Exchange Rate Policy

Recent Failures and Future Tasks

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The sudden depreciation of the peso beginning July 1997 was ultimately traceable to the Philippines' declining competitiveness. Hence the crisis had real domestic roots, which speculation and the regional currency crisis merely exposed. The authors discuss the crucial role played by the exchange rate in determining competitiveness and show how the Bangko Sentral's flawed policy of exchange rate pegging made the country vulnerable to speculative attack. They argue that tight money policies and high interest rates seeking to reverse it are a cure that may be worse than the disease. The authors call for a revamp of the goals and methods of exchange rate policy and suggest ways to accomplish this.

Until the sudden depreciation of the peso on July 11, self-congratulation and complacency were the predominant themes in evaluating Philippine economic performance. Nor was this mood totally unfounded. After all, the economy's performance over the past five years had been satisfactory in many respects. The economy grew continuously albeit moderately over the period, with GDP growth averaging 4.2 percent annually between 1993 and 1996. This figure was certainly better than the 3.2 percent of 1988-1992 or the 1.8 percent of 1978-1987. Inflation had been brought under control: from the double-digit levels of 1981-1991 to single-digit levels between 1992 and 1997. The public sector deficit had also been tamed, with a deficit equal to 2.1 percent of GDP in 1991 turning into a surplus of 0.3 percent of GDP by 1996. In dollar values, exports grew by a strong 15.4 percent annually between 1992 and 1996.

These accomplishments stemmed from reforms whose long-term significance is undeniable; three areas have been particularly important. The restoration of peace and order and political stability were indispensable factors making for a more predictable investment climate.[1] The policies of deregulation and privatization revived both domestic and private investment. A momentum of trade liberalization, both unilateral and in the context of multilateral agreements, encouraged new investments only in those sectors that are globally efficient and competitive.

The peso's sudden weakening has surprised many – the government not the least – and is prone to two extreme interpretations, which are both wrong. One is to view it as the signal of the end of the country's growth episode. This is the view of those who have never agreed with the broad direction of recent economic reforms to begin with and who have always regarded the economy's recent achievements as transitory or superficial. Among such commentators, therefore, the peso's sudden depreciation – as indeed with any piece of bad economic news – will be regarded as an ultimate vindication of opposition and an argument for re-examining and reversing the trend of all past policies.

The other extreme opinion is found mostly within government itself, notably the Bangko Sentral ng Pilipinas, which continues to intone the reality of "strong fundamentals," and is based on the assumption that nothing – including the previous level of the exchange rate – is fundamentally wrong. Carried to the extreme, such a mind-set then regards the circumstances underlying the peso's weakness as being largely artificial and attributable to the work of malicious speculators.

In this paper, we argue a position that is less dramatic but one that is hopefully closer to the truth and more helpful for the redesign of policy. We argue that the economy's achievements are real and that a great part of it is attributable to sound policy. However, recent progress should not be exaggerated to the point of denying that serious problems and policy failures exist. Indeed, one of the most crucial failures has been the conduct of exchange rate policy itself, whose inadequacies the recent debacle has only belatedly revealed.

PUTTING THINGS IN PERSPECTIVE

THE notion that the peso's current troubles are largely artificial is founded on the assessment that economic "fundamentals" are, in fact, sound. The economy's real achievements, however, should be placed in perspective.

First, while GDP growth has been respectable, it is well below the average for developing countries, and much less than the growth of Asian developing countries. In 1993-1996, all developing countries grew at 6.3

percent, and Asian developing countries grew at 8.6 percent. In comparison, Philippine GDP grew only 4.2 percent annually. It typically surprises people to learn that, even in 1997, the country has still not regained the per capita income (GDP) of 1981.

The fact that GNP has been consistently higher and has grown faster than GDP should also cause some concern. GDP, which measures the value of domestic production, is after all more closely related to the country's attractiveness as a production location, and this has consistently grown more slowly than GNP. The large difference between GNP and GDP is due to foreign exchange income from overseas, although possibly a systematic overstatement of GNP.

How Good is Philippine Growth?

GDP Growth in Comparison (in percent)

GDP Growth	1978-1987	1988-1992	1993-1996
World	3.3	3.0	3.4
All Developing Countries	4.5	5.1	6.3
Asian Developing Countries	6.8	7.4	8.6
Philippines	1.8	3.2	4.2

Source: Asian Development Bank, *Asian Development Outlook* 1997-1998

The recently released income figures for the first semester of 1997 (January to June), remembering that these events preceded the July 12 depreciation, depict a worsening of this trend. The deceleration in GNP growth is the most obvious. Following our discussion of GNP overstatement, however, this is in fact less important than it seems. What should cause more concern is the large deceleration in industrial growth, from 6.2 percent to 5.4 percent. The growth of manufacturing in particular has fallen from almost 6 percent to less than 4 percent, with declines in such industries as textiles, garments, rubber, metals and metal products, and transport equipment. Industries that have kept second semester growth going were mostly associated with the "bubble" economy, including construction in the industrial sector and services such as finance and real estate, as well as catch-up industries like transportation and communication.

Losing Momentum

Growth Deceleration in the First Semester (in percent)

	First semester 1996 vs. 1995	First semester 1997 vs. 1996
Agriculture	3.8	3.4
Industry	6.2	5.4
Manufacturing	5.6	3.9
Services	6.0	6.3
GDP	5.6	5.3
GNP	7.5	5.9

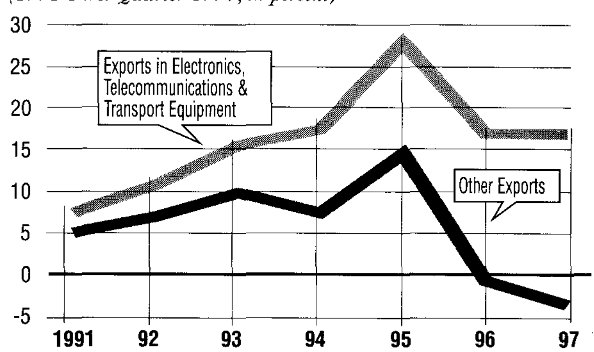
Source: National Statistical Coordination Board

Second, even as exports have indeed continued to grow, the growth is concentrated in a few commodities notably electronics and transport equipment. It is important to note that other manufactured exports, as well as agricultural exports, have stagnated or actually declined beginning in 1996. Chief among these failing sectors has been garments, which actually began to shrink as new suppliers such as China, Bangladesh, and India moved to take advantage of the expanding quotas provided under the World Trade Organization (WTO). Bangko Sentral figures show that all other exports aside from electronics, telecommunications, and transport equipment have grown more slowly since 1991, also implying that their share in the country's total exports has been decreasing (28 percent as of the first quarter of 1997). In addition, however, the figures show stagnation and decline in these other exports from 1996.

