

## EAST ASIA 1997-1998: TEETH AND CLAW DECAY

### I.

#### Before The Crash: Pomp and Whispers

It is hard to recall the mood of the general press, economic commentators, markets, the IMF, Uncle Tom Cobbley and (almost) all on the Tiger economies of Thailand, Malaysia, Indonesia, South Korea and, penumbally the Philippines prior to the July 1997 day the baht crashed and burnt in Bangkok. (Until then Singapore, Hong Kong and Taiwan were seen in the same grouping. Now as - despite some testing of all three, especially, Hong Kong - they have shown no signs of fracture they - with China - now appear to be viewed as fireproof - dragon! - economies not moth eaten, smoke blackened, scorched toothless tiger ones.

Up to that date the dominant perception was one of stable macroeconomic policies and structures and of sustainable high growth (and, to those for whom it mattered, absolute poverty reduction) based on rapid export growth and high levels of domestic savings underpinned by high human investment (especially in education), improving infrastructure (increasingly private enterprise financed and managed), relatively high freedom of manoeuvre for entrepreneurs (or at least domestic ones) as well as a vibrant (if inadequately open to foreign participation) and expanding financial system. "The Asian miracle" was the headline thought to comprehend/project these 'realities'.

There were criticisms but most were on details or on openness to foreign diners at the ongoing banquet, not directed to fundamentals - macro, sectoral, micro or institutional. Exchange rate policy - *de facto* near a nominal peg to the USA \$ in four case and a slightly more elastic real (inflation adjusted) peg one for Indonesia - was criticised, including by the IMF and USA. But in general, at least until the second quarter of 1997, the criticism was of Central Bank intervention to prevent upward floats (i.e. revaluation) **not** of sustaining increasingly overvalued exchange rates by Central Bank intervention to achieve high (attractive to foreign investors) interest rates. There were comments about overheating; queries of whether 2% or 5% of GDP were the safe ceilings for net annual government borrowing (including investment. "Above the line" surpluses dominated) and whether external current account balance financing requirements above 5% were prudent and/or whether higher levels were cyclical and could reconverge (albeit 5% was rarely exceeded on either in the 1990's). Some large companies were thought to be externally overborrowed and/or financially weak (e.g. the early 1997 Korean auto and steel debacles); some financial systems ramshackle (e.g. Thailand) or expanding too aggressively (e.g. Malaysia) some of property markets marked by potential overbuilding and bubbles (e.g. in the private sector in Bangkok and Manila and the public in KL).

But these criticisms and the calls for greater liberalisation of the financial and also the (less protected) enterprise sectors to let foreigners in to the feast were clearly within a context of approbation. From that perspective the Philippines was, not surprisingly, the

most criticised because it had - despite reconstruction and liberalisation following the removal of its Asian values/family values, father (or godfather) figure Ferdinand Marcos - notably failed to reach full Tiger growth, saving or export expansion rates.

Analysis of both financial flows and of exchange rates was characterised by a shallowness analogous to the quip "How many Chicago economists does it take to change a light bulb? None - if it needs doing the market will do it.". The sustained and rising inflows (many clearly linked to short term interest rate arbitrage) and the tendency of the exchange rates - if anything - to appreciate under market forces were seen as self validating. The curious pattern of massive Central Bank build-up of US government paper partly to sterilise inflows and limit upward exchange rate pressure was treated as either an irritating secondary distrust of markets or an example of the prudent pack a contingency policy of Central Banks to squirrel away reserves against a rainy day. In general, reserves were compared to current account (or trade) deficits and/or short term government external liabilities with **little analysis of (or even data collection/compilation on) commercial bank and enterprise external liabilities and their time profile.**

That tunnel vision - at least in retrospect - is odd. The early 1980's Southern Cone (Chile, Argentina, Uruguay) and 1994 Tequila (Mexico) crises had been marked by pegged exchange rates, increasing overvaluation, high Central Bank manipulated interest rates to attract short term, interest arbitrage foreign flows and exponential growth in commercial bank and directly productive enterprise short term external liabilities and by high growth and fund encouragement for the policies which proved disastrous. True the fiscal and current account balances had been more evidently shaky (at least after the event) and the domestic savings rates lower, but the driving interest rate - exchange rate - non government short term external liability mechanisms were virtually identical. The IMF did not appear to see Chile of the early 1980's or Mexico of 1994 as relevant nor did it seek very noticeably to secure the greater data collection and open availability to monitor either emerging structural weaknesses or short term vulnerabilities.

There were critics - notably but not uniquely in the Philippines. From 1991 Professor Solita Monsod and some (non financial sector) businessmen (as well as the present commentator) had begun to query the high interest rate, high exchange rate foundation of external financial policy as inherently inconsistent with export led growth and with combining import liberalisation and buoyancy of the domestic market oriented manufacturing sector. By 1995 the body of academic and business critics had broadened - intriguingly including several centre left activist domestic NGO fronts as advocates of devaluation - and the totally hegemony of Makati (the financial district) hard liners diluted at least in respect to artificially high real interest and exchange rates. By early 1997 the Central Bank behaved in ways which in retrospect suggest it anticipated a regional international financial crisis (e.g. negotiating an extension of its IMF standby for which it had no evident need, requiring special external liquid asset reserves against foreign currency denominated deposits) and **arguably devaluation in July was precipitated by the Thai crisis only a few months before the domestic manufacturing**

sector and the economic secretaries in the cabinet would have pressed it on the Central Bank in any case to reverse the increasing non-competitiveness of Philippine manufacturing in the domestic market. The breadth and influence of criticism elsewhere in the five countries does not seem to have been as great.

