The Developing Economies, XXXVII-4 (December 1999): 439–59

THE ASIAN FINANCIAL CRISIS AND PHILIPPINE RESPONSES: LONG-RUN CONSIDERATIONS

Florian A. ALBURO

I. INTRODUCTION

More than a year after the outbreak of the Asian financial crisis, there still does not seem to be a consensus as to its proximate causes and therefore what measures ought to be attended to avert its recurrence. Despite the numerous papers (scholarly as well as popular), conferences, publications, and official meetings that have proliferated, there is no convergence on its explanation—its unpredicted occurrence, its severity, and its wide spread across Asia and the rest of the world. At one extreme is a school of thought that the crisis was caused by fundamental weaknesses in the economies of the affected countries manifested by macroeconomic imbalances, excessive borrowings, overvalued currencies, and poor investments, among others (Moreno, Pasadilla, and Remolona 1998; Glick 1998). At the other extreme is an argument that the crisis was triggered by speculators and their panic behavior of fleeing emerging markets in fear of losses (Moreno 1998; Montes 1998). Between these two extremes are various shades of explanation. There is the notion of lack of governance in both public and private transactions especially in terms of close relationships between financial institutions and regulators.[1] There is the notion that corruption weakens the system of investment decision making in emerging markets. There is the notion that "Asian values" had dictated the manner of financial exchanges. There is the notion that the crisis is essentially a bubble crisis (Nomura 1999). While the truth may lie somewhere between these two extremes, these have different policy implications. If the crisis was caused by fundamental weaknesses of the economy, the crisis-hit countries should carry out reforms to improve the foundation for sustainable development. On the other hand, if the crisis was caused by the sudden loss of confidence among short-term investors and speculators not directly related to country fundamentals, then the essential task is not really reforms nor would they be necessary. Restoring confidence where the basic fundamentals are "correct" may require other measures

[1] The empirical question is whether there has been a rise in "corruption" and decline in "governance" in Asia prior to the crisis or whether this has remained the same and thus cannot have been a major cause of the crisis. For an interesting debate on this see Columbia Business School (1998).

that would bring back investors.[2] Without a clear specification which of these explanations jibes with the actual experience among the affected Asian countries it would be difficult to prescribe policy options.

There have been many attempts at quantitatively measuring the degree of importance of these factors in the evolution of the Asian crisis but events are still unfolding and until there is a definite "bottoming out" and a return to the growth experiences of the past these attempts remain incomplete. What seems evident however is a finding that weaknesses in the financial systems in Asia were stronger explanations of the crisis than of basic fundamental flaws in the economy (McKinnon and Pill 1998). The unusually large flows of short-term capital in these countries exposed them to reversals eventually draining reserves and squeezing liquidity. Moreover one particular reason for the quick transmission of the crisis from Thailand in July of 1997 into the other Southeast and East Asian countries was the high degree of financial and trade integration among them (Glick and Rose 1998). The vulnerability of the financial sector to external shocks was not a product of the economic fundamentals but of more micro aspects of the sector such as "less-than-arm's-length" transactions and poor risk management, which led to unusual credit booms. Indeed there is an argument that none of these explanations suffice since the Asian crisis is a bubble crisis, had its beginnings much earlier than the explosion in Thailand, and runs across most of Southeast and East Asia (Ichimura, James, and Ramstetter 1997).

In the more formal theoretical models of foreign exchange crisis, second-generation and third-generation models emphasize the importance of government conflicting objectives and interaction between banking and balance-of-payments crises, respectively. In this sense there is no necessity for domestic policy failures to precede a crisis for governments to decide to alter its exchange rate policy in the second-generation models. Domestic banking crisis however often precedes payments crisis among the third-generation models. The Asian crisis itself has spawned some theoretical exploration explaining the behavior of agents and institutions to overborrow that rely on the implicit government guarantees under fixed exchange rates (Krugman 1998; Montes 1997).

Both the empirical works and the extensions of the theoretical foundation have clearly enriched the competing alternative ways of describing the onset of an exchange rate crisis. While this may make it more difficult to ascertain the more likely channels and mechanisms that approximate the actual experiences, they provide a new set of issues and concerns which otherwise were overlooked in the past.