Until the peso's plunge, the fact that total exports continued to grow fed a good deal of complacency regarding the exchange rate and its role. After all, the peso remained stable, yet exports apparently increased. This was regarded as an argument that exports were "price-inelastic," that the exchange rate did not matter for exports. It should have been regarded as significant, however, that most export growth consisted of those sectors which, like electronics and transport equipment, relied the least on domestic inputs, and were associated with firms from countries with strong home currencies. On the other hand, those which were domestically owned or relied heavily on domestic inputs (e.g., garments, furniture, food exports, etc.) fared poorly. We shall argue that this curious pattern of export growth is in fact an indicator of worsening competitiveness.

Weakening Export Performance

Growth of Exports of Electronics, Telecommunications and Transport Equipment vs. Other Exports (1991-First Quarter 1997, in percent)



Source: Bangko Sentral ng Pilipinas, *Selected Economic Indicators*

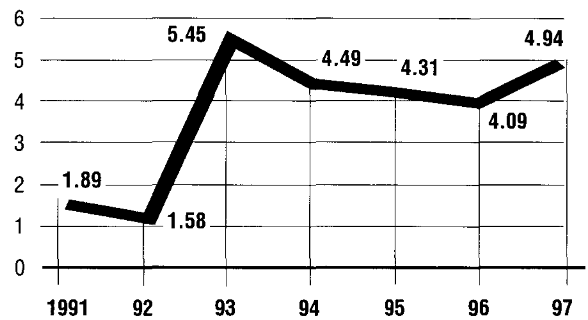
Industrial Hollowing Out. It is a disturbing feature of recent economic growth that the share of manufacturing in both total output and total employment, continues to stagnate or has even declined compared to a decade ago. The share of industry in GDP has fallen from an average of

40 percent in 1980-1985 to 35.7 percent by 1996. Industrial employment in 1996 was even lower as a percent of total employment than it was in 1980. Indeed, the basis of recent growth is still precariously narrow, and this is seen in the following trends. Growth has been concentrated in a few sectors. The most prominent of these are nontradables, that is, domestic industries that intrinsically face little or no competition from foreign substitutes. Examples of these are provision of infrastructure and utilities, construction, transport, real estate, and finance. In the export sector itself, it is those industries that have the weakest linkages to the domestic economy which have grown the fastest, notably electronics exports and transport equipment.

Widening Current Account Deficits. This is the result of lower competitiveness. The excess of imports over exports of goods and services (the current account deficit) has risen in recent years from 1.9 percent of GDP in 1991 to 4.9 percent in 1997 (first quarter). While this amount does not appear large, it is significant for two reasons. First, it indicates a trend towards worsening over the past five years. Second, there is a strong possibility of errors involved in imputing receipts from the foreign currency deposit withdrawals (the same item that may cause an overstatement of GNP).

The Worsening Gap

Current Account Deficits
(1991-1997 First Quarter; percent of GNP)



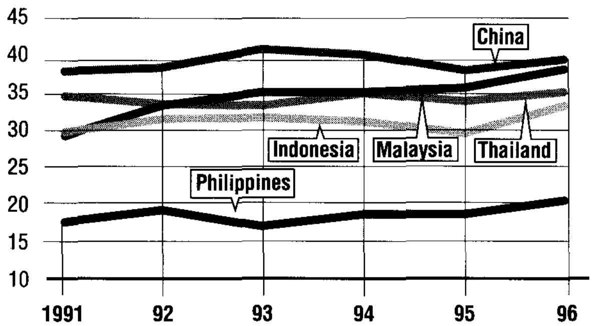
Source: Bangko Sentral ng Pilipinas, *Selected Economic Indicators*

Weak Saving Performance. The weakening export performance is not unrelated to another "nontiger" characteristic of Philippine growth, its weak saving mobilization, notwithstanding slight improvements. Where domestic saving rates equal to 30-40 percent of GDP appear to be the rule for fast-growing economies of the region, saving for the Philippines has remained mostly below 20 percent. The implication of weak saving for growth prospects is straightforward. As long as domestic saving remains weak, the level of investment needed to sustain a high level of growth must come from foreign saving. This in turn implies a greater resort to foreign borrowing, in the form of either foreign loans, portfolio investment, or direct investment. The fact of low saving bolsters the expectation that either current account deficits will continue, or future growth must be reduced to what can be financed.

Foreign Overborrowing. Related to the question of foreign financing has been the increasing importance of portfolio investments in financing current account deficits. A noticeable effect of recent growth has been the large spurt in foreign borrowing by private corporations, including banks. Domestic interest rates are far higher than those prevailing in the developed countries and, for some time now, the exchange rate has not moved. While this situation was expected to persist, there has been great incentive to borrow funds from abroad and lend these locally at the prevailing higher rates. The situation is similar to the Marcos borrowing euphoria of the late 1970s, except that now it is private, not public, entities that are doing the borrowing. Between 1993 and September 1996, total foreign exchange liabilities of the private sector, both banks and non-banks, rose almost three times, from $4.72 billion to $12.8 billion.

The Odd Man Out

Saving in Selected Asian countries (1991-1996; as percent of GDP)



Source: Asian Development Bank, *Asian Development Outlook* 1997-1998

Borrowing Spree

Private-sector Foreign Exchange Liabilities (In US$ million 1993-1996 September)

	Banks	Non-banks	Total
1993	521	4,199	**4,720**
1994	980	6,859	**7,839**
1995	2,000	7,251	**9,251**
1996 (Sept.)	4,158	8,696	**12,854**

Source: Bangko Sentral ng Pilipinas, *Selected Economic Indicators*, March 1997.

A further complication arises, since large foreign borrowing itself gradually builds a constituency against an upward exchange rate adjustment. A depreciation would enlarge the equivalent peso liabilities of heavily indebted entities, which could threaten their liquidity or even solvency. At that point, as in Thailand, the stability of the entire financial system could be threatened, requiring the government to step in. That a crisis of such proportions has not yet happened is due less to the prescience and prudence of Filipino financiers and central bankers and more to the fact that the Philippines' own period of creditworthiness has been much shorter.

COMPETITIVENESS

THE economic trends described above do not represent a random pattern but rather point to a fundamental problem of the past five years: the failure of Philippine competitiveness to rise. Many meanings have been attached to competitiveness, to the extent that the very significance of the concept has been questioned (e.g., Krugman 1992). Competitiveness is easy enough to define at the level of firms. At the level of entire countries or economies, however, the issue may be reduced to whether and how much more attractive it is to produce in this country rather than in other countries, a question that is asked from the viewpoint of both foreign and local investors alike.

