The Tyranny of Fundamentals

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I. Introduction

The Asian currency crisis is one year old and counting. July 1997 was when the sins of recent past finally caught up with the region and made mockery of the achievements of the past two decades. How the region tunnels through this economic nightmare will either confirm or belie the suggested demise of the East Asian model. This paper will steadfastly maintain that (i) the rumor of the East Asian model's demise is grossly exaggerated, (ii) that fundamentals, and not sentiment, will rule the long-run roost, (iii) that the worst of the crisis is passed us (but not because the peso is appreciating) and, if we play our cards well, 1998 will be a positive growth year and 1999 will see a 3-4% growth, and (iv) that laid before us in the guise of the crisis is the rarest opportunity in this half century to finally bid the boom-and-bust cycle adieu.

To address these issues, we first need to understand the East Asian crisis from a longer historical perspective. We first review what would now be the dominant perspective and then offer an interpretation with a different spin on the regional crisis.

II. The Crisis in East Asia: The Oft-Repeated View

One year into the currency crisis, the rough outline of its immediate forebears are acquiring clarity. The constantly recurring macroeconomic diagnostics were spelled out early on by H. Neiss, IMF's Asia and Pacific Division Director, speaking about Thailand in September 1997: "At the heart of Thailand's difficulties were a number of related problems: *a rising current account deficit not sustainable over the medium term; heavy reliance on short-term foreign borrowing that increased the economy's exposure to foreign exchange risk and to a potential reversal of capital flows; a rigid link of exchange rate of the baht to the US dollar which had appreciated over a considerable period; and a serious fragility in the financial sector linked to excessive growth of property-based lending.*" (IMF survey, September 17, 1997). A year later Pres. H. Tietmeyer of Bundesbank, speaking about the East Asian crisis, observed that "*On closer inspection, it can be seen that the economic successes of recent years already carried the seeds of the later crisis.*" The culprits were in his view, once more, *massive short-term capital flows, especially borrowing,* asset price inflation, misallocation of capital, rapid currency appreciation, decreasing competitiveness, and growing capital and trade account deficits (IMF Survey, 20 July 1998). Other summary reviews emphasize the microeconomic diagnostics which include: (a) weak and poorly supervised domestic banking sector, with little or no shield against moral hazard, (b) considerable lags or inaccessibility of relevant economic information, (c) wrong sequencing of reforms, (d) corruption and cronyism (e.g., Fischer, 1998).

This taxonomic and litanic account of the East Asian crisis suffers from not caring to explain how these same flawed institutions delivered phenomenal crisis-free growth in the decades of the 70s and 80s. These institutional infrastructures underpinned the East Asian Miracle and were roundly praised by a celebrated WB volume (1993). Banking crises and asset price bubbles were not invented in East Asia. The recent collapse of Long Term Capital Management, a hedge fund house, partly owned by economics Nobel prize winners Myron Scholes and Robert Merton and the subsequent \$3.5-b rescue workout by the FRB shows that financial fragility is not an LDC monopoly. Finally, Taiwan, Mainland China and India are dodging the onslaught while exhibiting some or all of the institutions culprited. The litanic account is a historical and leaves out too many crucial factors that made the currency crisis a logical historical outcome. Let me, therefore, propose a longer-term reinterpretation of events in the run-up to the crisis.

III. The East Asian Drama: A New Spin

The original East Asian model of growth centered on a conscious effort by an activist governance to anchor economic growth and in particular growth in tradeables (the sector closest to the East Asian notion of industrialization) on maximum export growth. With the exchange rate fixed at some initially high level (i.e., initial undervaluation after an initial devaluation), this export push under labor abundance is achieved by way of low domestic inflation pursued via a tight credit policy, which favors labor-intensive activities and economizes on the use of scarce capital. This is many times accompanied by credit rationing. The reason for this is interesting. With tight money, interest rate is high and (a) many worthy capital-intensive projects are not viable, (b) moral hazard under tight credit results in Stiglitz-Weiss deterioration in the quality of bank portfolio. Thus, rationing. This meant high average interest rate with some favored sectors (manufacturing and infrastructure) getting credit relatively cheaply presumably at or near the (world) market rate, while others viz., the nontradeables, getting it costly.

The relatively high effective interest rate facing most nontradeables embodied an implicit tax on negative externalities associated with asset price bubbles. This overall tight money-low inflation strategy maintains domestic terms of trade favorable to the tradeable sector and bottles the bubble tendencies in the credit-starved nontradeable sector.

The high average domestic interest rate in turn is sustained by a heavily regulated capital account which kept capital flows from imposing interest rate parity. With initial labor abundance, export growth depended not only on favorable domestic terms of trade (real exchange rate) but also on the real wage. Low inflation has the drawback of a growing real wage when nominal wage is rising. This poses a dilemma because the catching-up journey is a marathon rather than a sprint. The latter was kept in check by initial labor abundance and labor market regulations. These saw to it that success would not become its own best enemy.
The original East Asian model thus formed a consistent set

of policies that delivered rapid export and income growth with improving equity along the Stolper-Samuelson orbit. But this was at the expense of the nontraded sector especially the banking and services sectors, which were treated as mere appendages of the tradeable sector. The effective interest rate facing the *credit-starved* nontraded sector was naturally very high.

In the eve of the 90s the amalgam of political liberalization and labor scarcity resulting from singular success led to the explosion of nominal wages. Real wages shot upwards as inflation lagged behind. This threatened the capacity of the model designed initially to feed on labor abundance to sustain growth. The pressure to liberalize trade coming from WTO and partners could no longer be contained. With the rest of the LDC opening up and competing (notably China and Latin America) and the world economy stagnant, a drastic export growth slowdown seemed to be in the cards for the region. The buzz phrase in East Asia was *"higher value-added exports"*. The problem was financing the upgrading.

The logical response within the model itself should have been gradual upward exchange rate adjustments to protract the adjustment process. Thus, exports will continue to provide the financing of export upgrade. This ran first into two problems: (i) internal — the domestic constituency against eroding real wages was growing with the swelling of the middle class newly enfranchised by political liberalization. This also put into serious question the region's capacity to maintain a real devaluation in the face of sharpened militancy of labor unions exemplified by the Hyundai strike in late May 1998; (ii) external — with the record of export success of East Asia, an upward exchange rate adjustment would appear predatory to DC partners who were already protesting trade deficits and, being in recession, would have reacted unfavorably. As it was, an appreciation of East Asian currencies was being demanded. The emerging social contracts were therefore unfavorable to devaluation. In addition, (iii) the contest for DFIs, itself an upgrade financing strategy, was heating up and domestic markets were important come on. Devaluation immediately taxed DFIs, especially domestic market-oriented ones. Furthermore, the new breed of DFIs in the 90s was more eager to sell to than to export from East Asia, what with rapidly rising wages. (iv) The 90s also saw a new globalist perspective emerge among DC banks and mutual and hedge fund houses. They disappeared from the scene during the debt crisis decade of the 80s. These were justifiably very bullish on East Asia, titillated by the DFI miracles (Malaysia, Thailand, Indonesia) mesmerized by decades of solid growth, enviable macrofundamentals and enticed by emerging risk-reducing derivative instruments spearheaded by so-called "country funds" (e.g., Mexican "tesebonos").

The universal allergy to upward exchange adjustment was given a positive spin in the oft-repeated phrase: *devaluation does not work*. From exchange rate adjustment, the state could also have borrowed for the financing of higher value exports to replace labor-intensive ones. The upgrade exercise required resources exceeding even the remarkable East Asian domestic savings. But state-sponsored borrowing became pariah in the 1980s when the foreign debt crisis poisoned the development landscape. *Finally*, the economy could have gradually eased up credit, risking asset price bubbles in the nontraded goods sector and financial crisis as happened in Japan and Taiwan in the late 80s. As long as no foreign inflows take part in this workout, a currency crisis is remote. Taiwan also had huge forex reserves to finance the scaling of the export ladder.

Why not open the capital account? Here was a seeming panacea that can sustain growth while skirting around all the immediate political problems related to price-mediated adjustments. The difficult decisions can be made to wait! After more liberal DFI rules and after BOT legislation, the deregulation of *Mundell-Fleming flows*, i.e., short-term capital and private foreign borrowing which are interest rate-sensitive, seemed only natural. The confluence of high average domestic interest rate, stable currencies and over-enthusiastic foreign moneybags produced a flood of forex inflow just as the East Asian tradeable sector was experiencing a serious competitiveness thaw. Furthermore, and more importantly, the very structure of East Asian credit policy meant that the effective interest rate facing the nontraded sector was much higher! The flood, facilitated by unprecedented capital mobility, thus concentrated resources on the underdeveloped, undervalued and credit-starved nontraded sectors, which were prone to demand-led asset price bubbles. The authorities themselves, caught in the vortex of euphoria or even applauding it, offered only token sterilization resistance and *easy credit* ruled the roost.

