



Philippine Monetary Policy: A Critical Assessment and Search for Alternatives

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Alternatives to Inflation Targeting: Central Bank Policy for Employment Creation, Poverty Reduction and Sustainable Growth

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Philippine Monetary Policy: A Critical Assessment and Search for Alternatives

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Summary -- The change in monetary policy in the Philippines from ‘monetary targeting’ in the 1980s and 1990s to ‘inflation targeting’ in 2002 has so far resulted in a less contractionary monetary policy. Whether this more liberal policy will continue faces a critical test as the world and the Philippines face inflationary pressures from world oil prices. The problem is that both the monetary targeting and inflation targeting regimes are based on a demand explanation of inflation that blames overexpansion of money and credit for inflation. The evidence for the Philippines proves otherwise – the inflation experience through the decades had been mostly a supply-led and cost-push phenomenon. This paper proposes an alternative set of monetary policies to inflation targeting which veers away from the idea that monetary policy should have a single objective of fighting inflation and ‘overspending’, towards a viewpoint wherein monetary policy is part and parcel of a larger macro policy that contributes to economic development.

Key Words – inflation targeting, monetary policy, monetarist, macro policy, Philippines

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1. Introduction

Contractionary monetarist and fiscal policies that were used in response to inflation and current account deficits in the Philippines during the 1980s and 1990s were excessively pro-cyclical, aggravating and deepening recessions and downturns, and easing only when the economy showed an improvement in inflation and in the current account balances.

Since monetary targeting – employing a hard-line monetarist philosophy backed by IMF conditionalities – is generally accepted as a contributor to the depth of recessions in the Philippines in the last 25 years, and since it was replaced by inflation targeting only in 2002, the author will cover the Philippine experience with monetary targeting.

The next section documents monetarist policy as it responded to inflation and balance of payment crises. The third section discusses the shift from the monetary targeting regime to the inflation targeting regime starting 2002 and explains why it is more ‘benign’ than what was originally feared.

The fourth section puts monetary policy in the context of the complex macro situation of the Philippines in order to support the recommendations that the proposed alternative monetary policy should be multi-dimensional and address several concerns.

The last section gives detailed recommendations for an alternative monetary policy that will be sensitive to employment generation, preventing financial crises and easing the fiscal problem towards sustainable macroeconomic development of the country.

2. Monetarist Targeting in the Philippines

The Philippines' history of economic crises had always been connected with balance of payment and foreign exchange crises. These had led to some very sharp recessions – especially the economic collapse in 1984-85 --that destroyed the Philippine chances of becoming an East Asian success story

Monetary policy in response to these balance of payment crises consisted of sharp monetary contraction and fiscal austerity that aggravated the recession. Monetary targeting lasted throughout the 1980s till 2002.

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

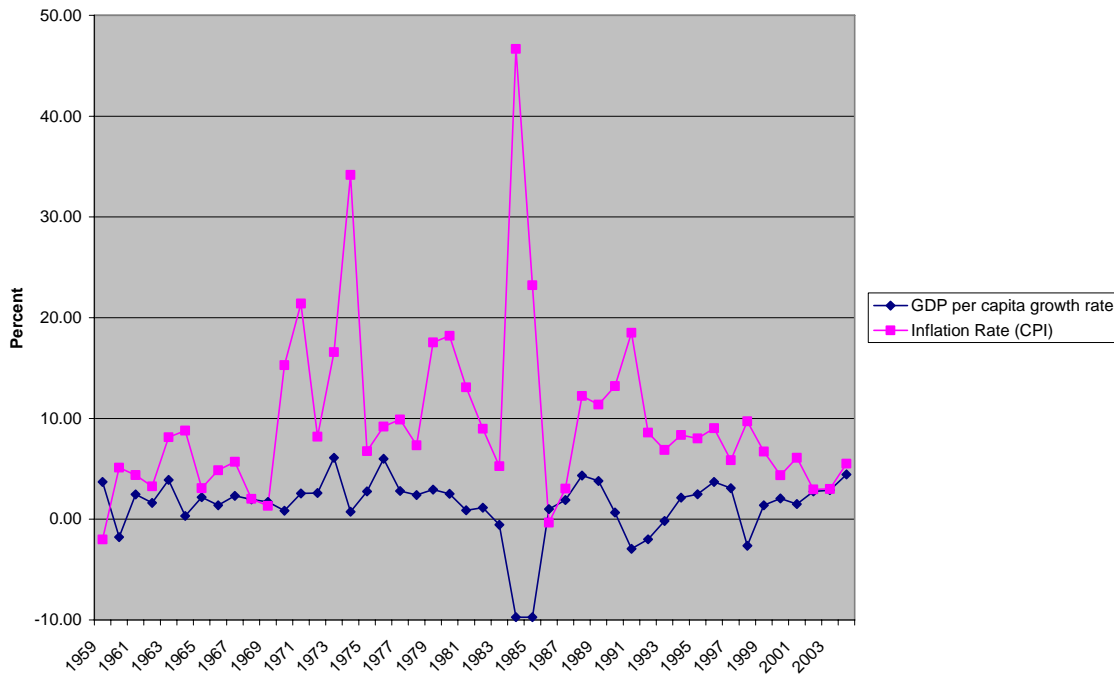
Monetarist policies assume that the cause or persistence of inflation and ‘overspending’ is due to increases in aggregate demand resulting from too much money supply increases.

This assumption is contradicted below;

(a) *Supply Side Causes of Inflation*

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

Fig. 1: GDP per Capita Growth Rate vs. Inflation Rate

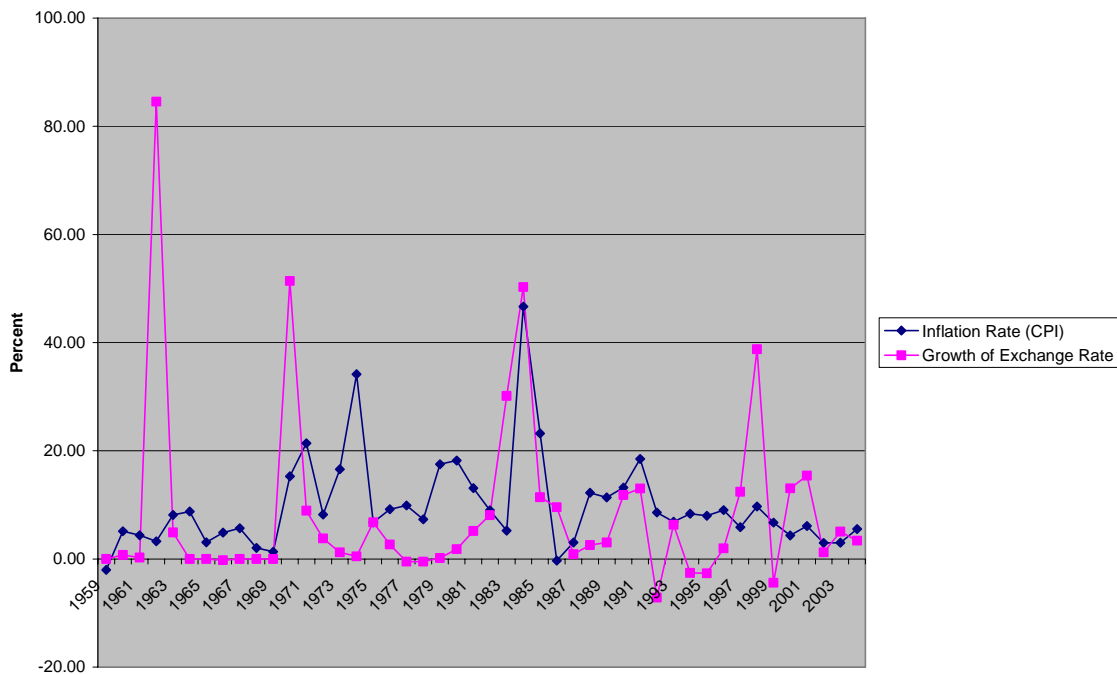


Source: National Statistics Coordination Board and IMF, International Financial Statistics