The concern for a country's competitiveness, as manifested in export performance and manufacturing growth, proceeds from two presumptions:

First, in small, open economies, learning, productivity, and efficiency are enhanced by exposure to competition and the drive to produce for larger global markets. True, sufficient competition and scale may exist in larger economies, such as the United States, that make it possible to attain productivity growth without this finding a reflection in vigorous export growth.[2] But in economies with smaller or poorer domestic markets, there are little chances of stimulating competition, reaping economies of scale, and accumulating industrial knowledge outside of export markets. Robert Lucas (1993) explains this causality as follows:

> The main engine of growth is the accumulation of human capital – of knowledge – and the main source of differences in living standards among nations is differences in human capital. Human capital accumulation takes place in schools, in research organizations, and in the course of producing goods and engaging in trade. Little is known about the relative importance of those different modes of accumulation, but for understanding periods of very rapid growth in a single economy, learning on the job seems to be by far the most central. For such learning to occur on a sustained basis, it is necessary that workers and managers continue to take on tasks that are new to them, to continue to move up...the 'quality ladders'. *For this to be done on a large scale, the economy must be a large-scale exporter.* [Emphasis ours.]

Second, under conditions where factors of production are increasingly mobile, countries must compete to attract them, or indeed to retain their own mobile production factors. The first reason cited above pointed to the importance to growth of accumulating industrial experience. Where capital, technology, and skills become globally "footloose," however, an economy's prospects of attaining that very industrial experience improves or worsens depending on whether it can attract and retain mobile factors of production to accumulate productive knowledge over a long enough period. In short, competition at the level of countries is largely locational competition (Siebert 1996).

It would require a long list to enumerate the elements that would induce capital, technology, and skilled labor to prefer one country over another, and the lists would probably differ from one industry to another. In the main, however, the following elements must be considered:

Productivity Growth. Higher productivity, of course, implies greater returns to investment. There is at least agreement that productivity matters. The productivity of investment in a country depends on more ultimate factors, such as transport, communication, and other "hard" infrastructure, as well as on "soft" infrastructure such as education and skills among the labor force, work ethics and discipline, managerial talent and entrepreneurship, supporting industries, and so on.

Past studies of overall manufacturing productivity in the Philippines, however, have not been encouraging (see Patalinghug 1997). Almost all studies suggest that productivity – measured as total factor productivity – has either declined or stagnated over long periods of time. Over the period 1971-1980, for example, Hooley (1985) estimates that total factor productivity in manufacturing declined and actually reduced output growth by 28 percent. Cororaton (1995) takes a longer period, 1956-1992, and calculates that productivity growth contributed only 0.8 percentage points to an output growth rate of 5.6 percent over the period. Finally, Austria and Martin (1992) studied the entire economy over the period 1950-1987, and similarly found that total factor productivity had declined and actually reduced output growth by 11 percent. It may be argued that these are studies of the past, reflecting the unsound basis of past industrial growth: May the current record not be different? Indeed. At most, however, prospects of productivity growth will improve as growth itself accelerates and is sustained.

From what we know of the nature of technological progress, productivity growth typically follows upon industrial experience and sustains it.

Higher productivity is a result of learning, which also means it cannot provide the initial impetus or occasion for learning. It is wrongheaded, therefore, to demand of business people that they should simply "concentrate on raising productivity" rather than worry about high costs or the exchange rate. For the motive to raise productivity itself (e.g., to invest in new machinery, to train personnel, etc.) is conditioned on the prospect of expanding markets, which in turn may depend on something as pedestrian as costs and the exchange rate.

Domestic Prices and Wages. Costs are the obverse of productivity, and this aspect of competitiveness may be measured as either domestic prices or wages, which in any case tend to move in the same direction. Considered from the viewpoint of supplying global markets, however, it is obvious that what matters is how much higher home prices and wages are relative to those of competing suppliers (and how much faster they are rising). A flavor of the situation as early as late 1995 can be found in the results of a survey of Japanese firms by the Japan External Trade Organization (JETRO). The figures show that wages (in dollar terms) in the Philippines ($160-220) were higher than those in China ($66-130) and in Indonesia ($100-200), countries which have average incomes similar to that of this country. The Philippines also has the highest power costs after Japan. The same set of surveys also showed that truck freight and marine freight costs in the Philippines exceeded even those of South Korea, Taiwan, Hong Kong, Singapore, and Malaysia. As for inflation, it has only been recently that domestic inflation tapered off to the single-digit levels that are the norm for East Asia (except China, although even there inflation has also come down).

Taxes are another aspect of costs, and there is an obvious trade-off. On the one hand, taxes of any kind raise the costs of investing and producing in a country, either by eating directly into incomes (e.g., corporate income taxes), or by raising the prices of domestically produced goods and services (e.g., indirect taxes). The flipside of the argument, however, is that public infrastructure – which we saw was vital to reducing costs – must itself be supported by tax revenues. Governments and investors alike, therefore, must weigh the costs entailed by having to pay more taxes, against the benefits of better infrastructure provision. On average, Philippine tax rates on paper are neither better nor worse than those of other countries; but the country suffers on the side of utilizing these tax revenues efficiently and productively.

Where Would Investors Locate?

Major Manufacturing-related Costs in Selected East Asian Cities and Japan (as of October 1995; in US$)

	Singapore	Bangkok	K. Lumpur	Jakarta	Manila	Shanghai	Japan
Wages							
(monthly)...	630-1150	160-310	190-290	100-200	160-220	66-130	3216
Industrial land (per sq. m.)	n.a.	82.5	85-128	60-66	n.a.	n.a.	370
Power (per kwh)	0.07	0.04	0.06	0.035-0.074	0.11	0.07	0.13

Source: Japan External Trade Organization, reproduced from Fabella (1997:455, Table 14.7).

But the black letter of taxation is only one part – perhaps not even the main part – of the costs of doing business in the Philippines. Business people openly complain of the "hidden costs" of dealing with the government, a phrase meant to encompass everything from government red tape, inefficiency, to the costs of litigation and contract enforcement, to lobbying and outright bribery.

This rundown of the factors affecting competitiveness thus far clearly shows that the Philippines possesses no obvious "competitive advantage" in any of them. The economy has no clear advantage in productivity[3] and suffers from clear penalties in terms of costs. Nor can one expect immediate relief with respect to any one. From the start, this ought to have led to the realization that in the short- to medium-term, only one instrument could be relied on to provide the initial impetus for sustained industrial growth based on exports – namely, the nominal exchange rate.

