Reforms and Resilience

If you would put economic reforms on trial, few people would come to their defense. This is unfortunate. Unpopular as they might have been, the reforms over the last few years have improved the resilience of the Philippine economy. To see how, one would have to think about how the Philippines would have managed today if these reforms had not been implemented, the so-called counterfactual evidence.

To put the current headwinds facing the Philippine economy in perspective, global output is projected to contract by a magnitude not seen since the great depression, global trade has collapsed, and financial markets around the world have been impaired for a prolonged period. Along several dimensions, the global recession has hurt Asian economies more than during the financial crisis in 1997-1998, despite stronger fiscal, financial, and monetary measures.

This is also the case for the Philippines. Nevertheless, the economy's performance remains robust relative to other countries in the region and relative to the country's past experience when faced with economic turbulence.

This can partly be attributed to past reforms and structural features of the Philippine economy, such as the flexible exchange rate regime (preventing a speculative run on the peso) and the steady inflow of workers' remittances (providing the most stable form of external financing). Without the oil deregulation law, what would the fiscal picture have looked like last year when oil prices skyrocketed?

In addition, recent reforms have critically contributed to this relative resilience. For example, the adoption of the inflation-targeting framework in early 2002 has facilitated the conduct and transparency of monetary policy. Without the enhanced credibility this offered, it would have been more challenging for the BSP to maintain a healthy flow of liquidity and monetary conditions conducive to growth.

Steady accumulation of international reserves to levels that well exceed the amount of short-term foreign-currency denominated debt that could leave the country at short notice provides an important layer of self-insurance, particularly in the recent period when international capital flows have been volatile. Indeed, if the Philippines had a fixed exchange rate regime and a level of short-term debt to GDP exceeding international reserves, a balance of payments crisis could have occurred with significant economic costs when risk aversion exploded after the collapse of Lehman Brothers in 2008.

Furthermore, the public sector deficit was reduced from close to six percent of GDP back in 2002 to a small surplus at end-2007, resulting in an unmatched decline in government debt from over one-hundred percent of GDP to about sixty percent of GDP today. This was achieved through a series of fiscal measures, including expenditure compression, the landmark increase in the VAT rate, and reforms to the power sector. Unpopular as these fiscal reforms might have been, without them, the Philippines would have entered the current

global crisis with a less enviable starting position. For example, with the strains in global credit markets, where would the Philippines have sourced the funding from to finance such a high deficit and debt? And at what cost? Indeed, the Philippines always used to pay more on its debt than the average emerging market until the fiscal reforms started to take hold in late 2006. Since then, and supported by strong remittances inflows, the Philippines' interest rate spread has consistently been lower than the average emerging market allowing additional resources to be allocated to more productive areas than interest payments.

In addition, financial reforms improved the banking sector's health as evidenced for example, by the high capital-adequacy ratio, both by prudential and regional standards. Past reforms have led to a significant decline in nonperforming loans and avoidance of direct exposure to the infamous toxic assets. To illustrate, the stock of non-performing loans by banks declined from close to seventeen percent in 2003 to below four percent today. Without these accomplishments, it would have been very difficult for corporations, the government, and households to have access to financing and we would have seen larger declines in production and employment as a result of the ongoing global financial deleveraging.

Economic reforms often inflict immediate pain, while the benefits occur later. Albeit being less tangible, the benefits of improved resilience and more room for fiscal, monetary and financial measures to support growth do need to be recognized: a combination of high debt, a large deficit, and weak bank balance sheets would have been very costly in the current economic climate. With this recognition comes the need and desire to push the reform agenda forward.

In this regard, if in real estate location is the mantra, then for the Philippines it is revenue. Strengthening the tax effort is key for several reasons. It will entrench investor confidence and reduce borrowing costs, thereby facilitating investment and job creation. It will provide the resources for targeted pro-poor spending and higher public investment in both human and physical capital, raising the growth rate of the economy, now and in the future. As a result, new measures that erode the tax base, including the VAT base, should be resisted. Raising the tax effort in an efficient and fair manner is no easy task, but is best achieved by demonstrating legislative commitment to stalled tax policy measures such as sin tax reform and rationalizing fiscal incentives. Moreover, these measures should be complemented with stronger tax enforcement. These types of reforms will provide the foundation for a stronger recovery once the world economy finally turns the corner.