## II.

### From Master Plan To Plaster Man

In the second half of 1997, beginning in the last days of June the image, the self image and - as a result - the underlying realities of the economies of Thailand, Indonesia, South Korea, Malaysia and the Philippines altered radically, rapidly and irreversibly. The process began with what initially appeared to be another minor run on the baht - which, like the other currencies involved, had ridden out both downward and upward pressures several times over the 1990's. But early in July after pouring almost all of its free reserves - most having been previously committed in very imprudent and non-transparent forward sales - the Bank of Thailand 'floated' the baht to sink - from under 25 to well over 30 at once, to nearly 45 in a month and to over 50 early in 1998 before a recovery to about 40 by May, 1998

In fairly quick succession Indonesia, Malaysia and the Philippines as well as - with a lag - South Korea were forced to follow suit. Runs on the Singapore and Hong Kong \$'s were beaten back and - because of capital account controls, limited short term external debt and high reserves. China's ren min bi was largely insulated from direct market pressure and was initially probably undervalued giving a margin to hold out.

A rising chorus of commentators abroad asserted - not without some justification - that not only were the five economies overvalued but also, that they had invested unwisely and/or corruptly, were characterised by crony capitalism, had put too much - or too little, the condemnation was uniform but not the target - in infrastructure, both physical and human. Further their macro position had not been uniformly sound - trade and current account deficits were substantial and rising (except for Indonesia), government borrowing requirements ditto and not only was there too much external borrowing but it was too short term and - because bank and other enterprise not state - inadequately transparent. ('Curiously' every debt crisis since 1973 has shaken large unknown amounts payable - especially short term and private - out of the woodwork, with resultant short term stress on full, more accurate, less lagged statistical compilation and reporting. **Each successive crisis has shown little or nothing has in fact been achieved on compiling/reporting.**). Even if price and wage inflation were not high, real wages were rising and asset prices - especially in respect to buildings and stocks - were bubbling. Most crucial the banking and financial sector was in most cases riddled with weaknesses to start (overlent and with bad asset and liability time pattern correspondence plus bad asset overhangs) and sure to collapse if the short term finance inflow and/or the property bubbles burst triggering cumulative illiquidities, defaults, devaluations and bankruptcies.

The proportion of 20-20 hindsight in this chorus was high but not 100%. USA - but not EU or Japanese - banks had been slowing loan build-up, especially to Thailand. A number of financial and other analysts had foreseen problems for South Korea because of high corporate debt/equity ratios and over-investment in sectors facing global over-capacity e.g. steel, automobiles, semi conductors. The IMF - in private from 1995/96, only on the record in 1997 - had warned Thailand that its trail of foreign short loans to banks on to finance companies and into a bubble building sector was a financial fuse threatening a massive detonation and by late 1996 had shifted its objection to pegging to arguing for a downward float paralleling tighter monetary and fiscal policy. But it is very difficult to see any basis for substantial expectations of what began in the opening days of June either as to breadth or depth. What is curious is that while many critics stressed both lack of transparency as to Central Bank - State - Banking Systems data and near total absence of systematic data on overseas borrowing levels and patterns foreign exchange and cash flow of major enterprises **in retrospect**, there had been no deafening chorus warning of these weaknesses (and citing the early 1980's Southern Cone and 1994 Mexican precedents) before the event.

### III.

#### **Meltdown In Manila: Catastrophe Avoidance, Shock Containment**

The **crash of the baht was instantly seen by the Central Bank, Treasury and Presidency of the Philippines as meaning trouble - probably big trouble**. There were **few illusions** that whether the Philippine economy shared the Thai's weaknesses or not (in large part it did but by no means equally or in all sectors), "**contagion**" and the lemming instinct (survival by mass straight line mob movement whatever the cost) of international financiers would prove to be tsunami the Philippines could not block by diking the exchange rate and piling interest rate sandbags on top.

Initial reaction in Manila - during the three working days of the initial baht crisis week and the opening of the next was overtly characterised by denial: that the Philippine economy had the same weaknesses as the baht; that the Philippine financial and enterprise sectors were fragile and seriously overextended; that baht (and as time passed the ringgit, rupiah and Singapore and Taiwan dollar) devaluation had any logical implications for the peso/\$ rate.

This period in retrospect was an attempt to buy time at limited cost in terms of reserve use. Trigger mechanisms halting trading when the exchange rate declined over 4% from the previous close and ratcheting up the overnight rate (past 30%), not massive dollar selling, were the main instruments albeit 10% to 15% of reserves (say \$1.5 billion) were so used.

Time buying had three purposes:

1. to see whether this was a real crisis or a blip like two to four (one earlier in 1997) already ridden out by the Central Bank;

2. to reach a weekend to see what impact reflection at leisure had on market actors and how the baht (and even more other regional currencies) would open the next week;
3. to communicate among the Central Bank, The Treasury and Ministry of Commerce and main financial and other enterprises to seek an agreed, real economy friendly exchange rate position in a context in which domestic producers and - perhaps - the Treasury Secretary had already come to favour managing a devaluation to redress growing lack of competitiveness against imports (especially from Japan) in the home market.

All three answers came and were uniform - **free (i.e. devalue) the peso** with limited subsequent smoothing. Clearly the 1997-98 crisis was not a mere blip and clearly it was affecting all of SEA not just Thailand (albeit the engulfing of South Korea came later). Greater and broader pressures, not any respite, marked market openings of the new week and a panic pandemic which was regional in orientation was clearly rising and sucking down the rupiah (which had initially been less affected) into a maelstrom vortex even though it had not been overvalued.

The Treasury and non-financial enterprise leaders were near unanimous as to the urgency of a significant (beyond P30=1\$) devaluation to reverse real appreciation which had eroded home market competitiveness (especially against Japan and South Korea but also China) and, at the very least, to prevent overvaluation rising with regional devaluations as well as the continued sinking of the yen.