The deluge sustained rapid income growth while maintaining low or even dipping inflation — a veritable non-inflationary expansionary easy credit policy! The implicit (and increasingly costly) social contracts remained unscathed while the attractiveness to DFIs and the capacity to finance higher value-added exports only improved. The required painful adjustment was postponed and, perhaps, for good.

Meanwhile, the nominal exchange rate was allowed to inch lower in the face of the inflows (a common feature of the so-called *volatility bands*) resulting in the tradeable sector eroding further. This was due to, among others, an *asymmetric interest group formation* that favored a currency appreciation and a misplaced inclination of monetary authorities to emphasize for the disinflationary effect of a currency appreciation. A growing trade and current account deficit increasingly financed by inflows exacerbated while the unhedged forex exposure of the banks and private sector was also growing. The situation was fast becoming a well-camouflaged set-up for a fall. While the original (also called "first generation" (Krugman, 1998)) indices of macroeconomic fundamentals (viz., inflation, fiscal balance, BOP balance) did even better, few noticed that their relevance was evaporating. But in the atmosphere characterized by euphoria, no news is bad news. Red flags were always a conspiracy to cap the good times. East Asia was intoxicated. The collapse was only a matter of time.

With the onset of the currency crisis, survival became the national concern and suddenly the old social contracts no longer bound. Large devaluations are now viewed as necessary for survival by both internal and external constituencies who previously saw them as irritating *beggar-thy-neighbor one-upsmanship*. We view this development as an *Olson upheaval* (Olson, 1982) which sweeps away the political gridlock standing in the way of renewal. It allows East Asia to embrace adjustments that were once closed by internal and external political opposition. It allows the region the option to return to its roots. The unthinkable had become casual fellow traveler. Yes there is a crisis but there is also renewal; one cannot be without the other. The IMF appears, by contrast, to favor recasting East Asia according to the imperatives of an open capital account. It has the carrots to get its way. Will it succeed in running roughshod over East Asian landscape?

A. The Crisis Tableau

The Asian Currency Crisis was the outcome of a confluence of historical legacies, world emerging environment, conscious policy choices of the state and rational responses by market players. In the context of the East Asian region, the players are:

a. The Central Bank
b. The Commercial Banks
c. Private Business
d. Government
e. Foreign Banks / Japanese Banks
f. Portfolio / Hedge and Mutual Fund Houses

The historical legacies by the early 90s are:

a. The economic structure of the East Asian model and its singular success;
b. The success of the DFI miracles (Singapore, Thailand, Malaysia, Indonesia);
c. The collapse of the Soviet Bloc and the ERM collapse.

The emerging world environment consisted of:

a. The WTO, AFTA-CEPT, APEC and Fortress Europe and the rapid trade liberalization initiatives;
b. The entry of and devaluation among emerging LDC rivals (China, Mexico, Chile and India);
c. US-Japan Trade Dispute, the Plaza Accord, the consequent easy money strategy in Japan and the collapse of the bubble economy;
d. The globalization of capital and the emergence of contagion volatility;
e. The recession in OECD countries in the early 90s.

The policies of note were:

a. Capital Account Liberalization — the lifting of barriers to short-term portfolio flows;
b. The Exchange Rate peg to the US dollar; together with free convertibility of the domestic currency;

c. Liberalization of private foreign borrowing.

To suggest the complicated interplay of forces, policies, outcomes and further outcomes, we designed the following tableau: *Genesis of the Crisis*.

[Keys and Tableau]

(1) We start the story at the upper left-hand corner of the Tableau. The historical legacy is the *East Asian Miracle* which was founded on the sound economic fundamentals of low inflation [low P*] consequent to tight monetary policy manifested in domestic interest rates [high r] very high relative to world interest rate [r^L]. This combines with capital restraints and "Erpeg" to sustain the *interest rate nonparity* where $(\%DE)^e$ is the expected % change in the nominal exchange rate E. Interest rate nonparity if combined with "Private Foreign Borrowing Liberalization" induces a massive flow of capital from "Foreign Banks / Japanese Banks" to domestic borrowers, viz., domestic banks and private business. It also combines with "Capital Account Liberalization", to induce "Portfolio Houses" to pour short-term capital into "Nontraded Sector". The Portfolio Houses in turn proffers "rosy reports" to the "Central Bank" which originates policies.

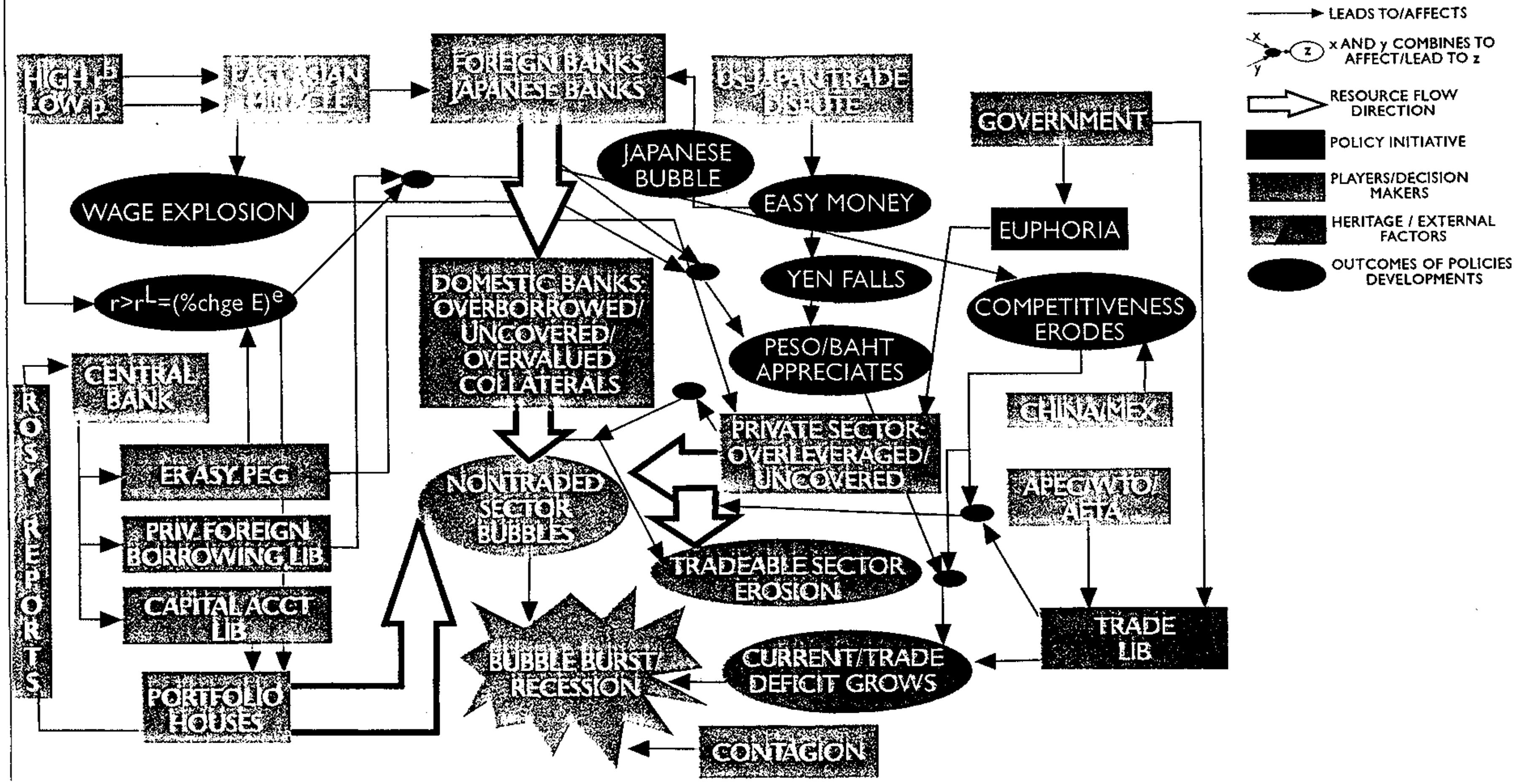
(2) Why were Foreign Banks so eager to lend to East Asia? The first reason is that the East Asian miracle was a matchless magnet for foreign capital seeking not only markets but also arbitrage opportunities. A decade of spectacular growth in the 80s, growing affluence and political perestroika made East Asia the peerless haven for so-called smart money. You cannot miss out on the Pacific Century.