THE CRUCIAL ROLE OF THE EXCHANGE RATE

APART from productivity and costs, a third factor affecting competitiveness is the exchange rate. Until hubris caught up with some of them, the rule among the rapidly developing economies of the region was not to allow the currency to appreciate so as to threaten competitiveness. In countries such as Indonesia, in 1988 and 1986, and China, in the 1990s, authorities would periodically engineer currency depreciations to ensure competitiveness was maintained. When Indonesia undertook massive devaluations in 1983 and 1986, its non-oil exports grew rapidly and had exceeded its oil exports by 1992. In an earlier period, deliberate devaluations or engineered depreciations were known as "beggar-my-neighbor" policies, in recognition of their potency in shifting the locus of world production towards the devaluing country.

The mechanism is easy enough to understand. For any given level of productivity and costs, a higher exchange rate – that is, a weaker currency – lowers the dollar cost of producing in the country and therefore makes local products appear less expensive to foreigners and residents alike. In other words, the stimulus to produce for export or for home consumption provided by a currency depreciation partly or wholly compensates for a country's feeble performance in productivity and costs. This is far from saying that a cheap currency alone and for all time should carry the day for exports and domestic industry – a caricature drawn by those who would deny that the exchange rate has any role at all. It does say, however, that competitive advantage must begin from somewhere. And since that advantage will not come easily or immediately through the catch-up in overall productivity or in the reduction of costs, then it might as well begin with an aggressively managed exchange rate to make exports look cheaper abroad. A competitive – or, even better, an undervalued – currency is a valuable means to kickstart an initially small and sluggish export sector. The currency depreciation does not by itself raise productivity or lower costs at the level of businesses; but – as Adam Smith noted long ago – unless sales rise and markets expand, productivity and innovation will not even be given a second look. In short, a competitive exchange rate is the indispensable first step to the export-based industrialization to which the country is ostensibly committed.

It is useful to devise a summary index that allows one to view the combined influence of productivity, costs, and the exchange rate on competitiveness. One such straightforward and serviceable measure is the real exchange rate (RER), which shows how much of locally produced goods can be bought by a dollar (or yen or mark, etc.) One version of the RER is given below:

$$\text{RER} = \frac{\text{exchange rate (₱/\$)}}{\text{average price of Philippine goods}} = \frac{\text{exchange rate (₱/\$)}}{\text{Consumer Price Index}}$$

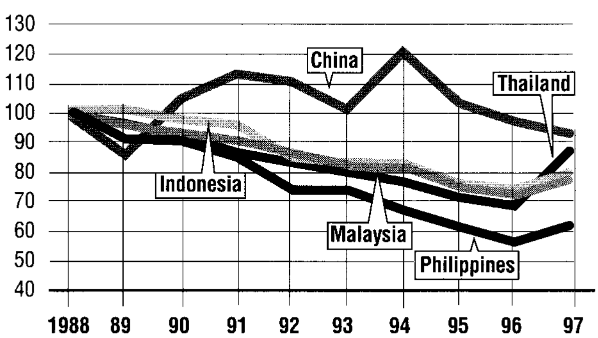
This may be interpreted as the typical basket of local goods a dollar can buy. The two elements it comprises are the nominal exchange rate and the average price level. For a given exchange rate, increases in productivity or lower production costs (including wages) would show up in lower prices (a lower denominator) and a higher value of RER. Similarly, for given domestic prices, a higher nominal exchange rate would allow more domestic goods to be bought by each unit of foreign currency and hence raise RER. In either case, RER would measure changes in competitiveness through time.

In this paper, such RERs for Thailand, Malaysia, Indonesia, and China are standardized so that 100 represents the state of competitiveness in 1990. Rising above 100 represents cheapening and a gain in competitiveness. Falling below 100 signifies that domestic goods are becoming more expensive. The record shows that between 1991 and 1996, most countries of the region did lose some competitiveness, but that the Philippines lost the most ground. In real terms, domestic goods were some 26 percent more expensive, relative to 1990. Among some of the changes in competitiveness that have occurred since the large depreciations of July and August this year, in particular, is the large recent depreciation of the Thai baht. This is a corrective that may be expected to restore a good deal of competitiveness for the Thai economy.

It will be noted that before 1997, virtually all Asian currencies shown here had appreciated in real terms, but that China has appreciated the least. It should therefore come as no surprise that virtually all of these economies have been attacked by "speculators." But what is more significant for policy is that it also points to the fact that competitiveness is a relative matter. An economy's own standing obviously depends on what its competitors have accomplished in terms of their own prices and costs, productivity – and nominal exchange rates. For exchange rate policy, the important lesson is that one cannot be oblivious to actions by others. If the Thai baht has depreciated to 35 to the dollar, with Thai inflation being controlled, competitiveness cannot be maintained at 28 pesos to the dollar with a higher inflation rate. Even the level of 30 pesos to the dollar shown here barely keeps the peso abreast of its competitors.

How the Philippines Lost Competitiveness

Real Exchange Rates for Selected Asian Countries (1988-1997; 1990 = 100)



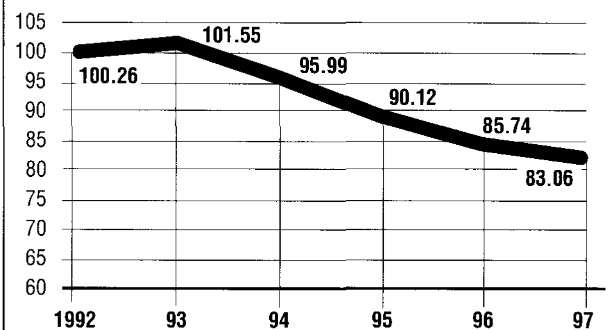
N.B. 1997 exchange rates used are from *Far Eastern Economic Review*, September 1997; 1997 inflation price levels are projections from the Asian Development Bank's *Asian Development Outlook*, 1997-1998. All others are annual data from Asian Development Bank, *Key Indicators for Developing Member Countries 1996.*

A measure that takes the relative changes in competitors' competitiveness is the so-called real effective exchange rate, which takes into account the fact that competitors have also lost competitiveness. The effect of doing so, of course, is to ameliorate the country's own loss in competitiveness. This is computed relative to Singapore, South Korea, Taiwan, Malaysia, Thailand, Indonesia, and Hong Kong. Our computations show the peso appreciating in real effective terms continuously and from 1993. By the first quarter of this year (the last datum in the figure) the peso was about 17 percent overvalued, i.e., (100 – 83.06) ÷100 = 16.94.

