the economic issues facing the Estrada presidency, but there were enormous opportunities available which he failed to take advantage of. Provided that the trial is relatively quick and Constitutional succession is not delayed, it would be possible to restore the economy back to relative health. The longer the succession is postponed (that is, if Estrada digs in and decides to continue in office if an acquittal in the Senate would take place), then the more the prospects of an economic tailspin and crisis of grave costs to the nation become almost certain.

The major political issue that Macapagal faces is how to bring about a cohesion among disparate groups that had helped to remove Estrada from government because of its corruption and inefficiency. Assurance of the main constituency of Estrada—the poor—will require not only a major effort in public information campaign on the reasons for his removal from office but also genuine efforts to show that the government is not turning its back on pro-poor and social justice programs. Despite the widespread publicity of the trial on television, some attitude surveys indicated that Estrada's hold on mass opinion remains strong, even though his fall from power will assure that the graft and corruption cases that he was accused of would become public knowledge and therefore weaken that charismatic hold. The main message therefore that the con-



ditions of the poor will improve with a change in focus of the leadership is very important.

For the short-term, the problem of Arroyo is how to reverse Estrada's erratic management of the economy and replace it with an economically focused leadership. Estrada's legacy is a compounding of the country's economic problems. Some of the missteps of Estrada have damaged the future of the economy because of mixed signals.⁶ Such thoughtless changes in policy were short of catastrophic but were certainly in a ruinous direction. Estrada simply missed good opportunities and aggravated problems where there ought to have been none. The problem of Arroyo is how to get a stalling engine to perform toward a smoother run.

This can only be done effectively by improving the conditions for raising both domestic and foreign investments. This requires a continuation of the liberalization program of the economy to raise its competitive level and improve efficiency. Most economists understand that the reason why other Asian countries have progressed far ahead of us is that their policies had

the effect of expanding the demand for labor faster than the supply. The objectives of their overall development policy were to increase the growth of efficient and competitive investments and industries, relying on the market demand that they were able to command and not on the basis of the state subsidies that they received. Structural reforms in the industrial and trade sectors which previous administrations implemented through major economic liberalization of policies led to an increase

in foreign investments and exports. As these reforms took root, the country began to reap the harvest of rising industrial exports throughout the 1990s, especially in the second half of that decade.

The expansion of labor-intensive types of export industries is an important sign in that should this continue and the export sector become more diversified, the domestic industrial base would be more integrated not only internally but also with the world economy. This would make the demand for labor grow much faster. It will only be then that the country will experience a strong rise in real wages. Thus, focusing on the expansion of investments for industries that utilize our inexpensive labor for products

⁶ An example was the unexpected decision to abrogate the Philippine-Taiwan air agreement, which sent the wrong message to Taiwanese investors. Of course, the policy was to give support to a crony's case of strengthening the position of the Philippine Airlines in a dispute on market sharing. In the end, Estrada retreated from this position after causing harm to the economy's investment promotion prospects and disruption of transportation routes for thousands of Filipino industrial contract workers in Taiwan's factories and establishments.

needed in foreign markets is a good policy focus.

Estrada's poor fiscal management is a major concern. The result of this is fiscal deficit. It has deteriorated each year since Estrada has been president. From close to zero as a percent of the GDP, the fiscal deficit has been rising each year. It is inching towards 3 percent of GDP whereas it was almost zero percent when he took office. (In nominal terms, a fiscal deficit of about P120 billion is expected by the end of 2000.) This fiscal deficit was not only caused by a growing demand for expenditure: it was a failure on the revenue side.

While the deficit was partly due to the Asian economic crisis, the other part dealt with the government's slow reaction to critical issues and developments. Foremost among these problems, of course, is fiscal restraint on the expenditure side followed by inadequate revenue efforts.

In fact, the increase of the fiscal deficit was also the handiwork of sloppy revenue work. First, tax administration weakened. The collapse in the pursuit of the Lucio Tan tax evasion case ruined incentives and morale in the tax collection agency front. The rise of customs smuggling has been associated with duty free imports by those with duty-free shop privileges. This was a problem of implementation that has been exacerbated by the perception that certain cronies of the President were behind the smuggling problem.