Despite this lack of consensus on the root causes of the Asian financial crisis, there is growing evidence that most of it has in fact subsided and the affected coun-

[2] Even if economic fundamentals may be there the *political* environment may not be there. So Indonesia is often illustrated as having the economic fundamentals right but not in other areas.

tries have bottomed out. What is not so clear is whether this recovery is sustainable and growth gets back on track. This paper argues that the Philippines (i) was equally exposed to the financial virus that affected the rest of Asia, (ii) suffered from its impact beyond the financial areas, (iii) took a response that seemed appropriate to the symptoms of the crisis, and (iv) has been damaged in the long run despite its early recovery. We begin by pointing out in the next section that the Philippines had all the symptoms of the "Asian flu" even before the crisis erupted in Thailand and thus was not an innocent bystander. Indeed if the events did not unfold in Thailand earlier the country could have erupted into its own crisis. In the third section we briefly describe the economic and financial impacts of and responses to the crisis. The end results seem to show that the country had taken the right approach to the management of the crisis. The fourth section tries to document the concomitant social effects of the crisis and responses. In the fifth section we outline the consequences of the responses and strategy applied by the country. Here we argue that the resulting outcome has created a potentially long-term injury. A final section sets forth my conclusions.

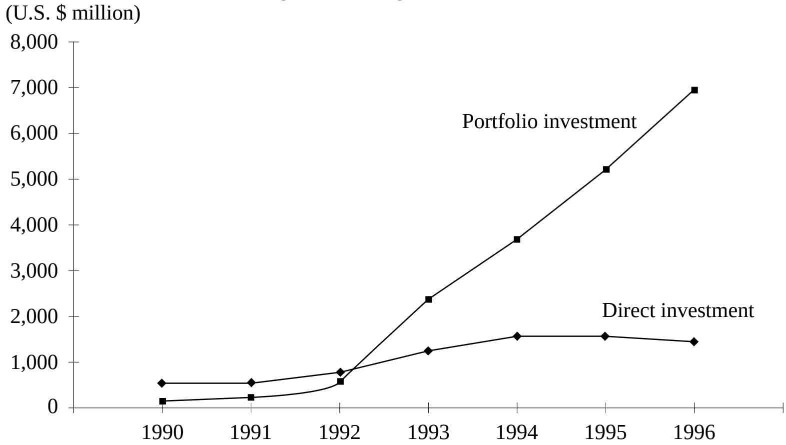
II. DELAYED START OF CRISIS IN THE PHILIPPINES

The Philippines manifested several symptoms of the crisis such as (a) the surge of short-term capital mostly in the form of portfolio investments relative to the flows of foreign direct investments, (b) a bubble in the economy shown by exuberance in the stock markets and price inflation of real estate and nontradables, (c) the rapid expansion of domestic credit extended by the commercial banking system, (d) a widening current account deficit, and (e) an overvaluation of the local currency. It will be recalled that these are also, but not exclusively, the same symptoms of the Mexican crisis in 1994.

The Philippines experience with short-term capital inflows has been relatively recent. In fact the portfolio capital component of them was negligible before the 1990s. Yet this surged beginning in 1993. From U.S.$156 million in 1990 this rose to U.S.$6.9 billion in 1996. Figure 1 shows the inflow of foreign investments in the Philippines. Notice the sharp increase after 1992 with a consequent scaling down of foreign direct investments.

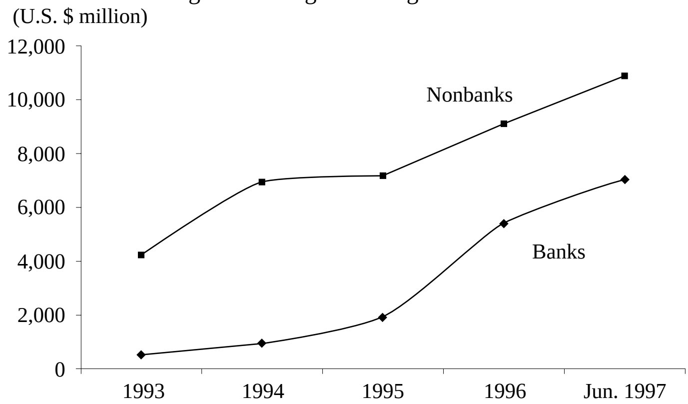
Apart from the inward flows of short-term portfolio investments, the country's financial institutions also tapped the global markets for both short-term and long-term foreign exchange resources. In the former, borrowings were utilized to take advantage of interest-rate differentials and the stable exchange rate for onward lending to local borrowers in local currency. For the latter, the institutions floated long-term bonds in international markets. Again the data show that borrowings, especially by banks, did surge but only beginning in 1995. Figure 2 tracks the foreign exchange liabilities (short and long term) of banks and nonbanks. Total liabilities