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

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

Fig. 2: Growth Rate of Exchange Rate vs Inflation Rate



Source: National Statistics Coordination Board and IMF, International Financial Statistics

It can be seen that the devaluation in 1970 had brought high inflation in 1970-71. The first oil price shock in 1973-74 brought about high inflation in 1973 and, especially 1974. Again, the second oil price shock and worldwide inflation in 1979-81 brought about the high inflation during the same years. The significant devaluations in 1983 and 1984 had led to high inflation in the economic collapse period of 1984-85. The moderate devaluation in 1990-91, plus oil price shock due to the first Gulf War crisis brought about the inflation in 1990 and 1991. The significant devaluation during the Asian crisis in 1998 brought a slight uptick in inflation, but nowhere near the high inflation that occurred in previous devaluations.

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

If one uses monthly or quarterly data on inflation, one can also see that agricultural price shocks also make their impact on price inflation. The Philippines is a victim of several typhoons every year and is susceptible to droughts. Both periodically bring about agricultural shortages and agricultural price increases.

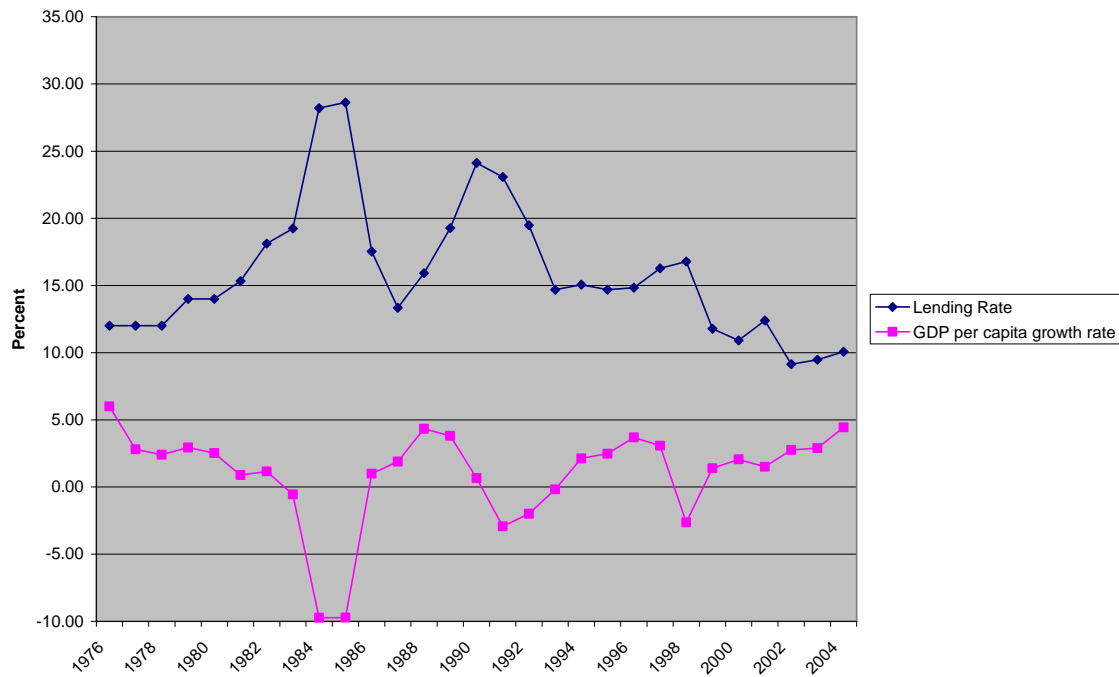
(b) *Monetary Contraction and Impact on GDP and Unemployment*

Thus, using monetary contraction to fight inflation magnifies the recession and unemployment that ensues, since the original supply shocks (devaluation, oil price shocks or adverse agricultural shortages) already have recessionary impact.

Figure 3 shows us the relationship of lending rate and GDP growth rate. Lending rates rise during crises because of the higher inflation, but credit and monetary contraction goes beyond this since the authorities specifically contracts the monetary base and increases required reserves and the Central Bank policy rate. As expected, one sees a strong inverse relationship between the lending rate and GDP growth rate, especially during the recession periods of 1984-85, 1991 and 1998. The sharp monetary contraction in 1984-85 and the high lending rate that ensued no doubt contributed significantly to the sharpest economic collapse the country experienced.

The lending rates in Fig. 3 actually underestimate the costs of borrowing since during monetary contraction periods, many firms are credit-rationed.

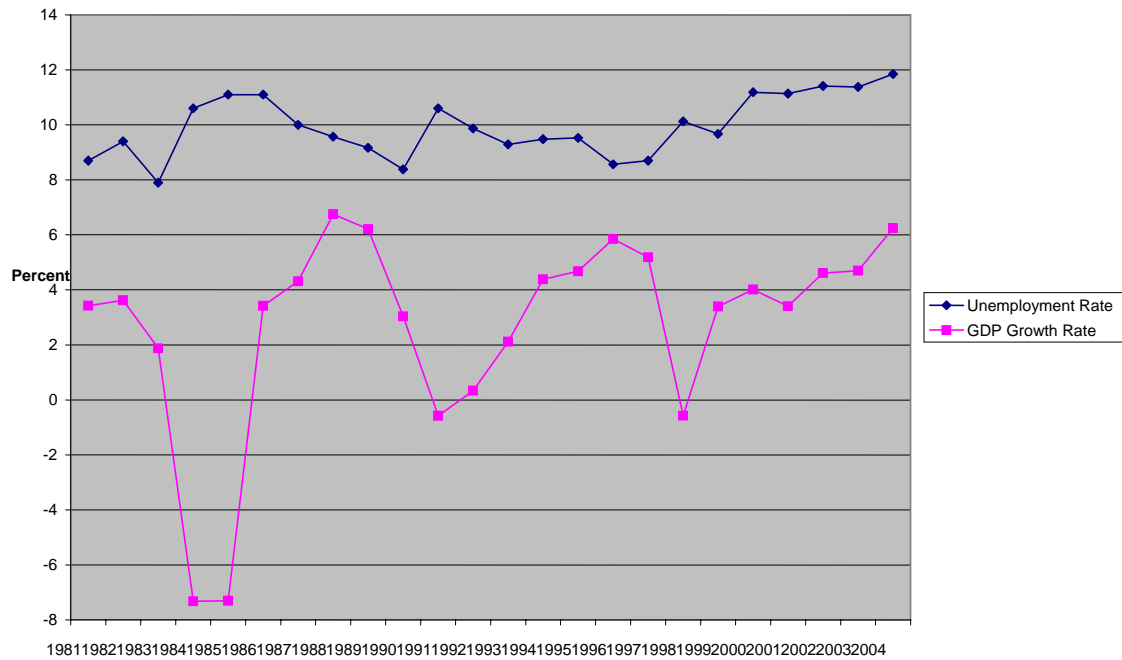
Fig. 3: Lending Rate vs Growth Rate of GDP per Capita



Source: National Statistics Coordination Board and IMF, International Financial Statistics

Fig. 4 shows that the recessions of 1984-85, 1991 and 1998 created significant upticks in the unemployment rate.