The peso was promptly - and relatively undramatically - 'floated'. Overnight rates were kept high. The exchange rate moved rapidly to P35 to the \$ and more gradually to P40 where it stabilised for some months before a brief fall to P45, related to apparent entry into meltdown by Indonesia, rapidly reversed to P38-40 partly because Indonesia did not collapse and partly (especially as Suharto fell) because by then markets were differentiating by country and Philippine real economy and financial sector basics were much stronger than the Indonesian.

There were **no major currency, bank run nor external denial of credit access crunches**. Domestic access was constrained both by higher interest rates and by banks seeking to shrink assets to maintain capital adequacy ratios and to limit rises in non performing assets, but not to the extent experienced in Thailand or *a fortiori* Indonesia.

On the whole there was broad acceptance that the tightening of finance, increase in inflation, devaluation of peso were external market context imposed so that they did not arouse great antagonism or tension. None of the significant presidential candidates and few, if any, prominent columnists chose to mount either a populist or a conservative protectionist attack on Central Bank-Treasury-Malacananang policy.

Interest rates were gradually pushed back as the currency market stabilised. The national budget was mildly expansionist - surprisingly little given that 1997-98 is an election year and the main budget dialogue preceded the crisis. Projected growth was marked down from over 6% to perhaps 2% to 3% (2.4% by April 1988 ADB estimates versus minus

1% for South Korea and minus 3% for Thailand and Indonesia, with later Indonesian forewarnings as low as -12% to -15%). While not published the projections seemed to be of reduced - but positive - levels of short and long term capital inflow and, at least, no large net outflow either of portfolio investment nor of foreign currency (USA\$) denominated accounts (a projection parallel to BIS second half 1997 bank lending outturn reports).

**Prudential regulations was tightened** - although with no real transparency on tests (beyond the 8% rule) or findings (albeit the lack of closures and forced mergers among significant actors, in this case, speaks for itself). An aura of careful oversight, prudent policy and anonymity prevailed and was - probably correctly - perceived as the best way to avert being in the eye of the financial hurricane.

#### IV.

##### **The Dog That Did Not Bark: Sleeping, Tranquillised or Fed?**

**Before the crisis the Philippines was viewed either as the sickly runt of the tiger brood or a mongrel wildcat attempting to pass as a tiger cub.** Perhaps partly because there was livelier academic and press debate - often with a factual and analytical base - the general tone of international press and analyst commentary was relatively critical. The low domestic savings rate (vis a vis the region) and the barely 5% growth trend were criticised as was the huge trade deficit (usually ignoring the huge remittances surplus from the long standing labour export position which made the overall current account deficit on goods and non factor services plus remittances comparable to other tigers) while the less opaque and dubious asset burdened banking system, the absence of either Malaysian/Korean "favoured agent" or Indonesian "family" structural resource allocation biases toward selected enterprises (rooted out because its beneficiaries were Marcosites as much as for good governance or sound economic management reasons) and the greater openness to foreign investment (including in banking) were much less frequently cited.

One might therefore, have expected the firestorm that spread from the burning baht to have engulfed the peso and the Philippine economy particularly severely and incandescently. It did not. While - parallel to Malaysia, Indonesia and, briefly, Singapore - the peso was targeted for a few days it never was at the centre of attention and as the first months of the crisis rolled on the Philippines largely dropped off agendas of speculation, alarm raising or crises to manage. Why?

First, it is necessary to note the limits of the lesser impact as well as its reality. The peso did fall 50% (from 26 to 39) vis a vis the USA dollar within two months, but then - except for a brief period in January 1998 when meltdown seemed imminent in Indonesia - stabilised in a +/- 5% range around P39 (with the Central Bank on balance a net buyer of dollars. The stock market fell by over 50% though it began to recover in 1998 (comparable to Malaysia, slightly better than Thailand). Inflation rose by about half by early 1998 - 6% to 9% - as did non performing asset share in banks - but from 2.8% to

4.7%. At no time did main Philippine banks face a boycott of their acceptances nor serious Philippine enterprise an embargo on trade credit. Neither enterprises nor the Central Bank nor external lenders perceived any need for a short term enterprise external debt moratorium or rescheduling (partly precisely because normal rollover and new short term debt replacing expiring amounts remained possible).

Second, it is true that the smaller Philippine market and rather more cautious banking practices made massive speculation against the peso more difficult than against the baht - or the ringgit, the Singapore dollar, the Korean won or the Hong Kong dollar though not necessarily than the Indonesian rupiah. But there is little evidence of significant speculative efforts nor even of massive outflows of interest rate arbitrage capital let alone dollar denominated deposits.

More positively the **Philippines' rapid, apparently purposeful (90% of reserves were still intact and useable) acceptance of a market determined (sinking) floating rate with only marginal smoothing intervention did achieve a suspension of disbelief.** That in turn limited panic withdrawals of credit, rejection of acceptances, refusals to renew trade credit. As a result no panic rush to get out before the compartment doors closed as the ship sank ever happened. The low key subsequent statements: various precautionary and prudential regulatory statements, relatively open data on rises in bank non-performing assets and on reserve levels (neither very good nor very bad and credible because not Panglossian nor forced out under pressure) helped. So did careful avoidance of wild flailing rhetorical blaming of others (except by implication Thailand) combined with repeating that little had changed in respect to Philippine fundamentals so taking panic action because the Philippines happened to be in SEA would be self damaging for investors and creditors). This not shouting may have been even more important than what was said fairly quietly. The combination of these steps was to feed creditors with credible information on a low key, to avoid antagonising them and to tranquillise them to feel that Philippine exposure was not one of their top line problems because while facing a slowing of growth it was not in crisis and certainly unlikely to default on government or enterprise account.