(3) The case of Japanese banks deserves greater scrutiny. The unending US-Japan Trade Dispute over Japanese trade surplus and trade barriers had taken many twists. It resulted in the Plaza Accord of 1985 when a concerted effort by the G-7 countries forced a sharp appreciation of the Yen. This hardly made a

dent on Japanese trade surplus (but changed the incentive structure in Japan in favor of nontraded goods) and prompted other courses of action. The US favored domestic expansionary policy for Japan to fuel imports and reduce the trade gap. Japan responded with a policy of Easy Money, which quickly fueled the famous "bubble economy". When the bubble burst, Japanese banks became saddled with enormous NPLs. The Bank of Japan, faithful to collegial rather than market rules, avoided closing virtually bankrupt banks. The strategy adopted was to attempt to outgrow NPLs. If the economy grew and the banks grew space, the proportion of NPLs to net worth will fall — problem solved. Easy money pushed the savings deposit rate virtually at zero, and gave banks much breathing space. But the economy failed to respond. The banks had money to lend but Japanese firms were borrowing for projects in East Asia where profits were four times higher than in Japan and in the West where real estate potentials were rosy. There is some truth to the claim that the financial shambles in Japan in the early 90s helped fuel East Asian prosperity. The Kobe earthquake in 1994 caused Japan to call back foreign investments, which caused the sharp Yen appreciation. But the continued flight from Yen assets, which earned little, continued and finally forced the Yen to fall from Y90 to Y110 to Y121 to a US dollar. This forced a drastic appreciation of East Asian currencies pegged to the US dollar. In particular, S. Korean industries which borrowed heavily and invested in new capacity to push Japanese goods out at Y100 to a US dollar found its products unsaleable at Y125. This was a terrible but understandable miscalculation! A massive bailout for Korean industries was required and it was the S. Korean households that bore the cost!

Meanwhile, Japanese banks, realizing the East Asian lending route to be the fastest path to outgrowing its massive NPL problems, lent without restraint ($260-b worth). It started with Hongkong and radiated from there. Had the East Asian growth continued to the year 2000, the Japanese bank prob-

KEYS TO GENESIS OF THE CRISIS



lem would, indeed, have evaporated! Instead, the Japanese banks faced a second "bubble collapse" in 6 years. Its NPL problem has worsened rather than improved with time and the East Asian collapse.

(4) The flow of borrowing and portfolio combined with "Asymmetric ER Peg" and "Yen Falls" to force "Peso / Baht Appreciation". This combines with the "Wage Explosion" in successful East Asia and the entry of China and Mexico to erode tradeable competitiveness.

(5) Meanwhile, world developments "APEC / WTO / AFTA" combines to push "Government" toward "Trade Liberalization" in the interest of long-run efficiency and to attract foreign investment. "Government" also fans euphoria with wish forecasts, which influences business decisions towards overgearing and overcapacity.

(6) The "Erosion of Competitiveness" combines with "Trade Liberalization" to bias the allocation of private business resources towards the "Nontraded Sector" where "Bubbles" are endemic. They also combined to bias the allocation of "Domestic Banks" towards the same Bubble-prone sectors.

(7) The channeling of borrowed resources towards the bubble-prone nontraded sectors leaves domestic banks increasingly uncovered against foreign exchange and capital reversal risks. As long as the economy is growing rapidly and inward flow of forex is rapid, the economy is buoyant and the usual indicators of macroeconomic health (inflation, interest rate, BOP, government deficit) will look good except...

(8) ...The "Trade and Current Account Deficit which, in view of the combined effect of eroded competitiveness, "Trade Lib" and the appreciation of the currency, grows. This sows some doubt on and finally ruins the sustainability of foreign borrowing-financed growth.

(9) Bubbles pull growth along initially. But, inevitably, bubbles collapse as the inflow slows down prompted by doubts of continued viability. Portfolio Houses beat a hasty retreat and the Bubbles burst. A recession follows as the domestic currency melts even as over-exposed private entities scramble for foreign exchange to service their obligations. A credit crunch overwhelms the financial sector and the whole economy. The collapse ensues.

B. The Emerging Regional Picture

A year into the currency and financial crisis, the toll on the East Asian region is massive. Table 1 profiles East Asian economic outcomes. The good news is that the Philippines is one of only five countries still registering positive growth. The bad news is that this is not enough of good news.

There are, however, reasons for optimism as the third quarter ends. It is called "bottoming".

C. Bottoming of the Crisis

The economic crisis has bottomed. The worst of the currency and financial crisis of 1997-98 occurred in the first semester of 1998. The confluence of high interest rates, the peso devaluation and El Nino resulted in a drastic retreat in the growth of domestic output (0.2%) in the wake of massive collapse in agricultural output (-7.5%) and a fall in the industrial output. The principal adverse factors have, however, begun to decamp in the second semester. The 91-day Treasury bill rate has fallen to 13.5%; the exchange rate is stabilizing at P42.43 per US dollar and the El Nino is only a memory. Since the agricultural output fall contributed around -1.6% growth to the first semester GDP growth, a zero growth in this sector in the 3rd quarter and a zero growth in Industry output would give one percent GDP growth a better than even chance of emerging, as long as the Service Sector growth holds up at 4%. The September inflation (10%) shows that price acceleration is not in the cards and the BSP's monetary easing is a correct response. While gnashing of teeth could still be heard from industry associations, the emanations are less grating as prime rates begin to come down, however, grudgingly. The peso-dollar exchange rate has, in part, registered the strengthening of the Japanese Yen but mostly its direction reflects the shriveled demand for dollars from importers and the continued strength of OCW remittance. Let me emphasize that there is here a role for forward-looking monetary and exchange rate policy. When the peso is strengthening despite a downward trend in interest rates, the peso is seeking a level consistent with a zero growth economy. *If this is not checked* (i.e., an ER consistent with zero growth prevails) *the ER will again be in a terrible mismatch in two years with the economy growing at 4-5%*. Devaluation will again be called for which will threaten the stability and recovery of the economy before the end of the Estrada presidency. I believe that the monetary authorities should now start to target ER stability at P42-43 per US dollar by raising forex reserves to six months of imports.

It is instructive to recall a 1980's episode involving Cory Aquino. From 1987, the pump price of gasoline was pulled back twice from P13 to about P10 per liter (to little applause) to reflect world petroleum price trend. When the trend reversed in 1989, the pump price was also reversed at the cost of social unrest and a costly attempted coup. The lesson: *if you have to bring a price back-up, resist letting it fall.*

Table 1.
GDP Growth, Inflation, Exchange and Time Deposit Interest Rates : Asia

	GDP growth (period)	Inflation rate (month)	Exchange rate Jul-97	Jul-98	% Devaluation		Time Deposit Interest Rate
1. Philippines	1.7 (Q1)	10.7 (June)	28.7	42	32		13.38
2. China	6.8 (Q2)	1.3 (June)	8.29	8.28	0		8.1
3. Hong Kong	-2.0 (Q1)	4.5 (May)	7.75	7.75	0		8.41
4. Indonesia	-6.2 (Q1)	59.5 (June)	2585	14150	82		57.77
5. Malaysia	-1.8 (Q1)	6.2 (June)	2.64	4.14	36		11.02
6. Thailand	-0.4 ('97)	10.7 (June)	31.6	41	23		16.5
7. Singapore	5.6 (Q1)	0.5 (May)	1.47	1.71	14.6		5.68
8. South Korea	-3.8 (Q1)	7.5 (June)	8.94	12.9	30.7		13
9. Taiwan	5.9 (Q1)	1.4 (June)	28	34.4	18.5		7
10. India	4.3 ('97)	10.5 (May)	35.7	42.4	16		7.75

D. Bottoming in East Asia

The signs are finally trickling in for a break of the storm in East Asia:

(i) The remarkable run of the Japanese Yen to ¥120 to a US dollar represents a ¥30 turnaround from the predicted ¥150 level. Did this represent a growing confidence in the Japanese economy or a growing uneasiness about the prospects of the US economy? Both. Prime Minister Obuchi has succeeded, however tenuously, in getting political approval of the recovery package. The slight reduction in the interest rate by US FRB implied recognition of the US economy's vulnerability, which softened the dollar. Since a further reduction was expected, this triggered uneasiness with even longer position on the dollar. Third, the gradually falling Yen from Y144 to Y135 triggered a stampede to service heavy Yen borrowings by foreign traders before further fall raised the cost. This, like the local prepay panic among dollar-exposed businesses in the late 1997, sent the Yen soaring in mid-October.