Fig. 4: Unemployment Rate vs. GDP Growth Rate



Source: National Statistics Coordination Board; Labor Force Survey, National Statistics Office; IMF, International Financial Statistics

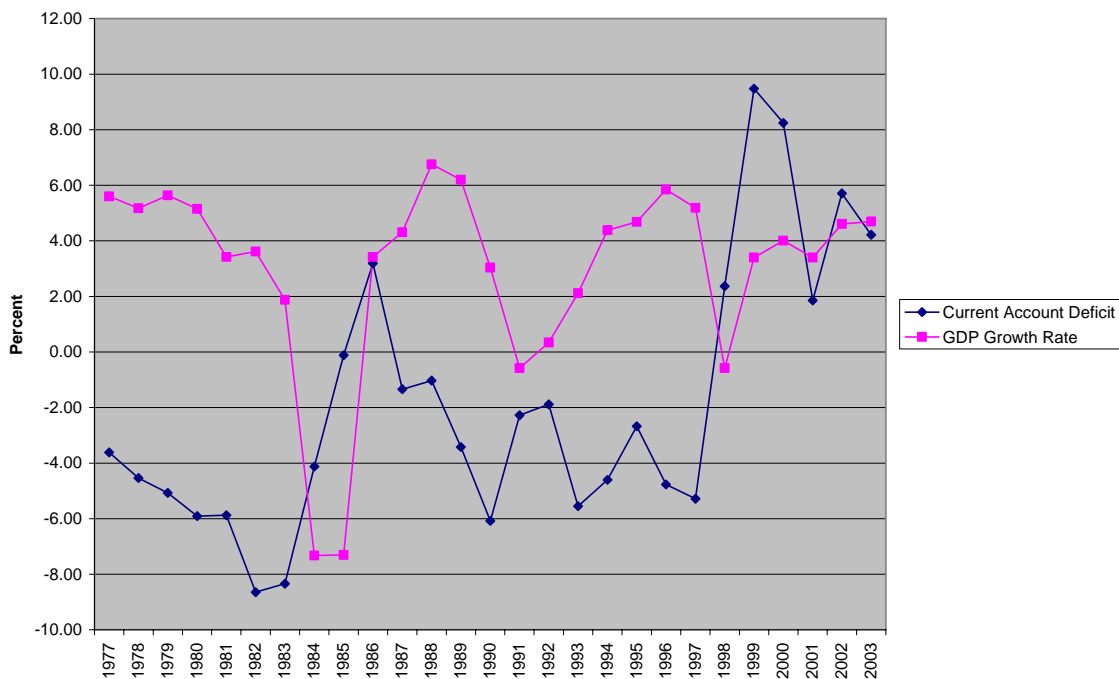
(c) *Monetary Contraction and External Deficits*

But of course the story is not just between inflation, monetary policy and output/employment effects. Much of the demand-suppressing austerity programs are implemented during times of balance of payment crises triggered partly by high current account deficits. Thus, these policies are perhaps more to ensure that current account deficits are substantially reduced. On paper demand-suppression through monetary contraction and high interest rates are used to fight inflation. In fact, it is also to reduce

aggregate demand so that current account and balance of payment deficits are turned into surpluses. This is undertaken of course at the expense of output and employment.

Figure 5 shows us a graph of the current account deficit (as % of GDP) and GDP growth rates. It is evident that the times when current account deficits deteriorated were mostly preceded by high GDP growth. High growth entails large import spending, which leads to higher current account deficits. This is especially true for Third World countries which rely a lot on imported inputs and capital goods for its growth. Monetarist theory and the IMF interprets large trade and current account deficits as ‘overspending’ due to monetary expansion, and requires monetary and fiscal tightness.

Fig. 5: Current Account Deficit (as % of GDP) vs. GDP Growth Rate



Source: National Statistics Coordination Board and IMF, International Financial Statistics

Let us concentrate on the three recession periods – 1984-85, 1991 and 1998. It is clear from the graph that each crisis was preceded by a year or two of very significant current account deficits. Evidently the current account deficit contributed to the crisis and loss of confidence in each case. It is clear that after each recession, the current account deficit improves, and in the cases of the crisis in the mid-1980s and the Asian crisis, the current account turns positive after the recession. It should be emphasized that the recession is partly caused and aggravated by the monetary contraction led by monetarist policy. Thus monetarist policy aggravates the recession in order to turn current account deficits into surpluses and improve the balance of payment situation.

This brings us to the question as to why draconian cutback of aggregate demand through monetarist contraction would be necessary to save the current account when massive currency depreciation has already occurred. It seems to only deepen the recession and cause serious increases in unemployment and poverty in the country. This leaves this monetarist policy open to criticisms that the main goal is to ensure that the balance of payment improvements are substantial so that external debt of foreign creditors will be safely repaid.

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

In the 1980s and 1990s, monetary policy's sole purpose to fight 'overspending' that had 'caused' current account deficits and high inflation ensured that monetary policy could not be used for countercyclical and growth purposes. The financial liberalization policies starting in the 1980s also ensured that monetary policy cannot be used to finance targeted or prioritized sectors of the economy. This complemented the prescription of the multilateral agencies for the country to abandon industrial policy and undertake trade liberalization.

3. From Monetary Targeting to Inflation Targeting

(a) A Switch in Regime: From Monetary Targeting to Inflation Targeting

In the Philippines, research work in the Central Bank itself pointed to the 'overkill' that monetarist policy resulted in to try to tame inflation. This is mainly because the use of the quantity theory of money equation assumes a unitary coefficient of money to prices with output holding steady, despite massive monetary contraction. The use of a single estimated inflation equation assumes all explanatory variables (exchange rate movements, output growth, etc.) to be exogenous and only the monetary variable will decrease inflation. A study by a staff member of the Central Bank (Dakila (2001)) shows that with a simultaneous equation system where exchange rate movements and output movements are endogenized, the degree of monetary tightening to achieve a stipulated amount of inflation reduction is lessened. This is because monetary tightening cum

recessionary policies tends to eventually cause some appreciation of the currency and a fall in output growth (both of which tend to be deflationary).

When single-digit inflation rates were achieved in the mid-1990s under the Ramos administration, the Central Bank relaxed the monetary targeting rule to what was called the 'modified monetary targeting' policy. This allowed the monetary targets to be exceeded as long as inflation targets were being met. This is the start of a hybrid system of inflation and monetary targeting. The official reason was that, due to financial liberalization, the link between monetary quantitative targets and inflation had weakened due to 'structural breaks' in the income velocity of money and volatilities and instabilities in the money multiplier. Thus the high liquidity and large monetary expansion in the mid-1990s failed to have any impact in inflation as inflation remained below double-digit and continued to decline until the Asian crisis (see Central Bank study by Guinigundo (2005)).