Fig. 1. Foreign Investment



Source: Bangko Sentral ng Pilipinas.

Fig. 2. Foreign Exchange Liabilities

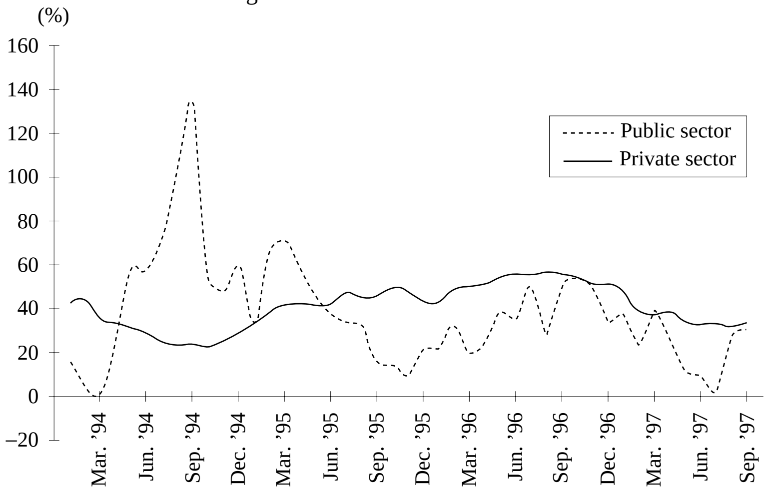


Source: Bangko Sentral ng Pilipinas.

stood at U.S.$4.7 billion in 1993 and surged to U.S.17.8 billion by 1997 (June). Though there may be issues here with regard to the use of Foreign Currency Deposit Units (FCDU) of offshore banks in the Philippines, the fact is that borrowings by the private sector escalated in two years between 1995 and 1997.

Portfolio investment inflows in the Philippines have found their way into the property sectors, into the stock markets, or into financial institutions, among others. Driven by continued privatization of public enterprises, initial public offerings by

Fig. 3. Growth of Domestic Credit



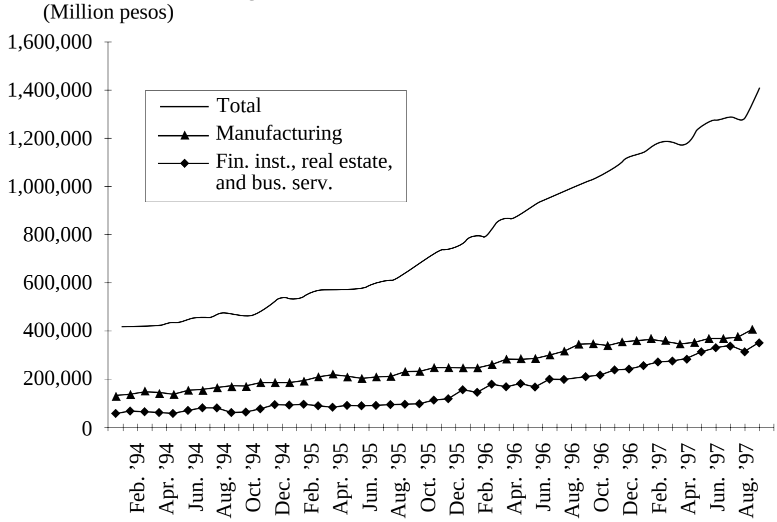
Source: Bangko Sentral ng Pilipinas.

corporations, and overall "irrational exuberance," these investments drove up asset prices and created large paper gains in the stock market. The flotation of the First Philippine Fund (FPF) in the New York Stock Exchange helped this along especially after 1992. Evidence of the property bubble can be readily observed in the rapid decline in property prices around the prime areas of the country, the shelving of planned property construction, and the sharp drop in prices of club and golf course shares in the immediate aftermath of the crisis.