(ii) However this has come about, Yen appreciation is always a welcome development for the revival of the Japanese economy stricken with demand anemia. Japanese households will now feel suddenly richer at least relative to import goods and the income effect will spill over to the other goods. More importantly, the exchange rate being the relative price of nontraded to traded goods, the appreciation serves to boost the wealth position of real asset holders (i.e., real estate) and breath life in real estate market. True, it weakens Japan's export position but (a) Japan's exports are competitive at Y100 to a dollar as evidenced by the Japanese trade surplus in 1995-1996. (b) The growing trade surplus would eventually trigger trade frictions, which have moved backstage due to the crisis. The Yen appreciation, thus, opens another unexpected front against the tenacious Japanese liquidity trap besides the fiscal stimulus and the recapitalization of Japanese banks (the bridge bank concept).

(iii) The Yen appreciation is sterling news for struggling East Asia with domestic currencies all strengthening. The response is not just "sympathetic", but "fundamental". (a) Episodes of Yen appreciation triggered growing Japanese DFI (e.g., post Plaza Accord development) which has all but halted; (b) The prospect of an export-led recovery of S. Korea is much brighter since it was largely the precipitous Yen decline that clobbered many S. Korean chaebols.

(iv) The Yen rebound reduces the likelihood of a Yuan devaluation and shifts the motive for such from sentiment to fundamentals. With a rebound in other East Asian currencies, the fundamentals turn ambiguous on the Yuan fall.

(v) The $30-b recovery aid package designed to guarantee new borrowings by East Asia is a stroke of brilliance. In theory, it should work like the successful "Brady bonds" which guaranteed new lending to debt-crisis countries, in effect, institutionalizing the bankruptcy practice of differential treatment of old and new lending. In practice, this could guarantee up to ten times the fund base. For countries like the Philippines who still can tap the commercial market, the guarantee can lower the spreads. It may also be possible to tap the facility to guarantee private sector borrowing from the panic-stricken banking sector to stimulate the flow of funds. This appears to be in the works here.

(vi) The spate of bad news, which came fast as furious in the first semester of 1998, has slowed down and contagion appears to have dissipated in the Andes. While Latin American countries remain vulnerable, bending with the wind (i.e., letting the exchange rates gradually adjust) appears to have cushioned the landing. At worst a gradual slowdown is in the cards.

(vii) The timely reduction in the US interest rate has resulted in world stock market rebounds and strengthens the conviction that contagion may be being contained.

(viii) The second semester appears decidedly upbeat. El Nino is over with the return of the rains, sometimes too much, but East Asia is more comfortable wet than dry. In fact, "monsoon Asia" was an earlier moniker made popular by the late Professor H. Oshima. The Hyundai strike is over and Hyundai has acquired Kia. The parades of consolidations include the end to the PAL impasse. Human rights are once again center stage in Southeast Asian discourse and that is a good sign.

For all these reasons, I suggest the following:

(i) The East Asian crisis has bottomed and is now poised for a recovery. How fast the recovery arrives depends on the menu of policies adopted and the response of the OECD countries in terms of resources and foreign investment.
(ii) The worst of the crisis occurred in the second quarter of 1998. The worst is now behind us.

We now turn our attention to the possible shape of East Asia's macroeconomic landscape.

E. East Asia's New Architecture

The East Asian model as a consistent package of policies for maximum growth in the *catch-up* episode is unequalled in postwar history. Unfettered capital account liberalization, however, is its worst enemy, its Achilles heel. The unfortunate mongrelization of the East Asian model economy produced a highly unstable mongrel that was bound to stumble.

1. Was it the backward financial sector or capital account liberalization that is to blame? The contention here is that the East Asian financial sector was well developed and very beneficial in the catch-up environment where it evolved. *A Western-style financial sector could not have underpinned the three decades of miracle growth.* But capital account liberalization unhinged this successful arrangement. Not only that, it exacerbated the problems inherent in credit rationing, viz., a potential for cronyism and corruption. Under tight credit and hard budget constraint, cronyism's elbow room is limited even with

muzzled press. With "easy money", the latitude for rent-seeking and legal larceny expands. This is true whether foreign money is borrowed publicly or privately. This brings us to the future of the East Asian model.

2. The East Asian model remains a valid vehicle for those economies still *deep in the catch-up mode.* For these countries, the IMF Treasury-Wall Street prescription of *total domestic reconfiguration according to the imperatives of free capital mobility should be viewed with great wariness.* Some capital control or drastic domestic incentives restructuring, or both, is required to accompany a substantially unchanged, if more open, architecture. For those economies *at the end of the catch-up mode,* i.e., S. Korea and Taiwan, at or near the OECD orbit, the East Asian model must, however, undergo substantial changes. That is why I consider S. Korea's faithful implementation of the IMF program and Japan's financial reform as generally correct. Taiwan, which ironically champions the cause of restricted capital account, may have to follow suit.

3. The currency crisis was a painful way out of the contradiction that the East Asian economies was embroiled in and that once it happened it represents an opportunity to continue the catch-up process in the more *honest, transparent, East Asian no-short-cut way.* Already, East Asia is reversing its borrowing-financed romance with trade and current and current account deficits (though still fueled by collapsed imports). There is no substitute to faster human capital accumulation and physical capital upgrade.

4. Possible Post-Crisis Policy Features:

   Post-crisis policy landscape will be riddled with individual country defenses against the ravages of massive, lightning-speed "hot money". A guiding idea is a quote from Michael Mussa (IMF Survey, 2 November 1998): "No country, no matter how soundly managed its economic policies, no matter how solid its banking sector, can maintain an open attitude towards international capital flows in the face of that type of system disturbance."

a) *Exchange Rate:*
The exchange rate policy that should emerge is a *managed float* explicitly designed to adjust to long-term (fundamental) flows and adjusted periodically to preserve a target real exchange rate. It will, in a sense, be like the pre-crisis Indonesian exchange rate policy but with a keen eye on developments elsewhere, notably China.

b) *Monetary Policy:*
Monetary policy will be tight and designed to target single digit inflation, and associated with aggressive sterilization. Asset price bubbles and "easy money" will long linger in memory as insidious co-conspirators.

c) *Capital Account Policy:*
1. To limit the fiscal drag associated with aggressive sterilization (high interest domestic borrowing vs. low interest forex reserves), some capital controls targeted towards short-term capital, or some incentives intervention such as a time-graduated capital gains tax, or both, may be called for. The latter is especially needed to reduce the likelihood of asset price bubbles.
2. In contrast, even more capital account openness to DFI will obtain.

d) Tighter prudential rules for the banking sector beneficial, whether the capital account is open or not, will be in place. The financial sector should be more competitive and open to foreign players.

e) Fiscal Policy will remain conservative with 3% GNP deficit being the ceiling and never monetized.

f) Trade Policy will still hue closely to the agreed upon liberalization schedule in AFTA and/or APEC.

Thus, although a partial return to the East Asian model is in the cards, new institutions will have to be accommodated in view of New World realities. We now turn our attention to the Philippines.

III. The 1998 Philippine Crisis: A Longer View

A. A History of Crises

1998 is only the latest in a long string of economic crises that graced Philippine shores. Table 1 reproduces Table 4 in Fabella (1995) which saw print two years ahead of the crisis. Note that *another crisis* was already at that time suggested for 1997-98 by Table 1 although, of the underlying suggested precipitants, only a growing trade deficit was on the money. For those interested in the health of the Philippine economy, the trade deficit is of extreme moment. The penchant of NEDA and other government agencies to pooh-pooh a growing trade deficit as due to growing capital imports in 1994-96 smacked of a lack of understanding of history.

The interval between crises was about ten years (hence a "ten year itch") to the end of the 70s. Since then, the interval has shrunk to about six years. The economy experiences rapid growth of about 6% real GDP in the run-up to the crisis. Then, it runs into a trade deficit wall and stumbles. Contrary to rhetoric, we never crossed the border to NICdom.

It is especially instructive to dwell on the crises of the last twenty years.

B. Crisis Since 1980

Figure 1 gives the real GDP growth trajectory of the Philippine economy over the last twenty years from 1980. Note that crisis segments are given in "red" and peak segments are given in "green".