The laxer monetary policy in the mid-1990s of course was shattered by the 'contagion' effects of massive depreciation pressures during the Asian crisis. The major ways to stave off the depreciation (and indirectly avoid inflationary pressures) were constant and periodic raising of the reverse repurchase rate (overnight lending rate or, what we call, the policy rate), and the raising of liquidity reserve ratios.¹

However, the massive currency depreciation (around 40%) during the Asian crisis had a very low 'pass-thru' to inflation (see Fig. 2), and did not even lead to double-digit

inflation. This allowed inflation rates to fall easily after the crisis (with a temporary uptick in 2001 due to another spate of currency depreciation brought about by political instabilities, and also due to weather disturbances). Inflation rates reached a very low 3% level in 2002 and 2003, replicating the inflation rates in the developed world.

In January 2000, the monetary authorities were already studying the alleged successes of developed and developing countries that had adopted inflation targeting (from a prior regime of exchange rate pegging or monetary targeting). The decision was to make the big switch to inflation targeting starting January 2002. The switch entailed the following elements: 1) continuation of the announcement of inflation targets based on a band over a two-year time period, 2) adopting a more passive monetary quantitative policy, and employing repurchase and reverse repurchase rates (policy rates) more as the monetary instrument, 3) continued use of liquidity reserve ratios and policy rates to stave off currency depreciation inasmuch as exchange rate is a key determinant of inflation, 4) increased sophistication in inflation rate estimation and in using single and multi-equation models to forecast inflation and setting of inflation targets, 5) the use of forward-looking models with monetary instruments reacting to and aiming to influence inflationary expectations rather than actual inflation; 6) creation of an Advisory Committee to recommend monetary policies based on the new inflation targeting regime; 7) the issuance of a quarterly inflation report explaining the Central Bank's policies and achievement or non-achievement of the inflation targets.

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

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

The study previously mentioned (Dakila (2001)) shows by simulation that using policy rates rather than monetary targets, and employing forward-looking models, lead to a more gradualist approach and less draconian and sudden reduction of inflation rates at the expense of growth. The setting up of the escape clauses and core inflation rate also point to the more flexible approach of current monetary policies compared to the past.

Guingundo (2005) mentions two important things: 1) The current inflation targeting method allows for 'ample room for judgment and discretion of policy makers'; 2) In explaining why overshooting of the inflation target in the fourth quarter of 2004 did not lead to increases in policy rates by the Central Bank, the paper gives the following

explanation: a) the inflationary pressures caused by supply-side shocks (oil price increase) were not susceptible to monetary action, since the latter would work on the demand side; b) the Central Bank forecasts indicated that the pressures would subside in 2006; c) there were downside risks to the overall strength of economic activity.

(b) *A More 'Benign' Policy?*

So far 'inflation targeting' for the Philippines had not led to very drastic monetary tightening as 'monetary targeting' had done. Between 2002 to 2006, the Central Bank raised policy rates by only 75 basis points (due to the higher inflation led by rising oil prices in 2005 and 2006) compared to more than 400 basis points done by the US Fed in the same period. Of course, the Philippine policy rate started at a higher level of 9% compared to the US Fed rate of 1%. (But Philippine inflation is also more than double that of the US inflation rate.)

The improvement in inflation targeting over monetary targeting can be due to following factors. First, the adoption of IT was not done as a precondition to IMF conditionality but was a conscious switch decided upon by the Central Bank. Thus, using policy rates as the key instrument allows the Central Bank to inject growth objectives in deciding what rates they will maintain, even if on paper the main goal of IT is inflation reduction; Second, the escape clauses mentioned above and the use of 'core inflation' allow the Philippines to use similar instruments as the US Fed and decide on policy rate changes based on the strength of the economy, and not only on inflation targets. Third, the focus of

international business news on the US Fed as it avoids increasing policy rates when the US economy is weak also has an impact on how the Philippine Central Bank behaves. Most importantly, the policy had been quite lax since world and domestic inflation had not been very high between 2002 to 2006. This last reason may provide the most important factor that will determine whether IT remains lax or tight in the Philippines. Because of the flexibilities open to the policy makers, the persons put in charge of the Central Bank and their relationship with the national government becomes crucial. If high growth is an objective of the government, and if the people in charge are not pure monetarists, it is possible to have a more growth-oriented IT regime. But if a pure monetarist were put in charge (most likely during times of high inflation), then the draconian monetarist policies may return.

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

Monetary policy should be perceived as only part of a whole system of tools and measures in the government's armory. In coming up with an alternative monetary policy, it is this paper's principle that monetary policy should not be solely concentrated on fighting inflation, but should be a macro tool to achieve economic development.

As mentioned earlier, although inflation targeting had so far been an improvement to the monetarist policy of monetary targeting that had dominated more than two decades of macro policy, it is constrained by two things: a) it is still based on a demand-constricting policy of reducing aggregate demand when evidence shows that most inflation is caused

and perpetuated by supply-led and cost-push factors; b) it has the potential of being one-track minded as the monetarist policy of fighting 'overspending' and may be used to aggravate recessions again during balance of payment crises. An alternative monetary policy has to address the current trends and constraints to growth and situate monetary policy among a consistent set of macro policies to deal with the objective realities.

In discussing monetary policy, one should therefore look at the macro setting of the country and to identify what role it should play in such a setting.

The Philippines has been beset by a special host of structural problems after the Asian crisis. The alleged perception of the country escaping the worst features of the crisis may be erroneous if we look at the following:

(a) *A Fiscal Crisis*

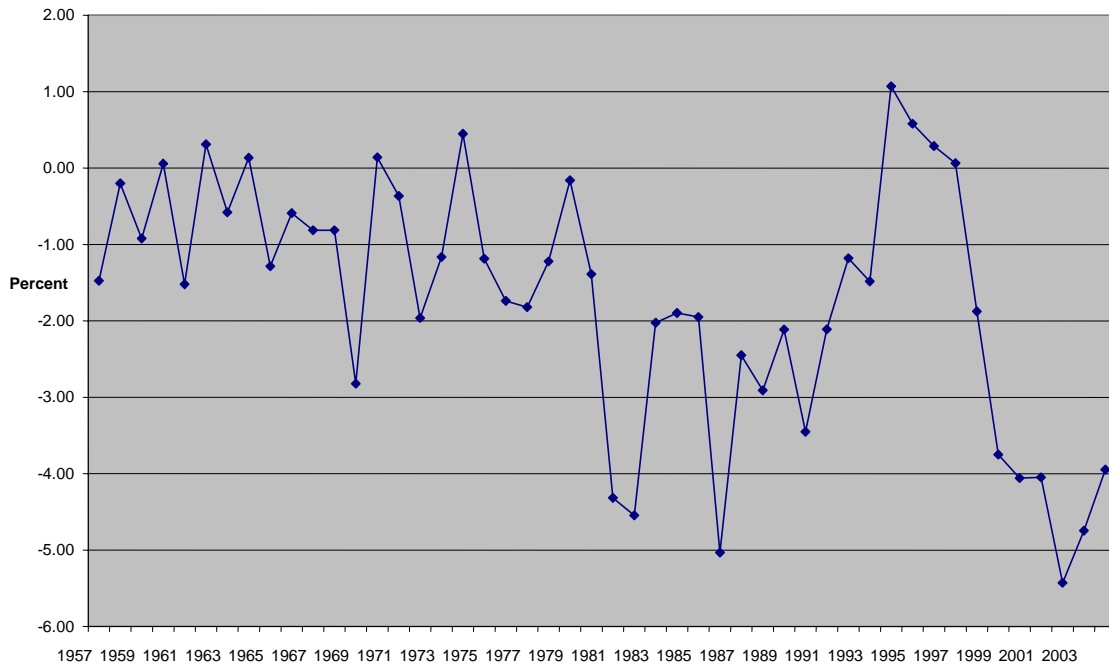
The biggest mainstream challenge to the current Philippine macroeconomy is the inability of government to reduce the fiscal deficits and a growing public debt that may become unmanageable in half a decade. Fig. 6 shows the fiscal deficit as a percentage of GDP.