As it happens, the real exchange rate appears to have some power in predicting speculative attacks on countries' currencies. Some of the countries of this region have experienced speculative attacks while those, like China (a low income country) and Taiwan (a higher income country) have not. The difference is the following: countries that have shown no large real appreciations and managed to have significant excess of exports over imports (current account surpluses) experience no major speculative attacks. Nor are the two unrelated: current account surpluses are piled up only by having competitive real exchange rates over a long period of time. By contrast, over the last few years, the Southeast Asian countries – perhaps in an episode of hubris – all began to run up large current account deficits, allowing their currencies to appreciate in real terms as they embarked on large public and private projects, at times with dubious payoffs. In particular, it was overbuilding in real property (a nontradable), combined with a bad bureaucratic rule for a fixed exchange rate in Thailand, which caused the debacle of the baht. To a lesser extent, the same may be said of the large currency deficits run by Malaysia and Indonesia. Prime Minister Mahathir's ambitious multimedia city and financial center projects are well known, as are Indonesia's large industrial and infrastructure projects. None is blameless.

Competitiveness is Relative

*Real Effective Exchange Rates of the Peso**
(1992-1997 First Quarter; 1986 = 100)



*Relative to Hong Kong, Singapore, South Korea, Taiwan, Malaysia, Indonesia, and Thailand.
Source: Own computations.

From a perspective of competitiveness, therefore, the events preceding the peso's drop in July fall neatly into place and should cause no surprise. The point to make is that recent events in the currency markets are not accidental, much less based on the arbitrary whims of speculators. They point to a clear lesson: "Live within your means; set the exchange rate to promote exports and narrow the current account deficit."

Similarly, all the apparently minor disturbing things about recent Philippine growth upon closer examination point to a loss of competitiveness and the greater attractiveness of foreign goods, foreign services, and foreign assets – the non-accelerating growth in total output; the slower consistently lower growth posted by GDP compared to GNP; the stagnation in manufacturing's share of output and employment; the weakening export performance in all but a few products – and the foreign over-borrowing syndrome. They simply indicate that producers – whether Filipino or foreign – encounter significant penalties the more they use domestic inputs.

Recent events in the currency markets are not accidental, much less based on the arbitary whims of speculators.

While growth has indeed continued, its sources appear to lie in either those sectors that either have the least to do with the domestic economy (e.g., overseas workers, exports with the least value-added), or nontradables such as real estate, finance, public utilities, where entry is restricted and there is little or no need to compete with foreign suppliers. Even the fact that electronics and transport equipment exports continue to rise – often cited by those who regard the exchange rate as inconsequential – is the exception that proves the rule. As it happens, semiconductors and wiring harnesses are the exports that have the lowest domestic value-added. This tends once more to confirm the bias against domestic production that the exchange rate represents.

The overvalued currency has been the mole that is silently but surely hollowing out the foundations of industrial growth and employment, whether in exporting or import-competing industries. Currency overvaluation renders competing imports cheap and exports expensive. It should come as no surprise, therefore, that the Export and Industry Development Council – in a rare show of unity between export and in import-substituting interests – forged a common stance to demand a fundamental shift in the Bangko Sentral's exchange rate policy.

In the meantime, a good deal of damage has been done by the futuristic technobabble surrounding such ideas as "leapfrogging," or worse, "pole-vaulting." Beyond the (perhaps forgivable) populist hyperbole involved, the official encouragement of discussion along these lines supports the misimpression that the economy can somehow avoid the difficult but necessary step of expanding manufactured exports and wiping out mass unemployment. Idle talk that the country can somehow graduate overnight into a services-exporter encourages complacency over the fact that the manufacturing sector has stagnated. The decline of agriculture and the shrinkage of labor-intensive industries such as garments, furniture, and footwear over the past five years is even dismissed offhand as a sign that the country's industries are moving "upscale." It is a disease of the mind when the stench of rotting carcasses is regarded as unparalleled fragrance. For it is clear that no amount of expansion in the services sector, as currently constituted, will provide enough good-paying jobs to wipe out mass unemployment and poverty in this country.

MOTIVATION BEHIND PAST POLICY

IF the Bangko Sentral's policy clearly failed to sustain competitiveness, what could have been its motivation? The only answer imaginable is price stability. Underlying the Bangko Sentral's exchange rate policy was its narrow interpretation of its "basic mandate"[4] of controlling inflation. To be sure, a constant nominal exchange rate contributes to price stability, while the converse – namely a depreciating currency – is bound to contribute to rising prices, if only because of higher peso price tags on imported goods.

With this understanding of its "mandate," the Bangko Sentral's policy towards the exchange rate was necessarily lopsided. During a period of heavy portfolio capital inflows, the Bangko Sentral erred on the side of largely tolerating real currency appreciation. It showed a noticeable asymmetry in its responses to appreciation and depreciation. When the peso was appreciating, the Bangko Sentral stated it had already done all it can, which was little more than buy modest amounts of foreign exchange. In marked contrast, when the peso threatened to fall in July, the Bangko Sentral pulled out all stops by raising interest rates and regulating "overbought-oversold" positions of banks, and so on.

The contention that the Bangko Sentral's stance contributed greatly to real overvaluation is typically denied by asserting (a) that the exchange rate was largely "market-determined," or (b) that the Bangko Sentral even actively intervened to prevent appreciation on behalf of exporters, since it was even a "net buyer of foreign exchange."

The first defense is based on the specious argument that if the

Bangko Sentral does not buy or sell foreign exchange, then it is not intervening. This is true only in the narrowest sense. In particular, money supply and interest rates may be manipulated to reduce demand for foreign exchange. Then indeed supply and demand "freely" determine the exchange rate, but it may be "demand" that bears the heavy hand of Bangko Sentral intervention. As an example, tight money and high interest rates during 1991-1992 (T-bill rates exceeding 20 percent) were sufficient to cause nominal peso appreciation during the period (incidentally also causing a recession).

Second, there is nothing either in (modern) theory or experience that says that "market-determined" exchange rates of the moment are always compatible with competitiveness in trade and manufacturing. Only old textbooks still give the impression that market-determined exchange rate movements suffice to balance the current account and promote the optimal level of exports. In the era of extreme capital mobility and open capital accounts – more about which later – it is largely the demand for financial assets that moves exchange rates.

Even if one grants that the exchange rate is "market-determined," therefore, this is far from saying that the exchange rate is sufficiently high or low to serve development needs. The current rate may simply reflect the three-month horizon of portfolio managers.

There is one scenario, though, in which the Bangko Sentral's policy of keeping the peso strong might work. A constant exchange rate at, say, 26 to 28 pesos to a dollar is compatible with competitiveness if domestic prices and wages were to fall across the board and productivity growth through some miracle were suddenly higher than in other countries. This is simple arithmetic following from the definition of a real exchange rate. Then we might recover the ground lost to competitors.