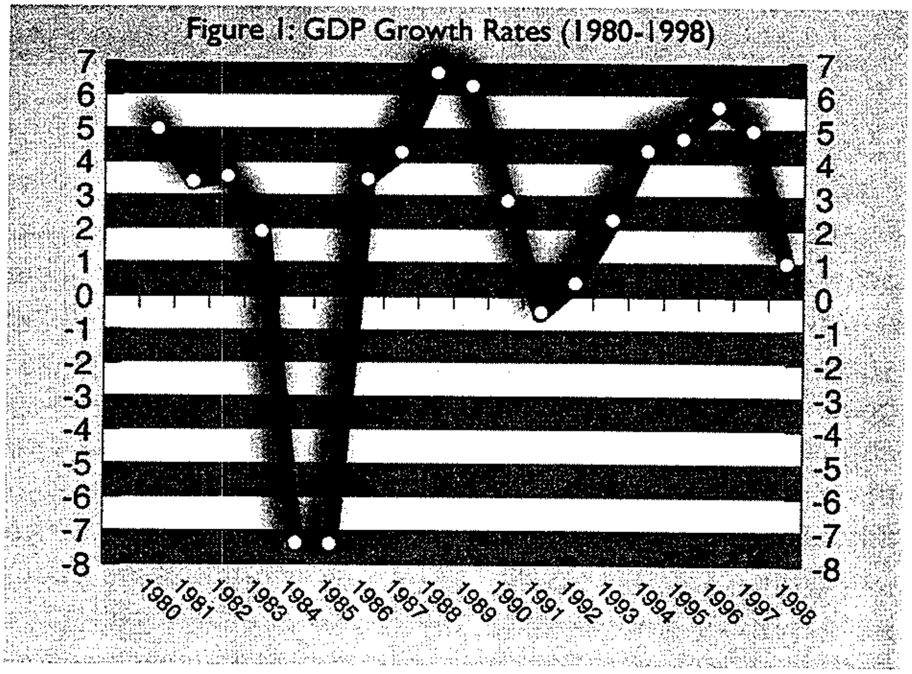


Table 2
BOP Crisis Episodes in the Philippines

(1) Date	(2) Immediate Precipitant	(3) Underlying Precipitant	(4) Average GDP Growth Rate : Past 4-5 Years
Nov-Dec 1949	1949 Presidential Elections	Rising trade deficit, rapid fall of reserves from \$420 to \$260 million	18
Nov-Dec	1957 Presidential Elections	Trade deficit pressure inherent in import substitution; reserves fell from \$160 to \$71M	7
Nov-Dec 1969	1969 President Elections	Trade deficit explosion; Rising debt service	5.4
1980-83	Oil shock, rise in world interest rate, political turmoil	Trade deficit pressure; rapid rise of debt service	
1990	Gulf war; natural calamities	Trade deficit pressure; Debt service explosion	6.44
1979-99?	Natural calamities? Oil price rebound? Presidential elections?	Trade deficit pressure; Still considerable debt service	5

Table 3:
1998 Crisis in Perspective

GDP growth rate	-7.32	-0.50	1.70
GNP growth rate	-8.72	0.41	2.50
Inflation rate	53.34	16.55	(June) 10.70
TB_{91} rate	30.53	21.35	(June) 14.50
National Government Deficit/GDP (%)	1.92	4.80	2.00
Gross International Reserves (in months of imports)	1.76	4.51	3.57
% Devaluation	33.47	11.54	35.54
Agriculture, Fishery & Forestry Sector Growth	-0.93	-1.38	-3.60
Industry Sector Growth	-11.51	-2.67	1.30
Manufacturing Sector Growth	-10.11	-0.44	1.30
Service Sector Growth	-6.53	0.33	4.70

Source: NIS (NSCB), ADB

A number of observations can be made from the growth experience of the last two decades (see also Fabella, September 1998):

1. Each of the last three administrations closed with an economic crisis: Marcos in 1984-85. Aquino in 1991-92 and Ramos in 1998.

2. The peak of each recovery cycle is *around 6% and is never sustained*. When 6% growth is attained, the economy invariably hits turbulence and retreats. Thus, we never attained the tiger economy growth of 7-8% sustained for a decade.

3. The current crisis expected to bottom at 1% growth of GDP will be the *least severe*. There, nevertheless, remains the danger that the crisis will worsen if knee-jerk reactions and political grandstanding take over the management of the crisis.

Table 2 gives the indicators for the three crisis years 1984, 1991 and 1998 with 1998 represented by first quarter numbers. It shows that, on all fronts, except Agriculture (standing for Agriculture, Fishery, Forestry) growth, 1998 Q1 is *moderate* compared to either 1984 or 1991. The unprecedented retreat in Agriculture output in 1998 Q1 (-3.6%) is *due primarily to El Nino* and thus could not have been helped. Note, in addition, that the 1997 Q1 growth of Agriculture output is 3.7% which is a hefty 3.2% higher than the average Q1 growth in Agriculture output of 0.5% during the 90s to 1996. This contributes to the downward pressure on this quarter's output. The 3.65 reduction in Q1 Agriculture output is more severe than the 3.28% drop for the whole year 1983, and the 2.51% reduction for the year 1992. The *good news* is that El Nino is over in the second half of 1998 and Agriculture output will return to trend at about 1.5% growth. Had Agriculture not contracted at all, i.e., 0% in 1998 Q1, GDP growth would have been 2.6% instead of 1.7% and GNP 3.4% instead of 2.5%. The growth numbers shorn of the El Nino effect look more like slowdown than a bust!

Especially notable are the comparative indicators for inflation and interest rate (TB 91). Even by 1994 basket, the inflation rate by June 1998 stood at 10.7% versus 16.55% average for the 1991 and 53.3% in 1984. The average TB 91 rate at 17.8% for 1998 Q1, although high, is much lower than averages in 1991 (22.35%) and 1984 (30.53%). The TB 91 rate in July 1998 stood at 14.5% and 14.2% in early August confirming the healthy downward trend in interest rate. The biggest immediate challenge to the Estrada economic team is the revival of growth and this trend is a necessary condition.

C. External Factors

How much did external development contribute to the economic outcomes in '84, '91 and '98? No doubt adverse external developments were present in all three outcomes busts. The second oil crisis in 1979 and steeply rising world and US interest rates put a squeeze on the heavily-indebted and increasingly politically shaky Marcos economy; the Gulf War and world oil price increase in 1990 exacerbated the deteriorating BOP picture under Aquino and the regional currency crisis and El Nino shattered the moorings of the peso under Ramos.

But external circumstances are, at best, specious explanations of economic busts. In all three episodes, there were countries exposed to the same external environment that did very well. The Asean region except the Philippines grew rapidly through the LDC's lost decade of the 80s. The growth performance of the same region hardly blinked through the Gulf War in 1990. Taiwan, Mainland China, Singapore, and even India are swimming through the Asean currency bloodbath hardly scathed. Why have, in particular, Taiwan and Mainland China escaped to date the Asean currency bloodbath? Three things come to mind:

1. a regulated capital account
2. a mountain of forex reserves, and
3. a trade surplus

These features are, by the way, inherent in the so-called *East Asian model.* However, these three features, previously cherished in the East Asian landscape, began to disappear in the 90s which rendered them increasingly vulnerable. Table 3 clearly shows that by 1996-97, current account deficits became endemic in the Crisis Countries of East Asia. Non-crisis Countries, however, bucked the tide.

Table 4:
Current Account Balance Short-Term Debt
and Forex Reserves in E. Asia

	CA Balance (% of GDP)		Short-Term Debt ($-B)	Forex Reserves
Crisis Countries	1996	1997	1998	1998
Indonesia	-3.4	-4.5	27.0	28
Malaysia	-6.3	-9.9	14.0	24
Philippines	-4.5	-6.2	12.5	9
Thailand	-7.9	-3.0	32.0	20
S. Korea	-4.9	-4.2	60.0	17
Non-Crisis Countries				
Taiwan	4.0	1.8	29	81
China	1.9	2.5	42	141
Singapore	15.2	16.2	-	88

Source: Lita, 1998 (J.P. Morgan); Davies, Feb. 1998 (Goldman Sachs), BSP.

In the troubled Asean (Thailand, Malaysia, Indonesia, and Philippines), banks and private corporations were allowed to borrow from foreign banks, foreign bourses and foreign portfolio and hedge fund houses were allowed unrestricted entry and exit. In South Korea, foreign banks were allowed to borrow abroad. And how they borrowed! In troubled East Asia, the foreign exchange reserves to short-term debt ratio began to dwindle. Indonesia, the Philippines and S. Korea never seemed to have maintained high gross reserves. Malaysia and Thailand had high gross reserves but forex reserves fell relative to liability (Table 3). Finally, as the 90s wore on, foreign flows began to finance trade and current account deficits. The economic fundamentals had become shaky and a crisis set-up was developing.