It is clear that the Philippines had very little experience with fiscal surplus. This was however achieved by the Ramos administration before the Asian crisis. The Asian crisis,

however, brought fiscal deficits back. The fiscal deficits in the graph from 2000 onwards underestimate the problem for it does not include the deficits of government corporations which had ballooned in 2001 to 2004, due to losses, especially of the National Power Corporation. These losses had been absorbed by the national government in 2002 to 2004. Furthermore, total public debt had grown to around 100% of GDP in 2004.

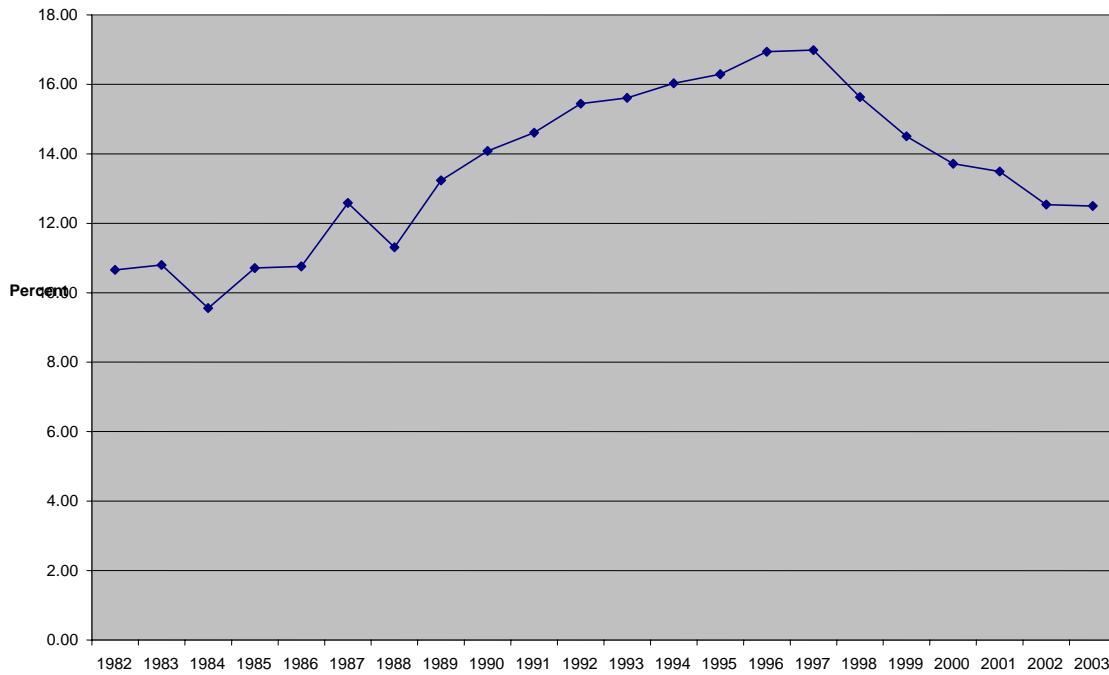
Another fact that reinforces the gravity of the fiscal problem is the fact that the post-Asian crisis economic recovery from 1999 up to 2005 had failed to improve tax effort. Fig. 7 shows that the tax effort, which peaked at more than 17% of GDP in 1996 and 1997 had consistently fallen since then and is only 12.5% in 2003, and slightly lower in 2004. The falling tax effort despite significant GDP growth had forced the government to undertake substantial tax reforms to respond to downgrades of the sovereign debt from the rating agencies.

Fig. 6: National Government Balance, % of GDP



Source: National Statistics Coordination Board and IMF, International Financial Statistics

Fig. 7: Tax Effort, As % of GDP



Source: National Statistics Coordination Board and IMF, International Financial Statistics

(b) *More Open Capital Accounts and More Volatile Exchange Rate Movements*

Fig. 2 shows that since the 1980s, the exchange rate had been very volatile with strong up and down movements. This has been aggravated from the mid-1990s till the present. The current floating exchange rate regime (with sporadic interventions if the depreciation or appreciation is deemed unmanageable) promises more volatilities in the future.

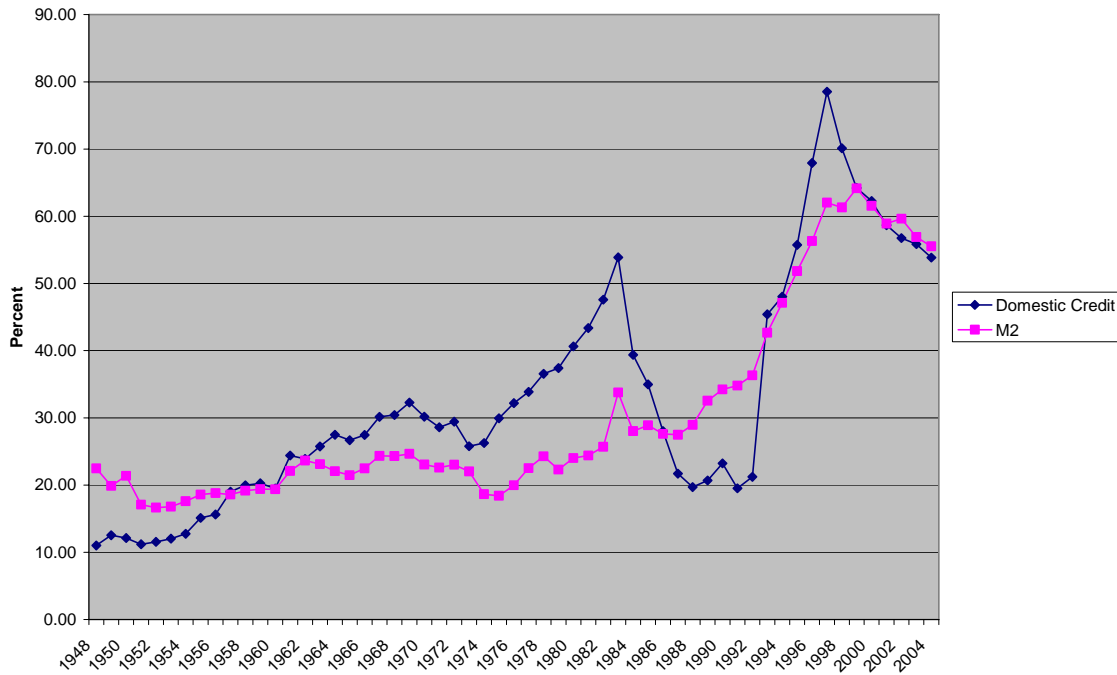
Obviously the exposure to financial and capital account liberalization had created a Pandora's box of dangerous short-term capital flows and volatile movements.