Arguably **IMF relations** were even more key in this successful massaging of external perceptions and creation of an aura of cautious prudence and realistic, sustainable commitment to meeting obligations. **Only partly by accident the Philippines was the only relevant Asian economy with a standby (a brand new one at that) as the crisis broke**, following on from a decade of IMF monitored fiscal, monetary, financial sector and liberalisation strategies which - despite limitations - were perceived by the IMF, the Philippine government and external investors/lenders as having been cumulatively largely successful. Ironically in that regard the smallest Asian IMF programme and the one not directly crisis triggered has arguably been the most successful at crisis avoidance/limitation. That suggests it may be useful to look in slightly more detail at mid 1990's IMF/ Philippine interaction.

It is instructive to note that the IMF was throughout late 1997 and early 1998 much more flexible in respect to the Philippines and much more willing to give weight to its Central Bank and Treasury opinions and proposals than it was in the cases of Thailand or - a

*fortiori* - Indonesia or, initially in South Korea. Malaysia would have been analogous to Thailand and may yet be if - as seems at least as likely as not - it needs to secure IMF backing for its own efforts which, while not inconsiderable, have been slow moving and - arguably - as much crisis delaying and partially containing as 'solving'.

This flexibility had several aspects:

1. a standby was in place at the time of the full baht crisis and - while not enlarged nor indeed fully drawn - was seen by domestic and external financial markets (and by the IMF) as both a "seal of approval" and a commitment to bridge;
2. while somewhat doubtful about the probable swing from a small above the line surplus to a small deficit between the 1996-7 and 1997-8 Budgets (in fact rather larger but apparently still well under 2% of GDP excluding external capital project soft loans and grants) the Fund did not see this as a "trigger" issue. It accepted that the Philippines faced real demand fall fuelled recession not government deficit driven overheating so did not repeat its initial prescriptions elsewhere of fiscal and monetary icepacks for supposed economic sunstroke when the real problem was clearly impending economic (and social) hypothermia;
3. similarly on interest rates it accepted the Central Bank's stance of temporary raises until the currency fall stabilised, but then easing down to real rates of a few per cent to avert investment and sound enterprise collapse;
4. and accepted that core Philippine banks and insurance companies were sound and unlikely to be overwhelmed by cumulative enterprise and lesser finance company chain collapses, and that the Central Bank's monitoring system and - where needed - regulatory actions could preserve that position.

Why was this so?

1. the Philippines had been under IMF tutelage since 1986 and indeed, the 1997 standby really was just that (a standby backup in case of need) more than another in an endless series of adjustment drawings;
2. the adjustment had led to prudent fiscal balance, to tax reform in support thereof (even if flawed in detail, the flaws were as much from IMF advice as the soundnesses), to totally overhauling and refloating the financial system; to substantial trade and finance liberalisation; to an end to full scale crony capitalism with some transparency on state - enterprise transactions as well as in respect to the Central Bank and the banking stem. Public external debt had been restructured (rather modestly and within a clear commitment to pay come what might (which whatever else it did impressed external lenders) and was declining (standing at perhaps 30% of GDP and its servicing at well under 20% of exports plus remittances);
3. a pattern of exchange of information and of opinions and of mutual trust/respect had emerged between IMF and Philippine officials and had not been strained by any serious 1986-97 divergences as had been the case in Thailand;



4. the Philippines - e.g. in seeking a standby it had little need of at the time and in putting in place external liquid asset reserve rules for domestic bank external currency accounts - showed at least as much foresight as the IMF;
5. the attempt to 'defend the peso' was halted as soon as the extent of pressures became clear and with only about 10% of Central Bank reserves used and the interbank rate hiked (briefly) to over 30% to deter speculation and attain stabilisation;
6. the Philippine Central Bank and State avoided high profile statements - especially sweeping condemnations of speculators, George Soros, the IMF, blind bankers who'd gone bonkers, Uncle Tom Cobbley and All. Keeping out of sight and not calling for attention while having some prudent measures and low key reassurance to hand were their stock in trade;
7. **The major error of Philippine policy** - especially through 1992- of promoting **cumulative overvaluation** by achieving nominal stability (real appreciation) against the USA \$ by Central Bank intervention to maintain an artificially high Treasury or Central Bank bill rate to sustain footloose financial capital inflows was hardly one the IMF could criticise (or even recognise). **The 'Makati Crowd' (Philippine financial elite including many academic analysts as well as financial journalists, analysts and managers) and the IMF saw it as a pillar of stability** with moderate dialogue on whether a wider band was needed, not on the principle of the strategy.

The foregoing snapshot exhibition on policy and perception is broadly positive in respect to Central Bank - Treasury/Malacawang (Presidency) - IMF policy, pronouncements and actions. To that positive evaluations there are serious caveats:

1. the Philippines has not emerged from the regional financial firestorm unscathed - 1998 and 1999 will be difficult. Although projections of up to 3 to 3.5% growth and as low as 9 to 11% inflation (CPI) are not implausible, they are at the optimistic end of a range bottoming at under 1% and over 15% respectively;
2. the basic problem of overvaluation can only be described as self inflicted. Having moved the exchange rate down to near P25 to \$1 by the end of the 1980's, the Central Bank proceeded to manage it settling on an apparent target of P25.5 to 26.5 to \$1 through mid 1997 and specifically rejecting early 1990 proposals to float it down to \$1 to P30 with a view to further managed decline. Both higher and lower rates were nudged back to create an atmosphere in which stable nominal rates were expected by market actors;
3. the principal tool used - beyond the creation of expectations - was the Treasury/Central Bank Bill rate with reserve purchases and sales the day to day calming instrument and the defensive mechanism to halt and reverse any apparent trend up or down. In practice these were set well above inflation to induce capital inflows to finance investment. The gradual swing augmenting short term financial capital with longer term loans plus joint venture and other equity while desired by the BoP was not self evidently the result of any policy measures;