Taiwan and Mainland China, by contrast, refused to follow the mad rush to lasso short-term capital. In a 1995 dinner address to the EAEA delegates in Taipei, the Taiwan CB governor criticized the rapid opening up of the capital account in East Asia.* Few people, then, realized how prescient he was! Taiwan consciously kept foreign money from bubble-prone real estate and stock market. Meanwhile, at the other side of Taiwan Strait, Mainland China devalued the Rmb on January 1994 by 50% to (a) slow down imports and reduce the threatening trade deficit, (b) to tax and in time discourage foreign money flowing into China's real estate sector. Likewise, Mainland China regulates capital flows apart from maintaining a dual stock market, one for locals (Shenshen) and another for foreigners (Shanghai) who can buy stocks of a limited number of public offerings. Barely two years after the Rmb adjustment, Mainland China is a trade surplus country with over $140 billion in foreign reserves. The danger is that Mainland China, *having tasted the fruits of competitive devaluation,* may decide to repeat January 1, 1994 in order to preserve its forward positions gained since 1994, now under renewed assault from the Asean. How its exports and trade account behave is crucial.

These inoculating factors, far from being lottery endowments, are domestic policy- related. It is heartening to note that the multilateral institutions (viz., WB and IMF) now carry the rhetoric of *prudent capital account liberalization* and recognize the value of the Chilean approach to hot money regulation after years of denial. It is even more heartening

*As related by then Dean, now Socio-economic Planning Secretary Felipe Medalla that the Bangko Sentral ng Pilipinas has targeted a rise of the gross international reserves to $20-b or about 4-5 months of imports to improve stability. A rise in GIR equal to 6 months of imports not by borrowing but *by absorbing and accommodating portfolio flows* (even at the risk of clashing with the IMF on monetary ceilings) would be a very welcome policy thrust. The difficult trick is to maintain an economic posture that diminishes the impact of external volatility without precluding external dynamism.

V. Made to Measure Devaluation

The decade from 1986 to 1996 can be viewed as a fateful if protracted journey towards political and economic stabilization. This march towards the market as the cradle of economic progress, as tentative and spasmodic as it seemed at times, was nonetheless substantial.

Under President Corazon Aquino, it took the form of trade liberalization and privatization even as the economy groaned under the mountain of debt it inherited. The Ramos Administration greatly widened the privatization net, quickened the pace of tariff reform, committed to and continuously implemented a progressive tariff reduction program towards a uniform tariff in 2003 and, more importantly, began the deregulation of the important domestic markets such as telecommunications, banking, shipping and transportation. Along the way, the foreign investment rules were relaxed, the foreign exchange market given a semblance of market determination and the capital account radically opened up (in regards portfolio flows and private foreign borrowing). Not all of these deserve applause, particularly the last, which for many, represents marketization gone berserk.

The Philippine economy is now closer to the market than at any time in its post-war history. That these occurred under the IMF tutelage and in the decade of worldwide acclaim of Adam Smith's vision in *The Wealth of Nations* should not diminish the achievement. Nor should the fact that in the second half of the same decade, most of the less developed world was in the same marketization ferment and we may not be farther ahead of the pack now than in 1986. If indeed the overall thrust was correct, why the two economic crises since 1986?

What was the *missing link* that rendered the fateful restructuring journey from 1986 to 1996 so fragile and so vulnerable to external shocks? It was the wrong exchange rate policy also known as the *cheap dollar policy*. This relic of the import substitution era has never been exorcised from our national consciousness. It seems that every reaffirmation of our national identity always requires the shift of consumption towards more and more imported goods. Which is why, those of us who fought the cheap dollar policy long and hard have known nothing but defeat. The *cheap dollar policy* at its most basic means continual subsidy to imports and continual penalty to domestic producers. It means a continual export of manufacturing jobs. It is not compatible with features (2) and (3) that saved Taiwan and Mainland China. This was true of Marcos, true of Aquino and also of Ramos. At the height of the Ramos recovery, businessmen were fleeing in droves from manufactures to real estate. The cheap dollar policy was choking economic recovery.

It is ironic that the currency crisis, which we view with fear and loathing, should turn out to be the bearer of some good tidings. The currency crisis has gifted us with *half of the missing link* alluded to above. To penalize imports and foster investment growth in manufacturing, we need two events: (1) a substantial nominal exchange rate adjustment *when the signs are good* and (2) a persistent low (single digit) inflation afterwards to preserve the incentives for investment in manufacturing. The first (substantial devaluation) we never had the political courage as a nation to effect *whenever the signs are good* (low inflation, normal forex reserves, fiscal balance, normal growth). We always had *devaluations only when the signs are unfavorable*. (high inflation, BOP crisis, dwindling forex reserves, fiscal imbalance). Devaluations under these latter circumstances, though necessary for stabilization, do not build economic muscles. The currency crisis has done for us what we failed to do for ourselves. The upward adjustment in late 1997, by contrast, came when, precisely, inflation was low, fiscal deficit close to zero and forex reserves normal. We make this comparison.

Table 3 gives the comparative picture of pre-crisis scenario for 1984, 1991 and 1998. It is immediately obvious that the years preceding 1998 showed indicators that were invariably better than the pre-crisis periods for 1991 and 1984, except in one: the trade and current account as % of GDP. The inflation was on the way down; the interest rate was on the way down, fiscal deficit was falling, output growth was healthier, GIR was normal, and export growth was healthy. The one big dark spot in the pre-crisis 1998 picture was the *trade deficit*.

The impression one gets is that in 1996-97, there was one loose end that was creating the trade imbalance and a policy adjustment can be trained to address this missing link. Not so in pre-crisis 1991 and 1984! There was a slew of imbalances and one needed a slew of policy initiatives to correct these. *An exchange rate adjustment alone could not properly address the array of fiscal and monetary problems.* The engine overheats from multiple causes: loose fanbelt, leaking radiator, no motor oil, etc. A new fanbelt alone cannot bring the engine to sustained driving. The same with exchange rate adjustment! It gets you nowhere if the whole economy is creaky. *1997 was different.* The engine was overheating but there was but one major source: the loose fanbelt! A new fanbelt gives it a new surge of power! The 1997-98 exchange rate adjustment opens up this type of possibility: an aggressive muscle-fixing devaluation (that rivals sometimes call "competitive devaluation"). Mainland China started this in 01 January 1994. By contrast, the devaluations in 1984 and 1991 were *never* competitive, they were all "stabilizing devaluations", just to get the fever down from 39ºC to 36ºC. Those devaluations could not, however large, correct massive faultlines in the fiscal, monetary and governance arenas.

If we had the political courage as a nation to effect a competitive devaluation, and were only waiting for the right moment to do so, we could hardly have chosen after 1993 a better year than 1997. Of course, 1993 would have been the best but that we missed that. 1997's was a made-to-measure devaluation! We only need to nurture it.

VI. Coping with the Crisis Philippine Style

A. Virtue By Default

The Philippines appears to be coping with the crisis better than its regional neighbors are. The reasons are far from flattering: (I) the Philippines came later to the "private foreign borrowing" party. It eventually had only a two-year frenzied borrowing window as against a decade for the rest of the region; (ii) the Philippines came to the party, in local joke parlance, "with a chaperon", i.e., it was after all an IMF ward, operating under strict IMF conditionalities, especially strict monetary ceilings. This reigned in somewhat the "easy money" frenzy in the 90s; (iii) the Philippines struggled with an economic crisis in 1984-85 and again in 1991-92; and (iv) the Philippines receives about $4-b in overseas contract worker remittance yearly. The devaluation from ₱26.00 to ₱40.00 to US $ has resulted in a transfer of about P70-b to OCWs and their households.

This turn of events appears, however, to reinforce the Philippines' image as marching in lock-step with Latin America which is doing better today relative to East Asia. When East Asia did well, the Philippines, as Latin America, did badly; when East Asia retreats, the Philippines does better, as does Latin America. The current crisis has not changed this image.

B. Responding to the Crisis

The response to the crisis had two distinct phases. Phase I lasted from September 1997 to the second quarter of 1998 (under the Ramos presidency). Phase II largely under the incoming President Estrada, started in about June 1998.

1. Phase I

The peso was allowed to float upwards in 11 September 1998. Attempts by the monetary authorities to reign in the exchange rate involved raising the overnight borrowing rates (OBR) and the required reserves. As the crisis deepened, the Central Bank sought and got a $3-b standby credit from the IMF as precaution against further deterioration of the forex reserves. The IMF swung into action with characteristic zeal. It insisted on the usual conditionalities.

a) a status quo on a ₱5-b fiscal surplus target for the year;
b) the imposition of stricter prudential rules for the banks such as the redefinition of NPLs;
c) a tight monetary policy and high interest rate to staunch the outflow of foreign exchange and a rise in loan-loss provision and reduction in real estate exposure.