The years following the Asian crisis – 1999 to 2005 – had been periods of volatile short-term portfolio flows with international capital shunning the country due to political instabilities and fiscal problems. Starting 2005 short-term capital came in the country due to the increases in VAT and expectations of the narrowing of the fiscal deficits. But they intermittently flowed out also due to political instabilities and increases in the US interest rates. Volatile capital flows and exchange rate movements are important problems that should be considered in the alternative monetary regime.

(c) *Low Financial Confidence and Credit to the Private Sector*

The post-Asian crisis period had been marked by low financial confidence due to the trauma of non-performing assets suddenly exploding and due to stringent financial supervision to achieve higher capital adequacy ratios and loan loss provisions. Fig. 8 shows M2 (money plus quasi-money) and domestic credit as percentages of GDP.

Fig. 8: M2 and Domestic Credit, as % of GDP



Source: National Statistics Coordination Board and IMF, International Financial Statistics

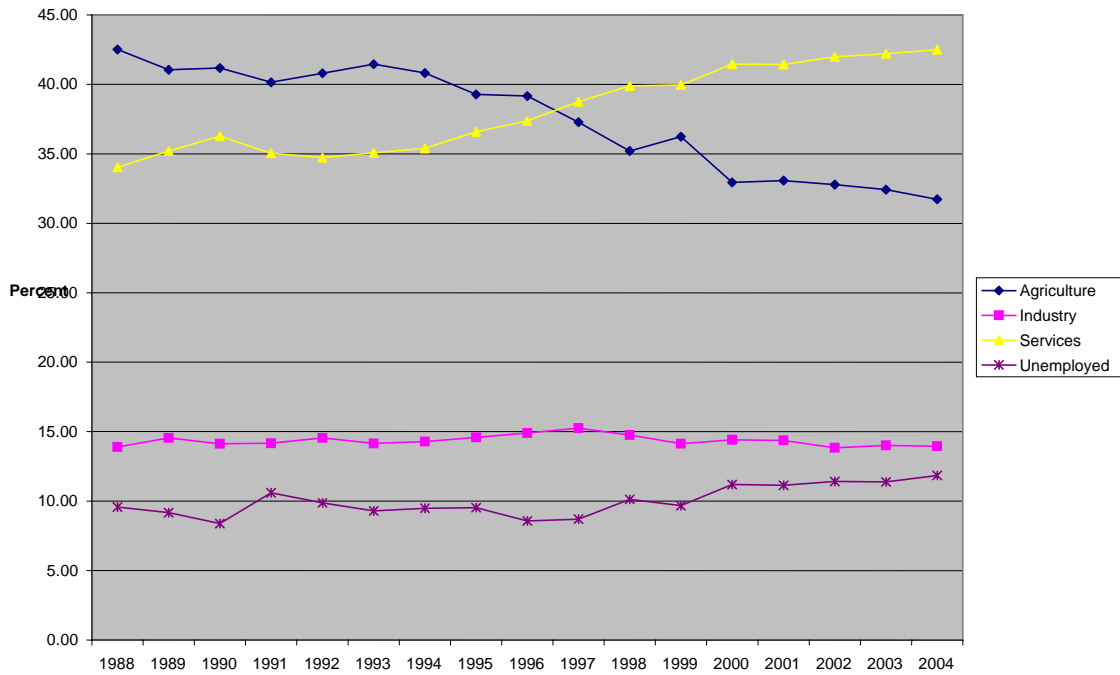
It is clear that the Philippines had not achieved substantial financial deepening as M2 and domestic credit hovers only around 55% of GDP in 2004. The lack of financial deepening is partly caused by the various recession and monetary tightening periods. Another big reason is the decline in financial confidence due to the financial crises. This is very clear in the decline of domestic credit (as percent of GDP) from the mid-1980s till 1992 due to the financial and economic collapse of 1984-85. It is happening again in the post-Asian crisis period as both domestic credit and M2 had declined as percentages of GDP declined from 1998 till 2004.

The Asian crisis had increased financial regulations on banks. Minimum capital adequacy (net worth to risk asset) ratios on banks for the Basel international standard is currently at 8%. The Philippines has been more stringent and had imposed a minimum capital adequacy ratio of 10% starting 2001. The actual current average capital adequacy ratio for Philippine banks ran at a high 15% to 16% in 2005. But the IMF still thinks this, and the loan-loss provision (which already is a high 72% in 2005), are too low due to underestimation of the risk assets of the banks. The situation, together with the perennial political crisis, has so far discouraged banks from aggressively lending to the private sector. The banking system is awashed with liquidity with a strong appetite for government securities – whether peso or dollar denominated – rather than private lending. This will constrain investments and employment generation in an economy with still underdeveloped long-term capital markets.

(d) *Persistently High Unemployment*

Fig. 4 shows persistently high unemployment in the latest economic recovery period of 2000-2004 despite positive economic growth. Fig. 9 gives more detail on the employment picture.

Fig. 9: Employment by Sector and Unemployed, As % of Labor Force



Source: Labor Force Survey, National Statistics Office.

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

It must be pointed out that the industrial and agricultural sectors are the main tradable sectors. With increased trade liberalization, globalization and competition among countries, these sectors are now exhibiting increasing output-employment ratios² as output increases are not matched with equivalent employment increases. This means labor shedding and labor-cost cutting in areas whose products are facing stiff competition

from imports. The overall effect is expelling of labor in the tradable sector as it is made to bear the main burden of adjustment to stiff international competition of imports. Thus, the biggest absorber of employment is services, which is largely a non-tradeable sector. But this is not enough to absorb the expelled labor from the tradable sector, and the new labor force entries (see Lim and Bautista (2006)) Of course the result is that unemployment remains persistently high, at more than 11% in 2004.

Apart from trade liberalization and globalization, two other factors may be contributing factors for the persistently high unemployment rates. First, as explained above, the lackluster recovery of the financial sector and domestic credit may have limited financing of working capital and hiring of new workers, especially in the industrial and agricultural sectors. Second, the series of political shocks and instabilities in the country during the Estrada and Arroyo governments (and continuing until today) may have deterred long-term employment of additional and more permanent workers.

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

(e) *High Oil Prices*

The volatile world oil price movements starting in the second half of 2004 had increased the average inflation rate in the Philippines from a low of 3% in 2002 and 2003 to more than double that in 2005 and 2006. But continuing pressures on oil prices may lead to

tighter monetary policies at home and abroad. Thus the lax monetary policy adopted since 2002 is being jeopardized by a possible return to monetary tightness via increases in policy rates if world inflationary pressures continue. There are pressures to increase the policy rate because of the continued raising of the dollar interest rate by the US Federal Reserve Bank in a capital-liberalized setting starting 2005. This is in order to avoid flight from the peso and sharp depreciation of the currency.

Thus, a policy to respond to increasing world oil prices and return to higher inflation is now an urgent task. Inflation may be further aggravated by the imposition of a 12% value-added tax on oil, gas, electricity and services starting early 2006. If these supply-led inflation leads to a policy of fighting inflation through demand-suppressing methods of increasing interest rates, recessionary pressures may again become a major monetary policy.