4. when - as happened endemically after 1990 - the footloose foreign financial capital inflow created what the BoP saw (quite possibly correctly) as excess liquidity, its response was to mop it up through pushing out bills (sometimes with higher interest rates) not reducing the interest rates to reduce the inflows;
5. this policy created an artificial base (usually 15% to 20% during 1989-94) for bank interest rate structures and taken together with lack of action to break up a major bank lending rate cartel which kept margins broad resulted in real interest rates for middle enterprises of the order of 15% to 20% - a range narrowed only after about 1994 when the Treasury under President Ramos began to take a more overall productive investment and enterprise oriented position than the BoP's (and Carazon Aquino era Treasury's) Makati (financial institution) focus;
6. the high real interest set by the BoP for bills had several partly unintended results:
  - a. they deterred middle and small enterprise borrowing on the demand side and - by providing a large pool of high real interest rate vs. deposit rate safe assets - also on the supply side;
  - b. although it was useful in financing rapid restoration of capital bases and balance sheets during 1987-1995 banking reconstruction including the smaller (e.g. rural) banks even if it shifted asset mix in a - presumably - unintended way (especially for the rural banks which, prudently from their optic, radically reduced rural lending);
  - c. but was very unuseful to the Treasury which over several periods was the "beneficiary" of bill borrowings it did not need for cash flow reasons on which it was charged 15 to 20% while credited with 0 to 4% interest on corresponding deposits with the BoP - hardly a contribution to efficient public finance;
  - d. albeit that *de facto* levy on the Treasury did help offset BoP losses on reserves hired at the bill rate (directly or via domestic commercial banks at 15 to 20% and invested in Northern short term, no risk money market assets at 4 to 6% and also in earlier years the loss on forward sales of foreign exchange at rates below those the BoP intended to attain/sustain notably to oil companies presumably to prop up a very slow moving administrated price/margin control/stability enhancement government policy for that sector;
7. by 1995 the overvaluation and interest overcharging policies began to do very serious harm particularly to middle enterprise investment and to competitiveness on the domestic market (as well as crushing the mineral export sector which had been an evident cost for much longer). Up to that point the Philippines (like Korea, Taiwan, Thailand, Malaysia, Singapore and Hong Kong on a pegs and Indonesia on a crawling peg to the \$) benefited because the \$/yen rate moved steadily in favour of the yen enabling them to meet Japanese import competition despite increases in real \$/local currency rates. When the \$/yen rate went into reverse and the \$ continued to escalate \$1=80Y to \$1=130 plus Y) the real cost of the peg grew explosively;

8. Little, if any, work was done on estimating the impact of systematic phased quantitative restriction near elimination and import duty reduction on domestic market oriented manufacturing with a view to evaluating potential interest and exchange rate offsets. (In agriculture the basic problem would appear to be the grower to buyer/bulker to wholesaler - direct or via a grain board - to retailer to consumer price gap which appears to be 3:1 vs. as low as 1.5:1 for rise in Thailand);
9. Tax reform to strengthen the budgetary position:
  - a. underestimated the limits of sophistication and the costs (or lags) of transition. For example a complete VAT plus excises, not a single point sales tax, was substituted for a patchwork crazy quilt of sales taxes but two and a half years after introduction still raised less than half of apparent amount due (and barely above the old rates);
  - b. grossly underestimated the costs of non-collection and the potential gains to be won from simple, monitored tax estimation and collection and from total reform of the autonomous, *de facto* unaccountable tax collection agencies created by President Marcos to eliminate Treasury constraints on managed corruption which post Marcos apparently little less corrupt but on an "own account" not a 'Presidential agency' basis;
10. the interest rate and exchange rate policies were not the result of inadvertence or of simple silliness:
  - a. bankers (control and commercial) do believe in sound money including stable currencies;
  - b. the high CB/Treasury bill rates did allow the CB to build reserves to over \$10 billion, thereby sterilising part of the financial inflows so far as domestic inflation went and to hedge them so far as the national economy (but not the commercial banks system) was concerned;
  - c. the high real bill rates and the blind eye to high cartelised margins (perhaps 4% average cost of deposits and 18%-30% lending rates in the early 1990's) did over 1987-1994 allow very substantial balance sheet reconstruction by banks with very limited use of public resources (a very real gain as a once for all balance sheet clean-up in 1986-88 could have cost 10% of GDP - \$5 to 6 billion. For comparison the Mexican 1994-98 cost is now expected to come to 15% of GDP);
  - d. the no win forward cover operation was largely confined to the petroleum sector and was an offset to the government's regulated cost plus pricing regime with lags of six months in adjusting prices to cost increases and few windfall gain periods to replenish the intended stabilisation fund. Clearly this was not appropriate role for the CB but the basic policy error lay elsewhere;

11. The overall operations and their coordination did improve during the Ramos Presidency:
  - a. the Treasury became an economic policy centre no longer dominated by Makati (the financial centre) or the CB and more concerned with the interest rate reduction/cartel eroding, overvaluation reversing concerns of directly productive enterprises;
  - b. tax reform (including a start on improved collection) did move the recurrent budget into surplus parallel to virtually ending or reversing net borrowing from the domestic banking system;
  - c. a modest external commercial source debt write-down/reconstruction programme (perhaps 10% reduction in present value of government external debt) plus increased external grants and soft loans reduced debt servicing costs and allowed a modest reduction in state external debt parallel to an increase of over one third in GDP over 1990-97;
  - d. the successful introduction of BOT in power and of liberalisation with coverage conditions in telecommunications improved the availability of power and of communications while radically reducing the need for state enterprise (power) or state (some aspects of communications) external borrowing. While it played a substantial role in the increase in enterprise sector external debt, most of it was medium to long term and often sourced or guaranteed by external enterprise ownership consortium members
  
12. However, Philippine strategy and policy - even by 1997 - still had several of its historic weaknesses:
  - a. better vision than articulated strategy;
  - b. little testing for gaps, side effects, desirable complementary programmes;
  - c. weak and lagged operational programme to implement policy decisions;
  - d. very, very weak monitoring, coordination and plugging on (including responding to feedback on weaknesses or opportunities revealed by monitoring).