The steep climb in prime lending rate resulted from the spike in the banks' liquidity preference consequent on the increase in required reserves, in loan-loss provision rules and in NPLs and a general sense of economic panic. Credit flow collapsed. Even exporters with export orders could not get credit. Private investment collapsed.

On the fiscal side, the government imposed a 25% forced saving on all government agencies to meet the ₱5-b fiscal surplus target. This was reinforced by a moratorium on fiscal expenditures due to upcoming presidential elections. Public investment growth fell.

To compound the panic, El Nino ravaged the countryside resulting in first semester Agriculture output growth of -7.5%, unprecedented in Philippine history. The outcome was predictable. A 0.2% growth in GDP in 1998 in 1998 S1, versus 5.0% in 1997 S1.

2. Phase II

President J. Estrada who ran squarely on the economic platform of lower interest rates to stimulate the economy in contravention of the IMF strictures, took over in July 1998. By then, wit revenue collection shortfalls of ₱80-b, a fiscal surplus had become a joke. The new government, convinced that it alone can break the panic and the coordination failure, entertained a fiscal deficit of 3% of GNP. It was going to pursue fiscal stimulus via infrastructure spending and low-cost housing.

On the monetary front, the Central Bank, sensing the ascendance and cogency of the lower interest rate rhetoric and the anger of the private sector, started gingerly along that path. The BSP first induced the bankers association to adopt a lower interest rate schedule, with itself as ultimate enforcer. This somewhat lowered posted rates but reduced access to credit and did not work. The lowering of required reserve was more successful in freeing resources for lending. But the situation is still schizophrenic. Banks are lending again but it is preferably to the government, which leaves the private sector still in a lurch.

The government sensing this, and in order to further stimulate activity, has provided funds from GFIs to be loaned at reasonable fixed interest rates. Borrowers studiously avoided variable interest loans in such volatile environment. Since the prime borrowing rate is about the same level but variable, this carries an implicit subsidy and constitutes a credible commitment to lower interest rate. Now housing loans with fixed rates are available through private banks.

The financing of the fiscal deficit remains a headache. The government has decided to ease up on domestic borrowing and to finance the bulk of its deficit by additional foreign borrowing from multilateral and foreign governments. Here the Miyasawa Fund will be godsend. Government also tapped FCDU as loan source. Private commercial loan spread is too large. All these are consistent with its lower interest rate policy but runs a currency risk. The Treasure has simply consistently rejected bids for T-bill auctions that are too high.

To ease the pain of the crisis, the government activated the use of *rolling stores*, which sell basic commodities at reduced prices in targeted depressed areas. Rice and sugar were imported for the purpose, which reduced or erased the subsidy element.

One really good sign in the policy front is the fact that all the actors and agencies in the economic policy team are *speaking with one voice*. The team has a coherent rhetoric in pursuit of the recovery while resisting excessive responses such as reforms reversal. The pressure for new protectionist measures mounts every quarter that the economy is in a downslide. If the economic team only succeeds in holding on to already achieved reforms, it would be already a feat.

3. The IMF Retreat

One really notable casualty of the crisis is the IMF's credibility. At the start of the crisis, the IMF resorted to its familiar formula of overall tightness. The fiscal surplus target was insisted on. When the IMF came to call in October 1998, it got little of substance in terms of concessions. In fact, it now insisted that the fiscal deficit target of 3% of GNP is too low and ~~can~~ be raised to 6-9%. It complained bitterly about the Treasury's consistent rejection of high bids of T-bill auction to little avail. Either the Philippine team got smarter or the IMF team lost its former intellectual high ground, or both. This is a milestone.

A. Exchange Rate: The Peso Appreciation

Our estimates show that the peso is, as of early October '98, undervalued relative to 1986 by about 15% (by RER or by DARER) versus an overvaluation of about 37% in July 1997. We have, in the last three months, attained a current and trade account surplus — rare moments in Philippine economic history. But the latter is a reflection of a very weak economy (» zero GDP growth) and thus a collapsed demand for imports. There is, in consequence, (a) a tendency for the peso to strengthen to accommodate zero growth of GDP, (b) a real danger of a whiff of portfolio investment roughing the ER into the thirties. An exchange rate consistent with zero growth will be vastly inconsistent with 4-5% growth and will threaten recovery with rising trade and current account deficits.

Viewed in this light, the current strengthening of the peso in early November '98 is very dangerous. It is not, as the BSP has lately claimed, a sign of recovery, but a sign of excessive weakness. If the appreciation is allowed to continue, it will wipe out the incentives restructuring gains from the crisis and devaluation manifested in the current undervaluation. If the current undervaluation is to beneficially impact on long-term recovery, *it must hold through the next episode of rapid investment.* This episode will come in 1999 and 2000. *If the peso appreciates now, the investment climate in 1999 and 2000 will be little different than in 1994-96.*

How should the BSP respond? The general idea is to convert the pressure for peso appreciation into a pressure to reduce interest rates consistent with the general strategy of the Estrada Administration.

(a) It should refrain from pointing to peso appreciation as a sign of confidence while the economy is growing at less that 5% GDP growth.

(b) It should shoot for exchange rate stability at a level between P42.00 and P43.00 where the economy has attained a relative comfort zone since June 1998.

(c) To do this, it should aggressively purchase dollars at the PDS within this band and *deliver on its promise to raise the forex reserves to $20b.*

The lowering of interest rate and the rise in forex reserves are, by far, the effective confidence builder and, by far, the most *correct strategy to stimulate a recovery without hostaging long-term sustainability.*

The experience of 1994-96 tells us in no uncertain terms that allowing the peso to appreciate has very temporary, if very tempting, benefits. It fits to the tee the Filipino phrase *"panandaliang aliw"*. In 1994-96, we pleaded with the BSP to purchase those dollars and raise the forex reserves to six months of imports. *We are pleading with the BSP today to heed this lesson of history.*

B. Inflation and the Exchange Rate

Another related object lesson of recent history is to try to harness peso appreciation to reduce inflationary pressure. This was the rhetoric put forth in defense of appreciation in 1994- 96. And it was and is, to an extent, correct in the short term. Insofar as the strategy created bulging trade deficits at the expense of domestic tradeables and helped the asset bubbles along by inducing even more foreign borrowing (in the sense of interest rate parity), the strategy was, in the long run (a horizon of four years), very inflationary. Again, *"panandaliang aliw kapalit ng pangmatagalang kirot."*

The current inflation is not a *monetary phenomenon* but a *cost-push* one combined with El Nino supply shock. With zero growth, expansionary monetary policy (induced by aggressive dollar purchase at the PDS) has little or no inflationary effect. That the general expansionary direction that the BSP has been pursuing in consonance with the Estrada strategy since the second quarter of 1998 is correct is that the inflation has softened from 10.7% in June to 10.0% in September even as the interest rate on TB91 is falling. This generally correct direction can only be advanced, and not hurt, by aggressive BSP purchase at the PDS.

C. "Danaos Dona Ferentes"

The Romans used to counsel fear of the "Greeks bearing gifts" ("Danaos dona ferentes"). Now the portfolio fund managers are beginning to look for bargains again in Manila, as Latin America and US stock markets look anemic. These were the same portfolio and hedge funds ogres who initiated the bubbles in East Asia before the collapse. In 1994-96, the economic managers in East Asia celebrated these ogres and their gifts. They even used their rosy reports to defend currency appreciation. They pooh-poohed the rising trade deficits as signs of strength rather than weakness.

In the closing days of 1998, economic managers, desperate for some or any growth and clutching at any straw of reassurance, will be sorely tempted to re-embrace hedge and portfolio funds. This will be a big mistake. A buoyant stock market is no sign of economic strength. Hedge and portfolio investors made Russia a stock market superstar right before the descent into the abyss. A wiser and older BSP will be better served by ignoring portfolio moneybags, however bulging are their pockets!

VIII. A Modest Alternative To Capital Controls

A. The Principal Postures

Three main strands dominate the debate on how to deal with the new global financial realities, in particular, massive and lightning-speed capital movements:

1. Free Trade View

This view, championed by the Wall Street-IMF-Treasury gnomes, is an extension of the free-trade-in-goods paradigm, which, after the collapse of the Soviet Bloc, has all but taken over. Since free-trade-in-goods has served the world economy very well (apart from minor costs that can be addressed by Dixit-Norman or lump sum taxes), free trade-in-capital must, by analogy, be similarly welfare improving. While the proposition appears largely unobjectionable in the case of long-term *direct foreign investment* (whether trade-reducing in the Mundell sense or trade-increasing in the Kemp-Jones sense, it invariably leads to factor-price equalization and welfare improvement except in the case of substantial trade distortions (Johnson-Brecher-Diaz-Alejandro)), the case of portfolio and short-term capital is hardly in the same category. More often than not they swarm to exploit existing price bubbles, distortions or propensities to the same and pull domestic resources along in a joy ride that ends tragically. The principal proposition in the Free Trade-in-Capital view is that the benefit of free capital movement (availability where most needed) outweighs its potential for harm if the banking and financial sector is open, competitive, properly monitored and accountable. Thus, the East Asian Crisis is largely due to a primitive (backward) banking sector unable to handle capital inflows and wallowing in cronyism. Prescription: reconfigure the domestic banking institutions to fit free capital mobility.