Figures 3 and 4 cap this manifestation. Domestic credit had annual growth rates in excess of 50 per cent beginning in 1996 with an increasing proportion going into financial institutions, real estate, and business services. Commercial bank loans to the manufacturing sector tapered off during the same period of rapid domestic credit growth (see Figure 4). Indeed there is consistency in the timing of these changes in the behavior of financial institutions especially during the mid-nineties.

Although these surges appear to be significant especially if viewed in potential trends, the stock magnitudes are far from alarming. Of the U.S.$44.8 billion external debt of the country (June 1997), only U.S.$8.5 billion or 18.9 per cent are short term in maturity with the rest in medium and long term. More than half of the debt is owed by the private sector with the central bank accounting for 24 per cent of the total. Finally, 25 per cent of the debt is owed to Japan with another 24 per cent owed to bondholders and noteholders, and 18.5 per cent owed to multilateral agencies. The rest are spread evenly across the United States, United Kingdom, France, and Germany. Banks, financial institutions, and suppliers account for 26.8 per cent of

Fig. 4. Commercial Bank Loans



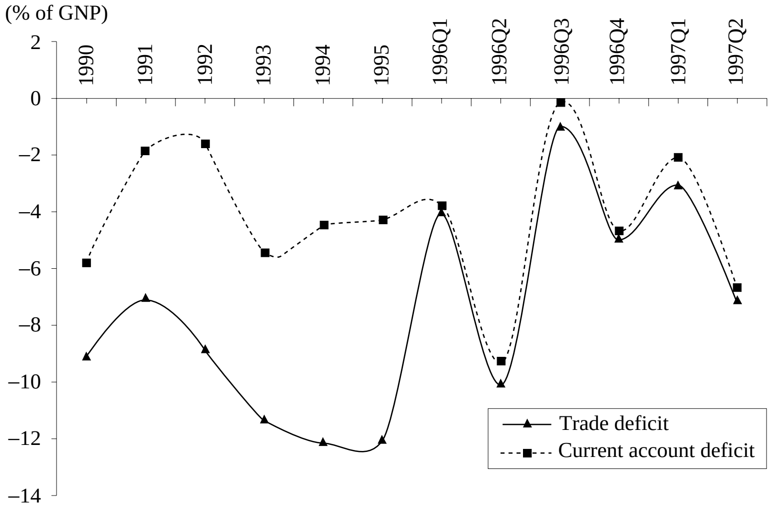
Source: Bangko Sentral ng Pilipinas.

the external debt in terms of institutional creditor with another 30.3 per cent owed to bilateral agencies (e.g., export agencies).

In terms of the trade and current account deficit characteristic, the Philippines has had a trade problem for some time and it has been persistent. On the other hand its current account deficit has fluctuated over the years narrowing the trade deficit with surpluses in the services trade, and net transfers. As a major source of overseas contract workers, Filipino workers send remittances, which partly pay for the country's trade deficits. In fact without these the Philippines current account would have been in a worse position. A look at Figure 5 reveals these facts. The current account deficit as a per cent of GNP never hit above 6 per cent with the exception of the second quarter of 1996. But in the second quarter of 1997 before the actual crisis took place the current account deficit stood at 6.7 per cent of GNP, which somehow was a threshold during the Mexican crisis. The narrowing of the gap between the two deficits has been covered by the surge in the net services trade. For example this item had an inflow of U.S.$4 billion in 1994 from U.S.$1.5 billion in 1990. By 1996 just before the crisis this had reached U.S.$6.8 billion. Of this net inflows remittances from overseas Filipino workers constitute more than 60 per cent.

The overall balance of payments (BOP) of the Philippines has been positive for most of the years between 1990 and 1996 principally because of a positive capital accounts position. In turn this has been carried by more significant inflows of me-

Fig. 5. Trade and Current Account Deficit



Source: Bangko Sentral ng Pilipinas.

dium- and long-term loans. It is only in 1995 when the net portfolio account began to be significant in the capital accounts.