5. Coming Up With an Alternative Monetary and Financial Set of Policies

The lax overall monetary policy in the last four years is a clear proof that the current government's objective and desire of achieving higher economic growth rates is obviously very strong. But as was clearly explained in section 3, a laxer monetary policy has not led to better credit expansion and better employment prospects. The 'alternative' clearly dictates much more than just a move from monetary targeting to inflation targeting. This is due to:

1. The lax monetary policy is accompanied by weak financial confidence and stricter financial requirements on banks (higher capital adequacy ratios, higher loan loss provisions). Thus the laxer monetary policy fails to translate into widespread increases in credit to spur economic growth.
2. The other avenue to stimulate growth – the fiscal stimulus -- is cut due to the fiscal crisis. The high fiscal deficits do not translate into economic pump-priming because most of the deficits are financing debt payments. Interest payments make up more than one-third of government expenditures. Debt payments (principal and interest payments) make up 86% of government revenues! Thus there is actually fiscal constriction in 2003 to 2005 as social and economic services – especially infrastructure building – had contracted in real terms to accommodate the debt payments and the targeted reduction in the deficits.
3. Even with economic growth moving between 4% to 6% in 2002 to 2005, the quality of the growth is inferior as unemployment rate had been steadily growing – leading to a historical high of almost 12% annual unemployment rate in 2004, at a time when economic growth was close to 6%. The firms' labor and wage cutbacks to be globally competitive, and the confidence-less growth, make the transmission mechanism from economic growth to employment generation very difficult to achieve.

4. There have to be safeguards against a very volatile external account brought about by unstable short-term capital flows resulting from the capital account liberalization in the 1990s.

The above point to the need to have a holistic view in analyzing the issue of inflation targeting and the role of monetary policy in economic growth and development.

(a) *Components of an Alternative Monetary Policy*

(1) *An Undervalued Currency and Tax-Based Capital Controls on Inflows*

We documented earlier the volatilities of the exchange rate due to capital account liberalization and the strong appreciation of the peso in recent months.

Thus, the first component on the recommended alternative scheme is a reasonably pegged exchange rate regime, but targeted at a value that will undervalue the peso. The models for this component would be China and Malaysia, which had set their exchange rate at an undervalued level despite high trade and current account surpluses. Other East Asian countries, such as South Korea, Thailand and Taiwan have more floating exchange rate regimes but are biased in keeping their currencies undervalued vis-à-vis the US dollar.

(This recommendation is consistent with the policy prescriptions of Frenkel and Taylor in this volume.)

If one is to follow the China or Malaysian models, significant capital and exchange controls will have to be reintroduced into the Philippine financial system. Because of weak political will and inexperience with successful capital controls (especially on the outflow side), the proposal will suggest working within a specified band which the Central Bank has determined to be an undervalued measure of the currency. To keep some stability within the band, it would be practical to propose tax-based (or market-based) capital controls on inflows a la Chile, which require short-term portfolio flows to remain in the country for at least a year, and will require some sort of required reserve for portfolio inflows. Complementing this will be stronger financial supervision on short term dollar loans, discouraging currency and term mismatches similar to those that occurred before the Asian crisis (part of this is already in place). These capital and financial controls will attempt at controlling the capital volatilities and help in reducing volatilities in the exchange rate regime. The stricter rules on capital inflows complement the bias towards an undervalued currency for these rules deter unnecessary surge of short-term capital inflows that tend to appreciate the peso substantially irregardless of the current account deficits.

The benefits of this first component are clear: 1) Except possibly for the first year of initial pegging of the currency at an undervalued level, the policy will lead to more stability in price and, especially, in the exchange rate. This allows the market players to price their products with more certainty⁴; 2) the policy will bias the trade and current account towards a surplus and reduce risks of sudden capital outflows and destructive devaluations as what happened during the Asian crisis and 2000-2004 in the Philippines;

3) related to the above, the undervalued currency will provide a price-based incentive for exports and disincentive for imports that will counteract negative employment and output effects on tradable goods brought about by import liberalization and tariff reduction; 3) the combination of undervalued currency and market-based capital control will leave some independence in monetary policy, which hopefully will be more biased towards accommodating monetary policy rather than on monetary contraction; 4) the possible tendencies towards higher inflation and current account deficit implied by monetary expansion will be offset by the stable exchange rate pegged at an undervalued measure of the currency; 5) possible risks of capital flight due to lower domestic interest rates are offset by the undervalued pegging of the currency.

Most likely, the current Central Bank and the IMF would view a fixed exchange regime as unacceptable since floating exchange rates are very much in fashion with mainstream organizations, especially after the Asian crisis. As a fallback position, the current practice of South Korea may be a model for the Philippines. The model looks like a floating exchange rate regime but in fact entails a lot of interventions attempting to prevent the currency in appreciating substantially. This is a feasible strategy for the Philippines especially since an undervalued peso can be justified due to rising trade deficits. But it is important to accompany this policy with the tax-based capital control on short-term portfolio and debt flows to avoid unnecessary pressures towards the appreciation of the currency, which is already happening starting 2006.

Because of the political and economic instabilities in the Philippines, it is also wise to periodically intervene during periods of losses of confidences which yield unstable currency depreciation. (This may entail some monetary contraction and interest rate hikes.) In this context, the paper's suggested exchange rate band which on the average undervalues the currency, and the tax-based capital control regime, would minimize the possibility of this happening, and if it does happen, the undervalued currency minimizes the necessary monetary contraction that has to be undertaken.

(2) *Incorporate Output and Employment Targets to Current Inflation Targeting Regime*

The less contractionary setting of the 'inflation targeting' experience from 2002 to the present is mainly due to the low inflation experienced during the period. As mentioned earlier, this scenario may be changed in the near future. If one envisions a transition away from the inflation targeting regime, it would be wise to recommend that output and employment goals be explicitly stated as part of the objectives of monetary policy.

It is ironic that while much of the developed world is following an inflation targeting regime, Mishkin (1997) refers to the US Fed monetary policy as the 'just do it' strategy. With this strategy, the US Federal Reserve Bank adjusts its policy rate based on the latest available information on output, employment, current account balances and prices. With multiple goals in its objective function, the Fed decides on the best Fed rate it thinks will lead the economy towards the direction it wants. Using this method, the Fed had actually become more Keynesian than monetarist in the last decade. It may be tough-talking

about beating inflation, but when employment and output shows softening, the policy rates are kept stable or increased only by 25 basis points. The ‘just do it strategy’ suggests much discretion and flexibility in monetary policies based on the latest mix of information on key macro and price variables. One can learn from this approach by following the Fed’s example of not announcing any figures at all for a targeted inflation rate, or at least broaden the band of the targeted inflation rate so that unexpected shocks will not lead to sudden and automatic interest rate hikes and liquidity constriction.