The rescue workout on the failed LTCM hastily organized by the FRB of New York signals that there is trouble even in financial paradise. In this case, unhampered trade in derivatives and their mutants designed by Nobel winners and their number crunchers threaten the "model" financial sector. The US "Savings and Loans Association Debacle", not quite out of memory yet, reminds us that banking whether in Main Street, USA, or in Pattaya, Thailand, is a minefield and has to be protected from itself. Whether aware of it or not, East Asia used the banking sector as an appendage to its development drive, heavily influencing the allocation of resources towards traded goods and infrastructure. This was highly applauded before the crisis as "developmental governance". What it did, unbeknownst to itself, was implement a *Stiglitz-Weiss rationing* to limit resources to "high-risk, high (short-term) return", bubble-prone sectors. From this vantagepoint, and in this environment, the financial policy was as modern as modern gets.

Capital mobility, however, undermined the financial environment and thus the banking sector rendering these unstable.

2. *The Targeted Capital Control View*

The spectacle of Taiwan and Mainland China weathering the current East Asian turmoil and Chile weathering the Mexican Tequila in 1994-95, has convinced many people that capital controls targeted at short-term capital is the safer way to navigate the financial ocean. Thus, J. Stiglitz, J. Bhagwati, lately S. Fischer of the IMF have paid minor or major obeisance to limited capital controls. In the case of Chile, it is in the form of a bond deposited with authorities interest-free if the capital investment is withdrawn within the year. It thus functions as a differential tax on foreign investment. The domestic currency remains a managed float and the message is the following: the value of the domestic currency is determined by long-term fundamental flows not by fickle sentiment (reflected by short-term capital movement). The drawback here is that it has no defense against locally financed asset bubbles such as the Taiwan bubble which collapse in 1990 (stock market fell 80%) or the Japanese Bubble Economy in late 80s whose collapse affects the world even today.

3. *Currency Controls*

This is capital control of the pervasive variety, affecting all types by dropping free convertibility of the domestic currency, which is usually fixed against the US dollar. Thus, local or foreign investors are forced to hold on to their peso assets. This is an extreme form of capital control because value of the domestic currency is administratively set and unreflective of either long-term or short-term supply and demand. Forex rationing is its usual form. China exemplifies this. While this may have short-term stability impact, its long-term impact is, on average, associated with the Latin American disease. Malaysia embraced it and Russia followed. Its advocates all claim that this is no more than a short-term measure as does its "get radical" proponent P. Krugman.

4. ***Free-Trade cum Global Intervention***

A concession to the increasingly undeniable disruptive nature of portfolio capital, free trade advocates propose international governance to mitigate the problems:

(i) IMF as lender-of-last-resort which calls for greater resources. This allows stricken countries more ammunition to fight back. The G-7 appears to endorse this tack with a pledge or billions of new monies for the IMF.

(ii) Chapter II type "orderly workout" which allows stricken economies to treat "new money" differently than "old money" along the "Brady bonds" framework. This will throw the risk back to creditors since their collectibles could sell at huge discounts. Who enforces the provisions of bankruptcy remains a question. J. Sachs proposes that a chapter 11-type workout could be initiated with expressed permission of the IMF.

(iii) Greater monitoring and surveillance of LDC by the IMF or some other specialized super body. But these proposals leave the defense of LDCs to external bodies and intervenors apart from the uncertainty of it ever being implemented.

(iv) In line with global governance but in a completely different spirit, C. Wiplozs suggests that LDCs should be restrained from capital account liberalization and that the right to do so should be rationed!

B. Time-Graduated Capital Gains Tax

1. Motivation

This proposal is motivated by several observations: (a) portfolio and short-term borrowing became a real problem when they financed asset bubbles, thus, rendering the financial sector uncovered and vulnerable to reversals at bubbles end; (b) local capital were drawn into the bubbles frenzy to the detriment of non-bubble sectors; (c) asset bubbles made their appearance in Taiwan when its substantial capital gains tax structure was dismantled. The proposal targets two sectors: the stock market and real estate market, where bubbles are endemic.

2. Features

The graduated capital gains tax proposal has the following features:

(a) The sale of stocks closed between 1 (purchase day) and 364 days after purchase is subject to a capital gains tax of 100% of all capital gains in excess of the TB91 rate prevailing at the close of the deal.

(b) The effective capital gains tax then gradually retreats to: (i) 70% of capital gains in excess of the TB91 rate compounded two years if the sale is between 365 and 739 days after purchase date; (ii) 50% of capital gains in excess of compounded TB91 rate $r(1+r)(1+r)$ if the sale is between 730 and 1084 days after purchase.

(c) A flat 15% of capital gains thereafter.

This will supercede the current flat capital gains tax of 20%.

IX. Summary

A. East Asia

This paper has engaged many issues in regards the East Asian currency crisis. It first fields an interpretation of the Asian crisis with a new spin, even a contrarian spin. It rejects the Western penchant for heaping blame solely on domestic institutions (banking, both central and commercial and governance) and refusing to accept that somehow the engine of East Asia's great success (the East Asian model) foundered under a radically new environment involving the capital account. The East Asian model has no peer in delivering growth in the catch-up environment of restricted capital mobility. Denied the latter, the East Asian model falls into a quagmire of policy inconsistency. Out of the water, even the barracuda goes spastic.

The paper also explored the political economy, both domestic and global, of capital account opening and concomitant policy responses such as the bias for strengthening currencies. The East Asian crisis is a process of healing. The IMF would like to see East Asia reconfigured according to the imperatives of open capital account. We opine otherwise. Targeted capital restrictions and a reconfigured domestic incentive structure in favor of tradeables can restore dynamism to East Asia. This process is all about fundamentals.

We also suggest that the East Asia crisis has bottomed both in the Philippines and in the region. The fundamentals are being slowly improved. But the process of healing is being threatened once more by appreciating domestic currencies. The ugly head of "hot money" is once more rearing its head to the blind applause of policymakers desperate for any reassurance. Where the domestic economy is very weak and real interest rate is relatively high, thanks to muted inflation, free capital mobility can and will force appreciation of the floating domestic currency. Even before they have failed, East Asian managers are again drawn into the very same speculative game that brought them low. East Asian monetary authorities must "Buy, buy, buy", i.e., buy foreign exchange to raise reserves. In the process, interest rates move downwards to stimulate recovery.

B. Philippines

The Philippines has a long romance with economic crisis. The 1997-98 crisis offers the best opportunity for incentives restructuring and breaking out of the boom-and-bust mold. The circumstances under which it occurred are very favorable for incentives restructuring. Marcos' watch ended with an economic bust; Aquino's watch ended with a bust; Ramos' watch ended with a bust. Will Estrada's end with a bust?

The Estrada economic team is doing a good job at managing the crisis and plotting the recovery. They are speaking with one voice so far. But the appreciation of the peso threatens the long-term viability of this recovery and the prospect of Estrada winding up without a bust. The BSP has publicly declared its intention to raise the gross international reserves to $20-b. Now is the time to be doing this — buy, buy, buy dollars in the PDS. President Estrada should avoid the mistake that suckered President Ramos — *to declare the peso appreciation as a sign of confidence in the economy* while GDP growth is below 4%.

The PAL predicament presents another test case. In an effort to keep it afloat, there are suggestions to the effect that GSIS and other government resources be marshaled. This is a mortal sin. If government's resources are once again wagered to keep certain private interests afloat, the economy is back to the Marcos years. This is both horrid fundamentals and horrid image management. PAL was privatized precisely to safeguard government coffers from the ravages of moral hazard. A government rescue package will now confirm in many people's mind that the Estrada Administration is really under the thumb of cronies. Double the insult, since they also appear to be Marcos cronies.

The crisis represents a tremendous opportunity. Can we, at the turn of the Century, buck our long history of squandering opportunities? Or are we condemned to repeat the mistakes of our forebears? Not, would to God, again. Not, would to God, this time.

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