To work for such a scenario, however, would be a recipe for disaster. In practice, it is naive to think that inflation may be squeezed out of the system without first plunging the economy into deep recession. And, indeed, if the high-interest rate policy of the Bangko Sentral is kept up long enough, a recession is exactly what we shall get. As an alternative, we propose that policymakers give up the exchange rate anchor for inflation; not to do so is being unrealistic. Friedman (1968) long ago made a point that appears to have been lost on policymakers, and it is this that "it is far simpler for one price to change, namely, the price of foreign exchange, than to rely upon changes in the multitude of prices that together constitute the internal price structure."

ON THE ROLE OF SPECULATION

GIVEN that fundamentals could not be regarded as healthy, it is not totally surprising that the levels of the peso – as well as other currencies of the region – should be tested by "speculation." In saying this, we disagree with the alternative "analysis" (notably shared by Mahathir) that the recent currency turmoil rests on nothing more than wanton schemes by international speculators.

It is wrong and idle to blame "speculators" for the country's woes. Like gambling, speculation is nothing more than betting on which way a price will go. Milton Friedman's (1968) observations a long time ago have unfortunately been forgotten too soon:

> People who argue that speculation is generally destabilizing seldom realize that this is largely equivalent to saying that speculators lose money, since speculation can be destabilizing in general only if speculators, on average, sell when the currency is low in price and buy when it is high.

Ordinarily, market-determined prices may go either up or down, so that bets may be on either side. Authorities themselves invite speculation, however, when – by following rigid rules – they allow the exchange rate to become seriously misaligned with fundamentals over a long period of time, until it becomes obvious to all that the current rate is insupportable. Such a situation leads in due course to all bets being on one side, the equivalent of a sure thing. At that point, no one can blame speculators for taking only one position. They have not created the odds, they merely reflect them.

In the case of the baht, real appreciation and the failure of the trade and current account deficits to narrow was certainly one indicator, worsened by the obvious problems caused by the property market crash and financial failures. No great intelligence was required to realize that the appropriateness of the prevailing exchange rate could be seriously – and perhaps profitably – tested.

The precipitating factor for the test of the peso in turn was the depreciation of the Thai baht. Competitiveness, we recall, is relative; that the baht had depreciated meant first of all that Thailand had regained some of its attractiveness at that point, but also that other countries of the region would need to keep up. Information on the baht's depreciation leads immediately to the question whether other governments can rationally expect to remain passive. The answer of course is "no." For this reason, any speculator would regard a test of all the currencies in the region as likely, but especially of economies that were running large current account deficits and whose currencies had appreciated substantially in real terms. Hence the "contagion" that has affected the region. As this explanation shows, speculation is much more a consequence rather than the cause of already latent instability.

BETTER LATE THAN NEVER

FOR all the surprise and uncertainty it causes, therefore, the depreciation of the peso should still be a welcome piece of news. Speculators have merely initiated what the Bangko Sentral should have done long ago – as many economists and other writers advised – and what it was forced to do finally in July. Comparatively speaking, the damage wrought by the Bangko Sentral's efforts to defend the peso by selling dollars was not as great as in Thailand's. The Bangko Sentral managed to squander only about $4 billion (compared to about $20 billion for the Bank of Thailand) before it gave up direct intervention to defend the peso. People with obviously less ammunition probably use it more prudently (although this still does not answer the question of many others as to whether any significant loss of international reserves was justifiable at all).

To be sure, uncertainties exist, two of which are important. The first one is the magnitude of depreciation needed before things settle down. As already mentioned, in many ways, the "equilibrium" level of the peso will depend on how the baht, the ringgit, the rupiah, and other currencies of the region fare, since competitiveness is relative. Second, as in all previous depreciations, there is always a risk that large increases in domestic prices and wages nullify the nominal depreciation, so that no gain in competitiveness results.

In principle, however, a number of factors augur well for a substantial depreciation at this time, which could render the period of uncertainty brief and allow the country to reap its benefits.

First, unlike numerous previous devaluation or depreciation episodes that the country has had in the past, the present one occurs when the economy is not undergoing a severe economic crisis but still experiencing positive (though slower) economic growth with a satisfactory investment climate. Some leeway for independent economic policy is provided by the Bangko Sentral's reserves (assuming it has the sense to conserve them), the economy's continued credit standing, and the fact that it needs to worry less about the International Monetary Fund (IMF) conditionality. Second, precisely because growth was slowing down even before the currency turmoil, some excess capacity exists in equipment and employment, which can serve to moderate inflation. Third, the economy in the 1990s is less repressed and restricted than it has ever been. In particular, trade liberalization permits imports where they can do some good in relieving supply bottlenecks, keeping prices in check.

In short, the depreciation has come just before it was too late and, if allowed to fully work its effects through, could provide the boost needed to rekindle export and industrial growth in the next few years.

SNATCHING DEFEAT FROM THE JAWS OF VICTORY

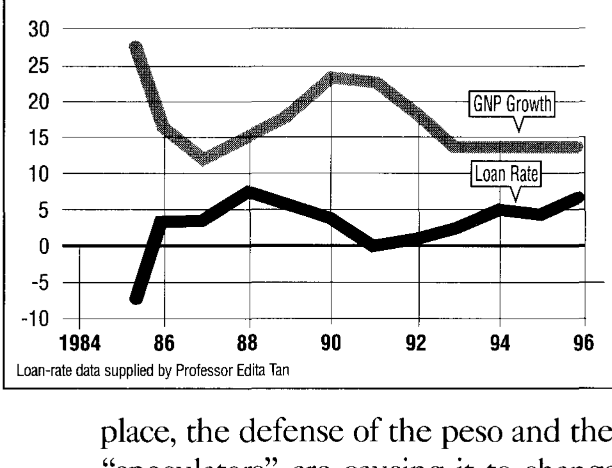
THE immediate obstacle to the economy's realizing the gains from the depreciation, however, is neither inflationary expectations nor uncertainty abroad. Rather it is the Bangko Sentral's continuing covert defense of the peso through its high interest rate policy and tight money. The Bangko Sentral has given up its attempts to intervene directly in the foreign exchange markets by selling foreign exchange – for the simple reason that its reserves are insufficient. But it continues to wage an incomprehensible campaign against "speculators," a campaign whose goals are far from clear but whose consequences can stifle economic growth. It is not even clear if the Bangko Sentral has accepted the need for a depreciation and is not seeking ways to undo it.

Just as soon as it had given up its open defense of the peso through foreign exchange sales, however, the Bangko Sentral deployed other tools in quick succession to prop up the peso, including raising overnight borrowing and call-loan rates, supporting the exclusion of foreign banks from transacting at the formal foreign exchange markets, increasing bank peso reserve requirements and changing their composition, and setting maximum limits on foreign exchange assets that may be held by banks. The wide array of levers used by the Bangko Sentral – whose capacity to surprise and bewilder the layperson and keep speculators off balance (which may be exactly what it wants) – is amazing. But the result is the same: all these have the common effect of restricting credit or raising the costs among banks and other financial intermediaries – and therefore raising interest rates. This complex of moves had, at the time of this writing, raised interest rates and kept them up for two months: prime lending rates by early September had reached 40 or more percent, and interbank call rates to 70 percent or more. While some monetary tightening is usually salutary after a devaluation in order to put the lid on inflation, this does not justify the current regime of monetary overkill.