A widening goods-trade deficit is a reflection of lack of competitiveness of Philippine exports. The extent to which a nominal exchange rate is unable to adjust relative to competing countries partly determines the extent of the deficit. To portray this more accurately, the real effective exchange rate (REER) is often calculated. The calculation of a real effective exchange rate is quite sensitive to the base year chosen, the countries included (and excluded) in the calculation, and the price indices. Thus there are many such indices. What is important to remember is that the REER of the Philippines is relevant when compared with the countries that we compete with in other external (and common) markets. A number of the recent calculations of these REERs for the Philippines appear to show that the country has been losing out to other countries in the region despite the fact that all other currencies have been overvalued. In short the peso has been more overvalued than the other currencies reflecting the long history of the currency's real effective values over time.[3]

In summary, it is evident that the Philippines had all the symptoms of a financial crisis even if it actually was not a direct casualty of the crisis that exploded in the region. What has kept it from acquiring the severity that others have experienced is

[3] For one of the more recent calculations of the real effective exchange rates in comparison with several Asian countries, see De Dios et al. (1997). Earlier calculations in the seventies and eighties which give similar results are found in Medalla et al. (1995).

its late exposure to the symptoms and not necessarily that the country had strong "fundamentals" to begin with. This does not mean that the measures being taken to address the root causes of the "Asian flu" should not be applicable to the country as well.

III. ECONOMIC AND FINANCIAL IMPACTS AND RESPONSES

The crisis was immediately transmitted to the country through the sharp depreciation of the peso—from a stable rate of P 26.4 to a U.S. dollar in June 1997 to a rate of P 42.7 by January 1998. The contagion took effect within days of the Thai baht depreciation and despite feeble attempts at defending the exchange rate there was not enough foreign exchange reserves to sustain it and by the end of July 1997 the rate was allowed to float freely. Via the route of exchange rate changes the rest of the economic and financial sectors were immediately affected. As private debt obligations in foreign currency were due (or re-financed as the case may be) their local currency requirements multiplied endangering the viability of projects (and debtors) and threatening the financial system as a whole. Consequently the inflation rate shot up by 1998 after falling to a cyclical low in 1996 (Reyes et al. 1999).

Thus, just as the Philippines was beginning to accelerate in terms of real GDP growth rate (from among its growth cycles), the Asian financial crisis erupted which spread to the country. The economy still managed to post a respectable growth rate of 5.8 per cent in 1996 before settling at 5.2 per cent in 1997 and then crashing to a –0.5 per cent decline by 1998. Indeed the year 1996 was the cycle's peak. This is the same pattern for growth among the affected Asian countries (in the sense of the growth decline not in the sense of growth cycle peaks and troughs) except for Thailand, which saw its growth decline starting in 1997. In fact if one looks at the record of real GDP growth rates between 1980 and 1997 there are three distinct growth "cycles" with their own peaks and troughs with the last one beginning in 1993 and peaking in 1996 (Reyes et al. 1999). This time the decline has been triggered by an external event in the form of the Asian crisis.

The economic and financial impacts of the crisis were not only immediate but were also clear in the sense that the transmission process is readily traceable. In fact, Table I shows some economic and financial indicators for the country in the three-year period 1996 through 1998. The peso depreciation raised the inflation rate, lowered the current account/GDP ratio (through import contraction), and of course led to the decline in the overall growth rate. The contraction in the money supply was equally drastic from 20.5 per cent in 1997 to 7.1 per cent in 1998. On the fiscal side, there was a slight increase in the deficit in 1998 from a surplus in 1997.

The country's response to the crisis can be seen from the reaction of its central bank. As early as June 1997, the Bangko Sentral ng Pilipinas (the Central Bank of

TABLE I

ECONOMIC AND FINANCIAL INDICATORS: PHILIPPINES, 1996–98

	1996	1997	1998
Real GDP growth rate (%)	5.7	5.2	–0.5
Inflation rate (%)	8.4	5.0	9.0
Interest rate (T-bill rate in %)	12.3	12.9	13.4
Money supply growth rate (M2 in %)	15.8	20.5	7.1
Real growth of private consumption (%)		5.0	3.5
Fiscal balance (% of GDP)	0.4	0.1	–1.8
Current account balance (% of GDP)	–4.7	–5.3	2.0