Second, the government did not pursue the privatization program as vigorously as required by the expected budget gap. The privatization program was supposed to yield significant supplemental revenues for the government to meet part of the expected fis-

cal gap. By falling into a relaxed posture in implementing the privatization program, it fell further into the trap of allowing major public corporations to depend on budget subsidies because they were not allowed to pursue price increases to meet the costs in selling their economic services to the general public. The contingent liabilities of these corporations became actual liabilities of the fiscal sector. Among these corporations were the Metro transit authorities, the National Food Corporation (NFA) and the National Power Corporation (NPC).

The privatization of the NFA was designed, from a fiscal standpoint, to bring in new and extraordinary revenues, and improve the distribution of food staples as well as reduce the losses draining the budget. But Estrada could not make up his mind to pursue a commitment made with the Asian Develop-

ment. These included the sale of the copper smelter plant and the phosphate fertilizer plants.

In general, work on remaining privatization projects were stalled. One of these are the reforms in the electricity generation sector which included the law designed to unbundle the huge generating assets of the NPC by privatizing the electric generation and distribution sectors. If said law was passed, new investments in the power sector would certainly follow. Another benefit would be to have a part of the public external debt reduced since, by virtue of privatization, some of that debt would be acquired by the private sector. But the major legislation on the power generation sector reform languished in the Congress because of lack of presidential leadership on this matter. This resulted in a major loss in terms of new investments because prior to the 1998 presidential election, the legislation was already close to passage by Congress.

Admittedly, major economic policy problems remain unresolved. But these were the problems that Estrada, with his huge mandate and popularity, failed to pursue because his attention apparently was on other things—the things that caused his impeachment. The impeachment trial has taken valuable time away from critical economic development issues. Thus, Estrada's succes-

sor will inherit a legacy of unresolved and difficult problems. Hard decisions are required and important steps have to be made in lifting the confidence of the investment sector and reintroducing foreign investments into the country.

The rising fiscal deficit always poses a threat of inflation. +16



ment Bank (ADB) in line with a public policy reform program designed to improve food distribution. This brought down Estrada's international credibility as a leader in the eyes of multilateral institutions. And while a number of privatization transactions of state assets took place, these were the sales that were near that stage before former President Fidel Ramos left the govern-

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A growing fiscal deficit could weaken the rest of the economy by transmitting higher borrowing costs on the rest of the economy. The increase in the fiscal deficit could also mean crowding out meaningful private sector activity.

Moreover and significantly, the size of the fiscal deficit has put the country out of compliance with the macroeconomic program with the International Monetary Fund (IMF). This means that the government could not turn to the IMF and other multilateral financial institutions to provide support for the financing of the fiscal deficit. This is the reason why the government has turned towards more expensive funds (offshore dollar funds and external capital) to finance the deficit. Initially, this financing method does not pose an inflationary threat, but it raises the external debt burden and the country's foreign exchange rate exposure.

But a new, highly motivated and forceful president who does the necessary homework...could articulate these benefits and could force the solution to the issues and get the work done.

The fiscal deficit already caused the downgrade of the Philippine government's sovereign debt ratings made independently by Standard and Poor's and by Moody's during the fourth quarter of 2000 by one notch in the rating levels, with a warning of a review for future reduction. This simply translates into higher cost of borrowing for the national government when it accesses the international market. With the downgrade, the obvious secondary impact is on Philippine companies and banks. Their borrowing cost

rises at least by the additional cost of the downgrades. They themselves could suffer downgrades if they are internationally rated by the credit agencies, as indeed the major Philippine banks such as the Metropolitan Bank and the Bank of Philippine Islands are.

The obvious cost of the rising fiscal deficit and the downgrade of sovereign debt rating is for the banks to pass on the rising cost of credit to Philippine borrowers. This means that companies and institutions in need of credit, including those that are already in debt and/or have credit to refinance, will have to face an increase in interest cost. This is the lurking danger, for if borrowing costs went up with the deteriorating posture of the overall macroeconomic picture—the negative Estrada factor—many companies that are highly leveraged are in danger of financial collapse. This could only lead to rising nonperforming loans (NPLs) in the banking system, the average of which had risen in 2000. Thus, a prolonged crisis will aggravate,

not help, the financial position of Philippine companies.

The succeeding president is therefore faced with difficult policy issues. These issues are not popular issues that could be easily understood. Some of the measures might require pain before the gains from their adoption become obvious. The improvement would help reduce the operational deficits of state corporations that keep rising because the government fails to take needed actions to improve

revenues and efficiency gains in public corporations. The first gains would therefore be felt in the improvement of the fiscal deficit. (But the popular mind does not digest the implications and benefits of reducing the fiscal deficit. It is only when its effects hit the people that people become aware of its bad consequences.) The other benefits would be improved efficiencies in the whole economy because the energy reform bill, if done right, could lead not only to cheaper energy prices in the longer term for the consuming public but also toward a large increase in infrastructure investments in the economy.