In sum these compromise the ability to respond to external shocks and especially to rapid implementation of agreed responses.

**The factors which appear on first examination to be structurally different in the Philippines are banking, enterprise capital structures and the domestic savings ratio.**

The last is on balance a negative, albeit with a stagnation/deflation avoidance upside factor. The Philippines has about a 15% gross savings/GDP ratio vs. twice that in more

tigerish Asian economics plus Japan. This does mean rapid growth requires substantial net capital inflows which - in principle - is not true of Thailand, Malaysia, Korea or - pre crisis - Indonesia. Its upside is that any boost in private sector incomes has a larger proportionate impact on domestic demand and budgetary revenues so that a scenario in which export/income increases but those impetuses run into the sand of 'oversaving' (a la Japan) is highly unlikely.

Philippine banks' present (April 1) 6% odd non-performing loans (USA definition) could double. The range among the five largest banks could be 8% to 18% against present provisioning of 3% to 5% and operating profits allowing up to 5% a year new provisions with moderate ease. Flight of dollar denominated deposits appears unlikely and external borrowing (probably under \$10 billion) at present can be continued on a normal basis. Some second tier and 'rural' banks are weaker (albeit many of the latter rebuilt by holding largely T Bills and Central Bank Bills so are both very solvent and very liquid). Finance companies seem to be much less important than in Thailand, Malaysia, Korea or, Indonesia and also less intertwined with banks in ways risking pulling the latter down.

**Corporation debt/equity ratios for the large enterprise sector** (excluding banks where it is - normally enough - about 10:1) appear to be in the range 1:1.5 (40% equity) 1.5 to 3:1. Property companies may be 4:1 but off balance sheet phased loan drawings, payments to ex-government land holding units as well as to contractors and cash flow from sales complicate analysis in that sector. The basic range is much lower than the 4:1 to 7:1 apparently characteristic of Thailand, Malaysia, Indonesia, Korea. Thus bank lending is substantially less than the 100% plus of GDP characterising the latter as is enterprise external debt to GDP (about \$35-40 billion in the Philippines apparently including \$18 billion of \$ deposits which are over half citizen and under \$15 billion non-bank enterprise).

In parallel the proportion of medium to long term fixed interest rate borrowing by enterprises appears to be higher in the Philippines - perhaps up to two thirds for large enterprises. For example major property development appear to be about 25% equity (often including an external joint venture partner), 50% medium to long term loans and under 25% short term with equity holder commitments to procure or provide future loans plus conservatively projected sales covering phased future contractor and land seller payments.

**The lower, longer, less interest volatile capital structure led to weaker profit during recent 5% to 6% growth with moderate real interest rates. Today if averts the disastrous impact divider (negative multiplier) of lower operating profits, higher interest charges and substantial maturing short term borrowing on non-financial enterprises and their domestic supplier banks.** The two flagship property companies (Ayala Land and the Fort Bonafacio group) have reported profits (albeit reduced) through March 31, 1998 and positive cash flow projections (including moderately conservative sales flows and commitments to build and to pay instalments for land). The heavily externally borrowed San Miguel group has faced doubled interest bills (devaluation plus interest rate impacts) parallel to losses on overseas regional brewing and beer price cuts

to meet domestic competition, but still has a positive first quarter 1998 profit and rising quantitative sales, especially of beer though perhaps flat on soft drinks, ice cream, margarine and vegetable oil.

This fairly positive perspective needs qualification. There are weak banks, finance companies and property companies. It would be most surprising if none crashed. Deposit insurance will be used to bail out depositors (as before) but not small and middle banks (not as before when the whole system was at risk). With no analogues to the chaebol and affine structural or quasi structured groups of the region and no likelihood of state bail-out weaker property and finance companies (as well as weak enterprises in other sectors) will be bankrupted or radically restructured under creditor supervision. Especially for small and medium enterprises, bank desires to increase liquidity, decrease even moderately risky exposure and enhance their interest rate margins do lead to serious squeezes albeit the leading freeze-up of Indonesia and the massive decrease in access of Thailand, Korea and Malaysia have not been paralleled.

The combination of positive (if limited) growth of domestic output and demand with a stable and - for a first rate risk - accessible banking sector and low likelihood of enterprise sector meltdowns apparently has influenced external investors. There is little evidence of large scale net withdrawal of even short term external capital and some of continued medium/long inflows often tied to equity investment in new or enlarged subsidiaries or joint ventures. Notably Ford is returning to set up a full scale (\$100 million plus largely externally injected equity) assembly and parts venture with substantial regional parts exports despite falls in Philippine and - *a fortiori* - regional automobile demand. That General Motors and Chrysler have felt forced to indicate they now plan to follow, suggests they share a relative positive view of Philippine medium term vehicle demand growth and enterprise stability.