Sources: National Statistics Office, Bangko Sentral ng Pilipinas, and National Statistical Coordination Board.

the Philippines) had taken some measures addressing the financial sector problems and some of the regulatory and prudential weaknesses, which as shown in the previous section were manifested in some indicators (Alburo 1998; Paderanga 1998). For example, bank loans to the real estate sector were limited to not more than 20 per cent of banks' total loan portfolio, more cover were required for the foreign exchange liabilities of the Foreign Currency Deposit Units (FCDU), and guidelines were issued on the duties and responsibilities of bank boards of directors. And at the end of June (*before* the actual eruption of the crisis) when there was perceptible pressure on the foreign exchange markets, the central bank raised its overnight lending rates by 100 per cent (to 34 per cent).

As the Thai baht was attacked on July 2, the immediate response of the Philippines was a defensive one, i.e., to become a residual seller of foreign exchange drawn from the country's foreign exchange reserves. Given the limited reserves of the country and the possible extent of the crisis in Thailand, this immediate response proved to be a futile and costly battle. After losing more than U.S.$1.5 billion in early defense of the peso, the Philippines finally devalued the currency on July 11 (by 9.7 per cent between the end of June and the end of July). Between the July 11 action and the end of the year with the Korean crisis breaking out in December, the peso had devalued by 43 per cent.[4] The central bank had only feeble participation in the country's foreign exchange market preferring to intervene through the interest rate route (reverse purchase, overnight rates). At one time or another in the immediate aftermath of the crisis the central bank floated the proposal for high interest bearing securities to ward of "speculators" in the currency markets. This did not fly as those with fresh history had pointed to the debacle on the central bank coffers resulting from such instruments.

[4] This was calculated by using the peso-dollar exchange rate between July and December 1997. In very large discrete devaluations it may be more appropriate to use the dollar-peso exchange rate.

Subsequently, the government continued to allow interest rates to remain high relative to what they were before the crisis putting them still in their firefighting mode. With interest rates hovering around 30 per cent in the months following the crisis,[5] they suggest that potential investments would be crippled, existing enterprises would be hit by the crisis from two fronts—foreign exchange obligations in local currency terms escalate and interest payments balloon. Indeed, the central bank even raised the liquidity reserves between the end of July and the end of August in addition to the statutory reserve requirements raising the costs of investments. This policy reflected an intention of stabilizing the exchange rate (or "restoring confidence") while keeping a lid on domestic demand. These immediate and subsequent policies though appropriate in the sense of stabilization were at the cost of the contraction in the real economy without clearly correcting the problems of the financial and banking sectors.

Apart from these policy responses on the banking side were actions intended to safeguard the system from similar episodes in the future. For example, there was a reduction in the allowable overbought foreign exchange position of banks, the consolidation of bank accounts with their subsidiaries and affiliates when computing for foreign exchange positions, and the institution of a non-deliverable forward hedging facility (Alburo 1998).

Although it had been shown that foreign direct investments (FDI) seemed to be immune from the effects of the crisis (based on the behavioral assertion that these are determined by long-run profit considerations),[6] the facts indicate that FDI did fall by 1998 from previous levels before the crisis. Ironically, comparisons with the severely affected Republic of Korea and Thailand show that FDI increased in those countries in the period after the crisis. It is not clear whether recent FDI behavior in the Philippines (and for that matter Korea and Thailand) can be attributed to the crisis or not given the short span of time when changes took place. What is clear is that if FDI behavior had been influenced by the crisis, the affected countries' long-run growth sustainability would be threatened even more since the more stable component of capital flows would then be subject to the vagaries of short-run changes.[7]

The financial turmoil arising from the crisis was exacerbated by the high interest-rate policies to quell speculation. Nevertheless from the point of view of the

[5] Although the Treasury bill rate rose only by 5 per cent between 1996 and 1997 on a yearly basis, the prime rates that banks charge their best clients escalated during the crisis.

[6] See UNCTAD (1998) for some econometric testing of the influence of long-run variables on the movement of FDI.