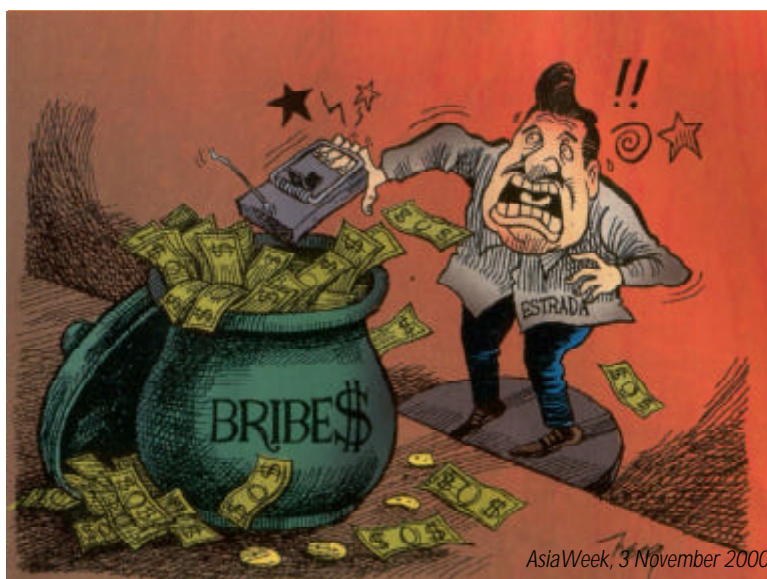
But a new, highly motivated and forceful president who does the necessary homework (unlike Estrada who was essentially sluggish in these matters) could articulate these benefits and could force the solution to the issues and get the work done.

All of these will put to the test the political skills of Gloria Macapagal Arroyo. This is, however, an area where she has not been sufficiently tested. Her background is largely in academic and technocratic work like in the industry department of government. Her stint in the Senate was relatively brief, and her management of the Department of Social Welfare and Development (DSWD), the assignment that she accepted as Vice President, was largely as head of a relatively safe sinecure uninvolved in the economic issues facing the Estrada government.

The political calendar has a presidential election in 2004. For any new president, introducing difficult economic reforms during the second half of an unexpired term could pose some serious calculations because the gains from those policies could only be realized later. But if these succeed, enormous potentials for future expansion of the economy would be in the offing. Policies are best put in place dur-

ing the first half of the presidency so that the benefits from them could be harvested during the second half. During the second half of the unexpired term of Estrada, potential candidates for president would attempt to make their presence felt to challenge her. Therefore, the last three years could pose difficult challenges regarding the passage of the most difficult economic reforms.

The Estrada government is remarkable in that it has failed to undertake any major reforms because of the innate deficiencies of the president as an economic leader. Every time he proposed reforms, he retreated quickly when the criticisms got tougher.⁷ Lacking the patience or the ability to articulate these programs, he failed to make the investment climate active.⁸



Estrada's accomplishment in the economy was one of providing the conditions for relative standstill. The economy grew at a level of growth permitted by an economy already beset in part by the Asian economic crisis. The period of rising growth rate that was the result of the economic reforms were stalled because of a multiplicity of factors, including the Asian crisis, but more because of Estrada's poor management style and inadequate leadership. The economic liberalization program stalled in some directions, notably in tariff reforms.⁹ There were some gains in policy—even in the tariff reforms—but overall, the actions of the government were to stall here and there.

Among the main problems related to poverty in the country—the

directions of reforms that a program for the poor could have made a major dent under the Estrada presidency—is how to raise the number of jobs in the country. This is far more important than the preoccupation with protective labor legislation, which has been the hallmark of Philippine policymakers' concern for decades. Key solutions could have been focused on raising in-

vestments, both domestic and foreign. Ultimately, such preoccupation could raise the demand for labor and domestic wage rate in the country.

A sustained program that leads to high employment growth results from a robust economy in which industries thrive because they operate at a competitive level with other countries. The best medicine for increasing the de-

mand for labor and the employment rate is to pattern the economy's growth toward the maintenance of industries that are competitive and whose existence are justified by commerce rather than protected markets. The momentum for growth was established by the strong efforts undertaken by the Ramos government to bring the country toward the international level. But there were major shortcomings because there was not enough time to pursue the next stage of reforms. Those reforms were part of the mandate of Estrada that were conveniently forgotten as soon as he stepped into office.