**Short to medium term prospects in the Philippines are exceedingly unclear:**

1. in terms of **Philippine fundamentals and the those of the global economy** - excluding Japan, Korea, Indonesia, Thailand and Malaysia - a return to a **5% to 6% trend growth** of output rate, and inflation rate at or slightly above that range and an investment (at least half medium to long term) led 5-6% capital account surplus with a slight smaller current account deficit (i.e. modestly rising reserves) would appear the most plausible scenario;
2. **but if Indonesia goes into meltdown**, Malaysia's exceedingly marginal adjustment/austerity policy fails leading to a full-blown crisis and/or - less likely - bad relapses characterise Thailand and Korea then the Philippines will suffer from contagion by proximity as well as real appreciation vis a vis second tier export competitors and second tier plus one first tier (Korea) import sources and 2% output growth could be the best attainable before the millennium;

3. **even gloomier scenarios would emerge if Japan goes into sustained deflationary recession** paralleled by a continued setting of the yen. (*Per* contra a Japanese return to 3% output growth would underpin 6% Philippine growth especially if the yen went well under 120 to the \$ increasing home market manufacturing competitiveness;
4. the Philippine electoral system has in 1998 again produced a winner with under 40% of the votes cast and one whose reputation as a populist with a taste for night clubbing and no clear economic strategy may deter investors even though his record is one of rather pragmatic and clever attempts to serve the public (including in health, education and user friendly policing) and his backroom economic advisers are second tier business, plus centre left (ex left) academic and people's organisation leaders. This may not matter as much as might be expected domestically - after all President Ramos won with 23% of the vote (with runners up at 21% and 18% vs. 12-15% vs. 33-37% in present poles) and at that time had no real economic strategy or non military management record. However, it would be idle to pretend President Anoint (by the lower middle income and centre left intellectual voters not by President Ramos) Erap Estrada is any foreign investors' pin-up. That might be negatively significant.
5. The stress above is on perceptions because unless a range of persons like the multi-millionaire Lucio Tan (brewing, cigarettes, airlines), the peoples' support group (Philippine Rural Reconstruction Movement) Leader Boy Morales and the hard headed/soft hearted semi neo liberal scholar and policy prober Solita Monsod have all misjudged very badly, no strategic economic policy shifts beyond increased stress on health (an old Estrada priority from his local government days), education and livelihood development aspects of rural poverty reduction is likely. Cronyism is unlikely as a main theme - established, conservative firms might well have less influence and second tier, "up and coming" Philipino Chinese ones more but in practice that would level playing fields. However, the Philippines is much weaker on coordination and follow-up than on strategic design and launching initiatives and has a US plus style Executive/Legislative relation of tension and trade-off. Nothing in the President anoint's record suggests coordination and following up are his strong points - albeit his Executive Secretary and Cabinet Secretaries could, if the President chose, be named to provide those inputs - and with no real party, he will (again, however, like President Ramos) have to cobble together a working coalition in the House and another in the Senate.

While not, perhaps, glowing the 1998-2000 central scenario does seem to be growing and consolidating. Barring relapses that parallels Thailand and Korea. Malaysia is more obscure and it is rather hard to see reason for any equally non-pessimistic tea leaf reading of Indonesia.

## V.

**Immediate Problem Potential: A Little List**

The present short to medium term problems confronting Philippines are:

1. Regional 'contagion' but more specifically Indonesian meltdown/conflagration. The latter is over 50:50. It would not on its face affect exports or Indonesian capital inflows (negligible to date) while Indonesian imports are readily resourceable. It might result in return of legal, extralegal and permanent migrant Philipinos from Indonesia but not huge numbers. The real risk is financial markets seeing cases as parallel which - perhaps - the genuine and orderly election and probable installation of a reasonably reassuring cabinet/policy cluster will avert.
2. Hidden weaknesses in banks or large enterprise balance sheets - i.e. more unhedged external debt than supposed. Private external debt is \$35,000 million (apparently including \$18,000 million dollar denominated deposits about half Philipino held). Little appears to be hedged either by banks (who do however have some external asset offsets) or by ultimate borrowers (except to the - substantial - extent they borrowed in P). This probably excludes short term trade credit not via banks and borrowings externally by externally based subsidiaries (which, however, appear - e.g. in San Miguel group - to have been invested abroad with substantial Thai risk but largely in Hong Kong, Malaysia, Taiwan, Singapore, USA and, for San Miguel, Spain).
3. "Chaebol" (or 'cronyism' for 'national champions') problems:
  - a. **cross subsidisation** from strong to weak units (at times useful, but now a source of weakness in Korea and being abandoned in Japan) in corporate groups. This is apparently not common - in several cases e.g. Ayala the land development side has been split off in separate quoted corporation - but one large case is the Fortune Tobacco/Asia Breweries/Philippine Airlines core of Lucio Tan's 'chaebol'. PAL is insolvent and probably bankrupt, Asia Breweries must be just above breakeven (dogfight with San Migel) and Fortune Tobacco's river of cash flow is clearly keeping PAL afloat but not so clearly focusing it on serious reforms which may need a competent external airline as a strategic investor (a thought which has now occurred to Tan).
  - b. **State - Enterprise relations.** Links to key office (political or bureaucratic) holders do matter in the Philippines (as where do they not?!). At present they guarantee access (whole absence may limit) but little more. Historically governments changed every four years so rotation of favourites. Under Marcos the rotation stopped and "cronyism" ceased to be 'picking national champions' from qualified on the basis of old boy networks and become deeply corrupted and corrupting with less uniform demand 'champions' be competent. Lucio Tan may be (though PAL leadership raises doubts) and probably is, Juan Ponce Enrile (largely retired) probably is, but there is little convincing evidence Eduardo



(Danding) Cojuanco is. President elect Estrada has links to all three and has had major financial backing from first and third. Whether he will give equal access (and no more) to them as well as to the Carrie Doll/Ramos era 'champions' or swing toward them (reversing rather than eroding tilt) is not clear. As a populist at heart and a poverty reducer with a fair grasp of financial constraints in his past history (including 17 as a mayor) he is unlikely to be 'Danding's man' as some fear. But...