[7] In explaining FDI into the Philippines in the nineties some of the short-run variables have been important determinants. For example movements in the stock price indices behave positively with FDI. But this does not mean that FDI went into purchases of stock market instruments. Rather the indices may be surrogates for long-run profitability in the country (Alburo 1999).

banks the crisis raised the magnitude of non-performing loans (NPL) in their portfolios. This in turn necessitated recapitalization to restore asset qualities. The ratio of NPL to total loans in the Philippine banking system stood at 11 per cent (November 1998) from a ratio of under 4 per cent prior to the crisis (Gochoco-Bautista et al. 1999). This remains unalarming when compared to the NPL ratios for Korea (at 21.8 per cent) and Thailand (at 40 per cent in June 1998). With slow growth and recovery one can expect more capital impairment among commercial banks in the Philippines.

The impact of the Asian crisis on the economy and the financial system was immediate. Through the sharp depreciation of the currency following the baht depreciation, the financial system's reaction, the dramatic decline in trade, and the fall in investments all drove the economy to the ground albeit in delayed fashion. But these impacts were far from the magnitudes experienced in the countries directly hit by the crisis. Given the relatively low ratio of NPLs, the country was far from seeing a collapse of the banking and financial system or the urgent search for recapitalization of the system. Indeed the financial system remained stable despite the apparent strains created by the sudden increases in the NPL ratios.

The policy responses to the crisis, both immediate and subsequent, parallel those of the other crisis-hit countries. The immediate ones were aimed at the stabilization of the financial system including measures to address some of the prudential and regulatory causes of the crisis.

The country's responses to the crisis elicit several observations. First is that they were considered the first line of defense, e.g., a discrete jump in the exchange rate after all efforts to prop it up failed. This first response is costly especially in social terms as foreign exchange reserves are spent to support private financial losses and mask the real structural conditions of the economy requiring correction and adjustment. Second is that the measures to stabilize the country through interest rate worsens the domestic side of the economy as even the viable projects lose their viabilities at the margin. The first cost pointed out is simply multiplied but the side effects become larger. Third is that the immediate support given the banking and financial systems confirms the implicit guarantees governments and international financial institutions provide private transactions that do not reflect moral hazard (Krugman 1998). Fourth, these responses, measures and costs are just the initial phase of the systemic consequences of the crisis. Those consequences (detailed below) have often been ignored in the discussion of issues emerging from the crisis. The focus of attention has been unduly confined to the financial and banking sectors. While this may be appropriate it would imply or gives the impression that correction in those sectors solves the crisis problems. Finally despite the fact that the Philippines did not utilize IMF windows to any significant degree during the height of the crisis, its policy responses were analogous to those of the countries that were directly hit. Indeed it behaved as if it were in the midst of the crisis belying official pronouncements that the country was not part of it. Recall that the IMF played a major role as the crisis deepened in Thailand and Korea and thus in their policy prescriptions.

IV. SOCIAL IMPACTS AND RESPONSES

The effects of the crisis in the Philippines extended beyond the confines of the financial sectors described earlier. Indeed through these sectors the other parts of the economy were similarly affected. There clearly are social impacts from this crisis. On the other hand it has to be recognized as well that the responses themselves have derivative impacts. Thus this section traces the social impacts from the crisis and the associated responses and vice versa.

The Philippines, as a result of a lackluster economic performance over the years, does not really have a laudable human development condition. Ranked according to the Human Development Index, the country is fourth among the ASEAN countries after Singapore, Malaysia, and Thailand while ahead of Indonesia in spite of the fact that for some of its components the country ranks first, e.g., adult literacy rates and mean years of schooling (UNDP 1998). Its social conditions were already wanting as the crisis unfolded in the region. Invariably the crisis may have worsened the economic *and* social conditions.

First of all, the contraction of the economy triggered by the immediate currency depreciation raised the unemployment and related indicators. However measured, the unemployment rate increased in 1998 to its highest rate in the decade keeping in mind that this rate is also the highest among the ASEAN-6 countries and among those affected by the crisis (ADB 1998).[8] In addition the underemployment rate also increased between 1996 and 1998 though not as marked as unemployment itself. Associated data from the Bureau of Labor and Employment Statistics show that the number of firms reporting either closure, retrenchment, or worker rotation more than tripled between the first quarter of 1997 (before the crisis) and the first quarter of 1998 (in the midst of the crisis). At the same time the number of workers affected likewise tripled during the same period. However the largest component of the workers affected were on temporary lay-off (47.6 per cent) rather than permanently laid-off (42.5 per cent). The 1997 figures had 77 per cent of the affected workers permanently laid-off.