The coming years are critical for the country because it is a period of rapid internationalization. First, the ASEAN market will be moving toward the reality of a common grouping of countries with regional commerce as a

major aim. The net result is the expansion of the domestic market of the economy. Second, the world's trading rules have been redefined by treaty obligations agreed upon in the World Trade Organization (WTO). The international trading system opens up enormous opportunities for countries to reap major rewards if they play their cards right. When China—the last of the socialist countries— +18

⁷ The following are instances of these retreats. He backtracked from the pork barrel issue that he had promised to do away with without substantial legislative concessions. The retail trade liberalization was passed with much watered-down provisions. The power reform bill had not yet passed; the constitutional revisions that he proposed were shelved. The tariff reform program was not fully revised as planned.

⁸ Refer to G. Sicat (2000) on the issue of Erap's weak economic leadership.

⁹ Refer to G. Tecson (2000). Her study cautiously noticed the progress in tariff reforms. However, the study noted the setbacks from planned tariff reforms in the manufacturing sector where some reversals in tariff changes had been put into effect to favor some industries. The issuance of Executive Order No. 63 singles out a number of manufacturing industries in which the action to raise tariffs reversed the general trend that the government has adopted since the 1980s.

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endorses active engagement within the WTO to promote her economic growth, it is time for a country, such as ours, to buckle up and work at how best we could gain from the international trading.

Probing what an Economist as President would do

If one's early professional work could serve as a gauge of a nation-builder's approach to problems, could we predict what President Gloria Macapagal Arroyo would do?

Here, I am reminded of a quote from a sage economist when he was posed the ultimate question: "As an economist, what would you do if you were President?" The answer was, "But if I were President, then I would be a politician!" Of course, this is an exaggeration designed to avoid the question.

The political skills of a leader are definitely important. But an economist seeking the ultimate improvement in the country's plight would attempt to position the country toward greater efficiency and to direct the country's resources toward comparative advantage as a principle of gaining world market attention. To do this, the country's factors of production have to be competitive. This means taking advantage of the competitive edge of labor as the magnet for attracting foreign investments. An economist can read better the myths and fallacies of policymaking¹⁰ and can understand the need to avoid their worst consequences.

If her doctoral thesis in Economics could serve as a rough guide, what can we predict about her economic inclinations if she becomes President of the Philippines? As President, she would have to make decisions based on

a broader set of factors, including, of course, economic ones.

It is fortunate that she chose to study government expenditure and its impact on the economy. That is an important area where it is possible to have a good reading of her views on managing fiscal issues. If her study provides a clue to what she would do if she were in the shoes of a President, I venture to make a few comments on how she

out" private sector activity. She will have a healthy skepticism about the so-called countercyclical policies.

Second, she will pay attention to the composition of public expenditure. She will make efforts to improve the share of social expenditure – education, health, and other social services. This means that specific budget components will have to be prioritized, paying greater attention to the need to im-

... An economist seeking the ultimate improvement in the country's plight would attempt to position the country toward greater efficiency and to direct the country's resources toward comparative advantage as a principle of gaining world market attention.

would approach them if she were mainly dealing with these issues from an economic context.

First, I think she might become a fiscal conservative if she does not get afflicted with the common disease that hits all political leaders: to spend more. All political leaders tend to regard public spending as a way to demonstrate ability to serve the constituents. But economists understand better that excessive spending not matched by a growth in tax resources could lead to inflation and to other economic dislocations. She will have reservations about having large budget deficits to finance operational deficits of the government. For this reason, she will put the budget deficit under a much tighter rein. This follows from her finding that excessive fiscal deficits could "crowd


prove social development services. This follows from the fact that, following her own investigations, she finds that expenditures on social services have a higher impact than expenditures on tourism.

Third, she will likely strengthen public investment financing so that public infrastructure investment need not hinder the growth of private investment. She will follow new techniques of financing public investment from private sector sources. But she will make an effort to make these financing arrangements productive so that they are not burdensome on the budget.

Fourth, although the responsibility of the Presidency will take on many demands, she will pay greater attention to economic issues. Her professional training as an economist will provide her with appropriate equipment in dealing with intricate issues.