The Bangko Sentral's purpose is clear enough: credit restriction leaves less liquidity available for speculation; at the same time, the high interest rates that result may make peso-denominated assets sufficiently attractive to lure portfolios back. In this way it might restore some of the peso's nominal value. Unfortunately, past experience has already shown that prolonged high interest rates have always managed to stifle investment and kill economic growth. This occurred in 1984-85 and 1991-92, and unless the course is soon changed, it is set to happen again. A simple juxtaposition of loan rates and economic growth will show an unmistakable opposite relationship between interest rates and economic growth. This mechanism works in two ways. High interest rates stifle loan demand, cutting back on both spending on investment and consumption. In addition, however, high interest rates also raise the costs of working capital and could ultimately work its way through to prices. The combined effect of these forces is more than sufficient to cause a recession with inflation to boot, as in 1984-85. Unlike 1984-85, however, high interest rates are less likely to succeed as a currency prop in these days when the stock market is much larger. High interest rates would only succeed in aggravating the stock market slump and drive away mobile international capital. The danger of a recession from this source is sufficiently real that the NEDA (National Economic and Development Authority) Director-General, Cielito Habito, has recently admitted the interruption of the growth momentum and called on the Bangko Sentral to abandon its policies.

High Interest Rates Stifle Growth

GNP Growth and Interest Rates (1985-1996; in percent)



Loan-rate data supplied by Professor Edita Tan

Beyond the immediate recessionary impact of the high-interest regime, however, the larger cost of the high-interest strong-peso regime is that hard-won structural reforms may be undone as a result. In the first place, the defense of the peso and the Bangko Sentral's witch-hunt against "speculators" are causing it to change the rules in quick succession (e.g., changes in overborrowed positions, changes in the Philippine Dealing System, raising reserve requirements, etc.). This prevents private business from drawing up plans. The confused signals emitted by policy is inhibiting exporters from making the necessary adjustments in their pricing and production that will allow the beneficial effects of the depreciation to be realized. Hence the Bangko Sentral's own pessimistic expectations about an export-response are fulfilled by its own actions.

Furthermore, the uncompetitive peso's failure to provide protection against imports, plus the impending recession caused by high interest rates, gives a justification to businesses to demand compensatory relief and protection. Among others, businesses feel justified in agitating to reverse or slow down tariff-reform commitments.

In a word, the exchange rate – and most particularly its futile defense – is turning into the single most important obstacle to the continuation of growth in the country. If depreciation is like diarrhea, it is probably better to let it run its course; the high interest-rate "cure" for the depreciation is patently worse than the disease.

CHOICES FOR FUTURE POLICY

THE present episode of currency turmoil shows the clear failure of exchange rate policy and the need for a radical change. There is a need to resolve two conflicting demands on exchange rate management which are, first, the urgent need to support competitiveness, and second, the desire for currency stability and consequent price stability. The question is whether it is at all possible to achieve these two together.

The experience of other countries suggests two alternative ways of approaching the issue, both of which carry some promise of success. One policy configuration, as observed in China in the 1990s and Indonesia in the 1980s,[5] involves periodically engineered aggressive depreciations or devaluations to restore competitiveness, as soon as the latter threatens to be eroded by domestic inflation. In such regimes, depreciations of 40 percent or more are not unheard of. The advantage of this course is that it allows authorities a good deal of flexibility in using monetary and fiscal tools to stimulate the economy, even to the point of tolerating moderate domestic inflation.

The basic idea is evident from our simple competitiveness framework, which shows real exchange rates being affected by depreciation and productivity (positively), and by domestic inflation (negatively). If inflation by default must be high – perhaps as a result of attempts to stimulate productivity – then depreciation must also be large. The loss in competitiveness occasioned by inflation may be made up for, subsequently, by depreciation.

Economies that follow this path are characterized by high fiscal deficits or rapid monetary growth, and moderate or high inflation as well as a substantially depreciating currency. The point, however, is that exports, investments, and growth continue to rise. The downside to such a regime, of course, is a risk that the depreciation-to-inflation process may spin out of control. At the point where inflation begins to outrun nominal depreciation, the gains from this approach run out and the economy is confronted with an inflationary spiral. Much therefore depends on the stability of social institutions and the nature of tripartite consensus, the economy's structural import dependence, and the degree of openness of the economy. Societies whose ability to foster trust and consensus on prices and incomes is weak, which are heavily dependent on imports, and which tend to be closed would have a more difficult time implementing such a strategy.

The US, Japan and Germany are prominent examples of countries where competitiveness is bought primarily with productivity growth.

Another strategy would seek to maintain low domestic inflation and stable currencies to maintain competitiveness. Again recall the simple framework: the real exchange rate falls with inflation and rises with nominal depreciation and productivity. If, out of an overriding concern for currency stability, nominal depreciation is chosen to be small or zero, competitiveness can be maintained only if productivity growth outpaces increases in wages. Such a regime would be appropriate for economies where a long industrial tradition has established a good record of productivity growth and where low inflation has become firmly established. Such a regime would also require, among other things, that there be fewer demands on fiscal and monetary intervention of all sorts. Governments with poor ability to generate resources, or with ambitious industrial or infrastructure plans are ill-advised to go this route, since they would be disposed to running large fiscal deficits or monetary expansion, which would run counter to the low-inflation requirement. The US, Japan and Germany are prominent examples of countries where competitiveness is bought primarily with productivity growth; Taiwan and Chile are developing-country exemplars.

Obviously, no one size fits all. The choice of an appropriate exchange rate regime depends on economic, social, and institutional characteristics, or, what is similar, choosing one regime or the other imposes certain requirements for success.

But under which category would the Philippines fall? On the one hand, its dependence on imports and weak ability to forge price and income consensus seem to predispose it towards a regime of low-inflation and stable currencies. On the other hand, its fiscal performance is fragile at best, and productivity growth is not yet a reliable anchor for competitiveness. In the end, however, we would advocate a position in between. Policy should target a real exchange rate for competitiveness. For this, it should be willing to engineer depreciation. But policy should also keep inflation low. This advice is based less on omniscience than on an assessment that imperfections in the formation of social consensus are more difficult to repair than defects within government or in economic policy-making. The factors that reduce the attractiveness to the Philippines of the second strategy – i.e., weak revenue-raising capacity, slow productivity growth – are easier to fix than managing social conflicts that may result from a high-inflation regime.