- c. **corruption.** Corruption is endemic in the Philippines - administrative, legislative, judicial, sacral (at least one 'church' quite openly sells its members bloc-vote), journalistic and private. But since Marcos it is not a system and has administrative, legislative, judicial, sacral, journalistic, private and civil society enemies. On the whole the President elect is among the latter. In the national champions at whatever cost or cost efficiency sense (which is only tangentially corruption strictly defined e.g. Malaysia's and Indonesia's auto and Indonesia's aviation flagships) the Philippines is relatively free of massive current misallocation burdens. These - as Korea demonstrates grow over time - focus fades, initially rational choices run into *folie de grandeur*, corruption to keep on approved list rises. Nor do the 'King's Chinese'/Royal Family problems of Indonesia nor the Bumiputra build-up capitalists of Malaysia (analogous to 1950's-1970's state backed Afrikaaner breakthrough to high capitalism in South Africa) cases have direct analogues in the Philippines.
4. Regulatory/Judicial uncertainty. The public contractual - sale process is often less than clear. The key e.g. is on ex Subic Naval Base Freeport Container Operation contract. The Free Zone Authority opted for the bidder guaranteeing highest investment and volume and no conflict of interest, but much lower per container fee. Presidency intervened in favour of higher fee, lower guaranteed volume firm who as one of main Port of Manila operators has a glaring conflict of interest. (Now in court.) This is a case of obscurity on how to weigh criteria and of when/why Malacanang can intervene, not corruption or cronyism. The higher judiciary is independent but exceedingly slow and unpredictable. Its appeal processes for a commercial case rather resemble the USA's for murder cases on snakes and ladders elements and time consumed. Further the Supreme Court has USA style powers to interpret Constitution and a rather breathtaking view as to how far it can go - e.g. it determined that a main Constitutional provision was void because it was unclear how the (called for in Constitution) implementing legislation should be drafted! On a business issue it developed a national heritage criteria to reverse bid award for Manila Hotel. Again this is not quite what it seems - the Manila is a 1920's grande dame which the foreign bidder wanted to gut and modernise and the domestic to 'restore' (to the 1890's it seemed!). In fairness as the SC worded its ruling it seems to have a very narrow scope. But the uncertainty as to outcome and - even more - as to timing and certainty could become serious. The lower judiciary are seen by many (including the President elect) as including many "hoodlums in robes" who practice free market bidding as a means to deciding commercial (not so much criminal) cases unless they are too high profile to risk.

5. The *de facto* banking cartel (including the 4 or 5 pre independence and up to 10 1995 authorised foreign banks) is not conducive to new product extension nor to reasonable rates (or even access) for medium and small business. Nor with the decline of 10% real interest/no risk short term CB/Government paper is it clear whether all the secondary and rural banks are viable if "non performing" rise from - say - 6% to 7% today to - say - 10% to 15%. Because of 1986-94 reconstruction, the CB has regulatory and monitoring capacity and fairly good (it seems) data flows (and to be fair transparency in publishing them) but these have yet to be tested under pressure comparable to that of the past nine months;
6. Home market competitiveness should now be adequate **unless** China devalues the ren min bi and/or the Japanese yen falls a further 25% (against the \$) - and in practice as either one would probably lead the other. The gains since July '97 are against yuan, yen dollar, Euro area, pound, Hong Kong \$, and to a degree Taiwan and Singapore \$s and Malaysian ringgit. (The appreciation vis a vis the rupiah is a symbol of Indonesian implosion. If that rate is validated, Indonesia will be a sick export kitten not a Philippino eating tiger and if not the rupiah will bounce back to under R5,000 = \$1.)
7. Export market competitiveness is harder to guesstimate. The gains for mining and some agricultural commodities (coconut, perhaps pineapple - oil palm - banana) are real but limited where Thailand or Taiwan is a major competitor (or Indonesia post, or in the absence of, meltdown). For manufactures (embodies labour and infrastructure thru processed raw materials to deeper manufacturing e.g. cement, some steel items) the gains are unclear because of slowdowns in Japan, China, Korea and SEA which are among the main markets.
8. **How to avoid either recurrence of market driven/or at least 'validated' overvaluation and the build-up of huge pools of footloose financial capital behind confidence cemented retaining walls has not been tackled coherently.** The concept that easing down short term CB/Treasury bill rates can manage short term **inflows** is now accepted. So is that of requiring **special liquid external asset reserves against some types of foreign currency liabilities** (\$ denominated deposits) but there appears to be **neither an overall strategy nor a quick monitoring system** (even monthly reporting fifteen days in arrears is not quick enough in the case of a potential external lender outflow (tsunami).
9. While a moderately comprehensive (or believed to be) enterprise (as well as financial enterprise) external debt monitoring system exists there are no official prudential or regulatory guidelines on non-bank ratios of short or total external liabilities to equity or to cash flow nor of total borrowing to equity. In practice the Philippines does not have direct non bank enterprise external borrowing on a scale comparable to Indonesia (perhaps \$5-7.5 billion vs. \$75-100 billion with much of the Philippine total medium to long term from equity partners). Nor are its large enterprise

debt/equity ratios even in the same league as Koreas or Indonesia. (In Korea chaebol ratios apparently range from 4 to 1 to 8 to 1 for solvent chaebol. In the Philippines the San Miguel group - with a moderately stable, high cash flow beer - ice cream - margarine - soft drinks core - is perceived as on the verge of imprudence with a ratio of 1.5 to 1!). However, these results are independent of monitoring of total debt/equity ratios and of prudential or regulatory guidelines for short term external, total external or total debt whether in relation to cash or foreign exchange flows or to equity.