¹⁰ Some of the glaring myths and fallacies that have afflicted Philippine policymaking are discussed in one piece in a recent article (Sicat 1999).

Fifth, she will likely encourage the growth of the domestic economy in line with improving the Philippine competitive position abroad. In doing this, she will have a greater appreciation of the importance of a sound exchange rate policy as a means of pricing Philippine factors of production more competitively for international markets. Since she has a more thorough understanding of many economic policy questions than most Philippine leaders, she will surely show a quicker absorption of economic issues than her immediate predecessor.

The country therefore faces the prospects of having good luck on the leadership front after almost three years of a rudderless presidency. 

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China's economic boom: A boon to RP and other ASEAN nations

The Philippines, together with its neighboring countries in Southeast Asia, has a lot to gain from China's rapid economic growth, particularly its increasing foreign trade and investment activities.

This was the conclusion of a study entitled "China's Changing Trade Patterns: Implications for ASEAN-China Trade" by Dr. Ellen H. Palanca, a professor of economics and the director of the Chinese Studies Program at the Ateneo de Manila University. The research paper is part of a bigger project on China undertaken by the Philippine APEC Study Center Network (PASCN), the lead convenor of which is the Philippine Institute for Development Studies (PIDS).

This finding is contrary to the common belief that some Southeast Asian countries are going to lose their competitive advantages in many sectors because of China's economic rise. Palanca argued that based on the data available, the rapid economic growth of China, specifically its foreign trade, has not been at the expense of the growth of its neighbors' trade activities.

Palanca's paper explained that business opportunities are expected to multiply following China's accession to the World Trade Organization (WTO). Demand for imports will increase, particularly consumer products and services, as the standard of living of China's huge population goes up

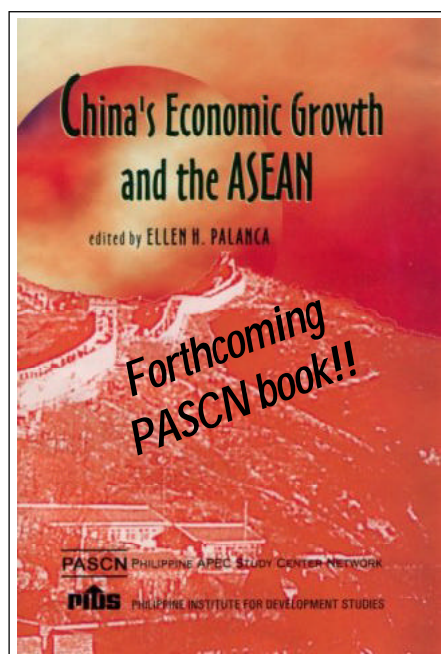
swiftly. Likewise, China's focus on rural industrialization will force it to increase its imports for food and primary inputs. In this case, she suggested that the Philippines can explore the gaps in agricultural and mineral resource supplies in China and fill up said insufficiencies by exporting agricultural and other primary inputs to China.

However, she stressed that before the Philippines could tap the growing trade opportunities in China, it has to improve first the efficiency of its industries, particularly the export industries, to make them more globally competitive. This includes improvement in the country's labor productivity as well as the efficiency of the government bu-

reaucracy and infrastructure such as power, telecommunication and transportation. The government should also be on guard that the peso is not overvalued.

Palanca also recommended that the Philippines should coordinate with China in the conduct of joint research to identify trade opportunities and niches based on comparative advantage as well as on intra-industry division of labor. She added that the Philippines should explore investment possibilities in China to facilitate the expansion and growth of the country's export of inputs and services.

Finally, Palanca explained that greater liberalization in China would also result in an increase in China's foreign investments. Thus, she concluded that special attention should be given to attract Chinese direct investments to the Philippines. According to her, these investments will not only provide capital but also technology that may be more appropriate than those from advanced countries. *GFG*



Editor's Notes

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economic managers "do not commit the same mistakes," there is no doubt that a better 2001 is possible.

The other special article in this issue is a middle-of-the-road profile of the new president, Gloria Macapagal-Arroyo, and how she may address the economic woes of the nation, being an economist. The piece was written a little more than two weeks before the historic four days culminating on January 20, 2001. It was written by Dr. Gerardo P. Sicat, former socio-economic planning secretary of the Philippines and professor at the University of the Philippines School of Economics (UPSE) where President Arroyo obtained her Doctor of Philosophy Degree in Economics in 1985. DRN