(3) *Some Offshoots of the Above Monetary Policy*

The above monetary policy can have some beneficial impact, especially on the current problems of high fiscal deficits, lack of financial confidence and unemployment. The more accommodating monetary policy may be complementary to the moves to improve and increase financial loans in the post-Asian crisis period, and to offset the natural conservative tendencies in credit expansion due to higher capital adequacy ratios and loan-loss provisions. Furthermore, this may create a better atmosphere for involving credit allocation in employment generating activities (see section (5) below). Finally, especially when oil prices had returned to normal levels and world interest rates stabilize, the more accommodating policy may allow some room for monetizing the fiscal deficits inasmuch as the pass-thru of monetary increases to inflation had been accepted as weak and unstable. Fiscal expansionary policies – especially in social, economic and infrastructure spending – are vital to return the system to quality and employment-generating growth. And due to the high debt-to-GDP and debt service ratios of the

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

(4) *Heterodox Policies of Income Policies, Price Controls and Price Stabilization*

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

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

The oil price shocks had led many in the Philippines to question the deregulated structure of the oil industry. There is a perception that there is an asymmetry of quick price

increases during times when world price are rising, but slow and lagging price decreases when the world prices are falling. The question of a domestic oil cartel is arising, as many new players are finding it hard to compete in the setting of rising world prices. It is difficult to handle this problem as the fiscal bind prohibits any temporary support of oil prices, and as cross-subsidies to low-income households in electricity charges had been mostly dismantled in the recent years. Regulatory boards still regulate electricity charges and transportation fares, while the Department of Energy has clout to stop unreasonable price increases in oil and gasoline products. Thus, the importance of regulation in public utilities and oil/gasoline products become crucial to foster competition and stop cartel-like pricing. The Philippines also lack anti-trust legislation that will remove monopoly and predatory pricing in key economic sectors.

Equally important is the need to develop, in the medium and long run, alternative fuel sources and to reenact laws giving special tax incentives for firms providing these alternative fuel sources.

The Philippines has an incomes policy that deliberately keeps minimum wages very low and lagging behind price increases. This has led to lower inflation but has also led to a long run decline in real wages, which may have contributed to worsening income distribution and poverty. Other regulated prices (aside from minimum wages) are those for public transportation and energy. A more balanced approach that is recommended by this paper involves the following: 1) depending more on tripartite agreements derived by government, labor and employers to impose agreed-upon ceilings on price and wage

increases, 2) enact laws and rules that punish monopoly and cartel-like pricing (especially for the oil and telecommunications industries), and 3) do more monitoring and temporary regulation of key products such as food, oil, telecommunications and rent-control housing during periods of price instabilities.

(5) *Credit Allocation to High Value-Added and Employment Generating Sectors*

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

There are some targeted credit schemes outside the scope of the Central Bank administered by the Land Bank of the Philippines (LBP) and Development Bank of the Philippines (DBP) targeted at agricultural cooperatives, farmers' groups and small scale industries with funds from the Department of Agriculture (DA), Department of Agrarian Reform (DAR), other agencies and multilateral organizations. The Department of Trade and Industry (DTI) also has some credit lines targeted to small and medium enterprises. Again the amounts are small compared to the economy at large and may not have much macro impact. One of the biggest programs targeted for agricultural cooperatives (administered by LBP) for agrarian reform beneficiaries has also been noted for its lackluster performance and impact. To revive agricultural and rural loans, active promotion of sectoral and local economies in the countryside is required, accompanied by activist policies of opening the rediscount windows to rural and cooperative banks active in employment generation and providing loans to small and medium enterprises. Such activist policies, however, should be matched by performance-based criteria on the facility with priority to banks with low default risks and satisfactory repayment rates.

The current system has become rather schizophrenic as the formal system and the big government agencies such as the National Economic Development Authority (NEDA) and the Central Bank promote financial liberalization and reduction of targeted credit in the formal sector. But the Arroyo government currently promotes microfinance lending by government-supported agencies as one of its key anti-poverty strategy. Thus the National Anti-Poverty Commission (NAPC) has within its organization an active microfinance unit and the People's Credit and Finance Corporation, which gives

wholesale credit to microfinance units, such as rural banks, cooperatives and NGOs (using market-based interest rates). The Department for Social Welfare and Development (DSWD) gives subsidized credit to poor families to finance livelihood programs.

Although there are some striking successes by some rural banks, cooperative banks and other microfinance units in providing credit to develop local economies and some economic sectors, this is not being mainstreamed in the system. The targeting of small and medium enterprises (SMEs) and micro-enterprises, largely in the informal sector, for microfinance has positive aspects inasmuch as these entities have high employment generating potentials. However, the provision of microfinance has oftentimes been politicized⁵ and lacks a holistic approach of providing the SMEs and micro-enterprises access to markets and linkages in the formal sector, access to technology and good management practices, skills development and technical assistance for product development. This, unfortunately, matches the overall industrial policy of the government for several decades, which prohibits ‘picking winners’ and frowns at promoting priority economic sectors (consistent with the ‘Washington Consensus’ view and WTO rules). Thus credit allocation in this setting becomes directionless and providing small ‘livelihood’ programs for the poor, rather than providing permanent, productive and growing industries and employment for a vibrant economy.

The above set of alternative monetary policies points to a need for a change in mind-set from a dichotomy between the financial and real sectors to a viewpoint wherein the financial sector is integrally linked and supportive of the real sector. The strategy is to

coordinate and link the current targeted credit programs in the anti-poverty strategy campaign with the initiatives of the Department of Trade and Industry (DTI), the Department of Science and Technology (DOST), Technical Education and Skills Development Authority (TESDA) in developing and promoting key priority economic sectors that have high value-added and employment generating potentials. Successes in this arena will hopefully spill over to the formal and big business sector of the economy.

(6) *Testing the New Alternative*

Inasmuch as the Central Bank already has a long-term and a short-term macroeconomic model, it is suggested that the new alternative be tested employing similar types of macro model. The new econometric model poses some challenges: 1) How to model a more discretionary monetary policy based on the objectives of both output/ employment generation and price stability (various simulation scenarios and quadratic loss functions might be used); 2) How to define and model 'overheating' and excessive aggregate demand in the model (to identify when some monetary contraction may be beneficial to the economy and to identify when monetary contraction will not be beneficial); 3) How to model the incomes policies and temporary price controls without biasing the results a priori to a positive outcome; 4) How to model increased credit allocation without biasing the results a priori to a positive outcome, and incorporating the impact of credit allocation to the growth of key economic sectors with high value-added and employment generation impact.

(c) *A Difficult Endeavor*

The above alternative set of policies run counter to the current macro policies of the Philippine government and go beyond policies traditionally reserved to the Central Bank. Thus the adoption of the alternative monetary policy is a formidable endeavor that requires a change, not only in the inflation targeting regime, but also in the current macro framework of the country. Hopefully the important shift to putting more emphasis in output growth in the current monetary policy is the beginning of a change in attitude and approach in the formulation and implementation of monetary and financial policies in the country.

NOTES

- 1 Liquidity reserves are required liquid reserves for banks which they can keep in the form of short-term government securities with the Central Bank. The raising of this ratio reduces the liquid funds of banks that are used for speculation on the dollar during periods of currency depreciation.
- 2 In fact, the laxer policy of the inflation targeting regime as compared to the monetarist monetary targeting regime is precisely the implicit inclusion of growth objectives in the Central Bank's decisions concerning policy interest rates, which will be explained later.
- 3 Other papers use the word 'labor productivity' to describe the 'output-employment ratio'. The paper uses the latter term to avoid any normative interpretation of 'labor productivity'.
- 4 There is currently a roller coaster ride with the US dollar alternately appreciating and depreciating depending on information on the US current account position and the Fed's position on interest rate hikes.
- 5 The current anti-poverty strategy of the Arroyo government assumes that each microfinance loan generates one job. The government has announced millions of jobs created based on this assumption.

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