It may appear the distance is not great between this position and the form of Bangko Sentral policy up to now, which is also directed primarily at currency stability. We contend, however, that current policy has been implemented for the wrong motives, in too rigid a manner, with the wrong initial conditions, and without the supporting mechanisms.

First, it must be said, the starting point is all-important. Currency stability is compatible with sustained competitiveness if the exchange rate to be defended is realistic. A rate of 26 pesos to a dollar, however, was patently uncompetitive and was the wrong place for the Bangko Sentral to draw the line. The current episode of realignment should be used by the authorities – cursing foreign speculators all the way, if need be – to re-establish a new par-value for the currency that will sustain competitiveness over the long run. It must, therefore, abandon the foolish and futile attempt to the old exchange rate.

A *second* element of policy should be the willingness to support such a higher, defensible exchange rate through aggressive purchases of foreign exchange and the accumulation of international reserves, as required. The nominal rate must not be allowed to fall below the level needed to support competitiveness. The Bangko Sentral cites its net purchase of foreign exchange in the past as proof that it had actually prevented the peso from appreciating. However, the subsequent speculative attack on the peso and the Bangko Sentral's shortage of reserves are the ultimate proof that it has not done enough.

The standard objection to "doing more" in the sense of making larger purchases of foreign exchange has been that this would require increases in money supply. Indeed, this is what proves to be the difference. Past Bangko Sentral policy was based on foreign exchange purchases in the midst of high interest rates and tight money. To begin with, the binding constraint that caused the appreciation was the high domestic interest rates that attracted portfolio inflows and encouraged private firms to borrow heavily abroad. Without undertaking the necessary measures to reduce the demand for peso assets, it was no surprise that the dollar purchases were ineffective and superficial. The alternative proposed here differs from current policy in that it gives priority to competitiveness over stable money growth in the short-term. Nonetheless, we do realize that while unsterilized purchases of foreign exchange may initially work, it is ill-advised as a long-term recourse, lest it create a "bubble economy" as in Japan.

Third, related to the previous paragraph, authorities must be willing to engineer timely and adequate exchange rate adjustments to maintain competitiveness. The structural problems and bottlenecks encountered by most developing countries make it almost inevitable that inflation will arise – even if monetary and fiscal policy are relatively conservative. Hence it would be unreasonable to expect that consistently low inflation and productivity growth alone would carry the drive towards competitiveness. If necessary, the monetary authorities should anticipate when the exchange rate threatens to be out of line and should preempt speculative activity through an engineered competitive depreciation.

The alternative proposed here differs from current policy in that it gives priority to competitiveness over stable money growth in the short-term.

Fourth, a regime of low interest rates should be maintained to stave off the threats of large portfolio capital inflows that have caused the unwanted currency appreciation of the past. This should be attained primarily by continuing to run fiscal surpluses to reduce the public sector demand for funds. Fiscal surpluses prevent an overreliance on expansive monetary policy to prevent appreciation. A formidable challenge, however, is achieving fiscal prudence while increasing the social and infrastructure spending needed to raise productivity. For this reason improving tax revenues attains a special significance. (Note that fiscal stability is less important for the approach involving high inflation-cum-large-depreciation.) This also points out that a particular challenge of the low-inflation-stable currency strategy is a coordination between exchange rate, monetary, and fiscal policy.

Finally, it will be a difficult but necessary step to review the treatment of portfolio capital flows. A good part of the reason for the most recent currency instability was the unprecedented opening up of the capital account in 1992. The resulting inflows of portfolio funds and the foreign borrowing spree by the local private sector – combined with the Bangko Sentral's passivity – were responsible for the peso's appreciation, just as the sudden withdrawal of such funds caused its sudden fall. In either case there is bound to have been "overshooting." There are good grounds for saying that complete capital liberalization in 1992 was premature and invited exchange rate instability. The present crisis is a good occasion to rethink the rules and send a signal to portfolio managers that coming and going henceforth may not be so easy. This should reduce another source of instability for the currency.

There is no more eloquent testimony to the failure of past exchange rate policy than its collapse brought on by recent events. The broad outlines for an alternative have been presented. We leave others to decide, however, whether all that is required is a change in policy, or also a change in the leadership that implements policy.

CONCLUSIONS

THE recent depreciation of the peso may have been unwanted and unexpected for most, but it has been necessary for some time now to make up for lost competitiveness. The surprise element was due only to the inappropriateness and inflexibility of existing policy, which lulled policymakers and ordinary citizens into thinking that the previous state of affairs was completely normal and indefinitely sustainable. The baht depreciation and the test of speculation brought that illusion to an end.

Two main dangers face the economy following the depreciation. First is the possibility that inflationary expectations would become so aroused that excessive price and wage rises may wipe out any real depreciation. Such a mood is especially encouraged if the process of price and wage-setting becomes politicized, e.g., through legislated minimum-wage increases. It is somewhat encouraging, however, that two months after the currency turmoil, inflation remains at low single-digit levels. The other danger, is that the "interest-rate cure" and tight-money overkill pursued by the Bangko Sentral may work too well. In that case, the peso may yet stabilize at low levels, but not before causing a recession. Then the cure will indeed have been worse than the disease.

Nonetheless, at no other time in recent years is the Philippines poised to benefit more from a currency depreciation than at present, if it meets the challenge and seizes the opportunity. If, as a result of this most recent crisis, the mind-set of policymakers, the media, and the public is changed regarding the new rules and the stakes in a more global economy, then the lessons may well have been worth the pain.

NOTES

Authors' Note: This article is based on a presentation by the authors, all professors of the School of Economics, University of the Philippines before the House Committee on Economic Affairs in August. The views contained reflect solely the personal opinions of the above and do not express any official position of the School of Economics or the University of the Philippines.

1. In the midst of current debates to change the Constitution, it is worth remembering the crucial part in stability played by the orderly presidential succession from Aquino to Ramos.
2. This appears to be the gist of Paul Krugman's (1994) well-known objection to the whole notion of national "competitiveness."
3. We do not wish to paint an entirely bleak picture. Random interviews suggest that compared to countries in similar positions, the Philippines has a productivity advantage among skilled and semi-skilled workers, but not among the unskilled. Even if this were true, however, it would not suffice as an anchor of an entire development strategy, for the simple reason that it would not encompass the majority of the labor force and would therefore not suffice to erase unemployment.
4. See, e.g., Guinigundo (1997).
5. Indonesia had huge devaluations in 1983 and 1986. After 1986, however, it undertook gradual and predictable depreciations, which unfortunately were significantly less than the difference between the interest-rate differentials between itself and the US. This encouraged Indonesian corporations to borrow huge amounts in foreign currency.

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