The increase in unemployment that the crisis caused set off a chain reaction throughout the economic system unleashing more adverse effects. The incidence of poverty quickly rose as fixed income earners and other vulnerable groups were

8 The estimation of unemployment rates is seasonally sensitive. In the Philippines the second quarter (April) surveys generally register the highest unemployment rate (students of labor force age are on vacation). The figures in Table II use the third quarter results which do not reveal the substantial jumps in the unemployment rate between 1996 and 1998.

affected through loss of livelihood and through increases in prices. These affected groups in turn responded by cutting down on expenditures, forgoing further education of their children, postponing consumption of medical and related services, and other amenities. In one sense these impacts were direct results of the crisis. On the other hand the way policies have reacted to the crisis has also created social impacts which have either aggravated the initial effects or muffled them.

There is no doubt that poverty incidence must have increased in the course of the crisis but there is no quantitative basis for this assertion. Poverty incidence did decline from 35.5 per cent of families in 1994 to 32.1 per cent by 1997 though the absolute number of poor families increased (Reyes et al. 1999).[9] In a household survey on self-rated poverty, the incidence increased from 40 per cent just before the crisis to 43 per cent in January 1999. While these two results are not comparable, they indicate that the magnitude of poverty has been high to begin with and this has likely increased arising from the crisis.[10]

One of the safety valves of high unemployment and poverty incidence has been the continuing deployment of overseas Filipino workers abroad who remit their earnings which support the country's balance-of-payments accounts. The crisis affected the emerging Asian destination markets for these workers and thus their deployment. In fact there was only a slight increase of 1.1 per cent in numbers deployed in 1998 compared to the 13.3 per cent increase in 1997. On the other hand remittances in U.S. dollar terms also declined though not in peso terms.

The impact of the crisis on education can be observed from two modes of behavior. The first is a reduction in the enrollment rate for elementary education between the school year 1996–97 and 1997–98 and the school year 1997–98 to 1998–99. This grew by 3.3 per cent for all grades (and 0.1 per cent in Grade I) with a decline of 0.2 per cent in public school enrollment in the period 1996–97 to 1997–98. Between school year 1997–98 and 1998–99 there was only a 0.7 per cent increase in enrollment with a decline in public and private school Grade I enrollment of 2.9 per cent and 10.1 per cent, respectively (Reyes et al. 1999). The crisis may have forced parents not to enroll their school-aged children either in public or private schools. On the other hand, there was a decrease in the dropout rate in elementary schools from a 10.3 per cent increase between school year 1995–96 and 1996–97 in all levels both public and private, and a decrease of 7.9 per cent in dropouts between school year 1996–97 and 1997–98. These two behaviors reinforce each other. Lack of resources forces families with school-age children from new enrollment while lack of work opportunities forces them to retain those already in school.

9 These are the proportion of families whose incomes fall below the poverty line (minimum needed to achieve adequate nutritional requirements for a typical family), based on the Family Income and Expenditure Surveys conducted every three years.

10 The increases in self-rated poverty indices are similar across different surveys, e.g., the household survey conducted by Reyes et al. (1999) and the regular Social Weather Stations surveys.

TABLE II

SELECTED SOCIAL INDICATORS: PHILIPPINES, 1995–99

	1995	1996	1997	1998	1999
Unemployment rate (3rd qtr., in %)	8.8	7.5	8.7	8.9	9.0
Underemployment rate (3rd qtr., in %)	21.3	21.5	23.1	20.8	22.1
Poverty incidence (%)			32.1[a]		43.0[b]
Enrollment rate (% of school age group):					
Elementary		3.3	0.7		
Secondary		0.6	–7.9		
Dropout rate (% of school age group):					
Elementary		10.3	–7.9		
Secondary		8.7	8.7		

Sources: Bureau of Labor Statistics, National Statistics Office, and Department of Education.
[a] Based on income and expenditure surveys.
[b] Based on self-rating.

In terms of health and nutrition, several sources of primary data seem to indicate that the crisis resulted in the reduction in coverage of immunization programs, household eating patterns being affected but not resulting in increases in malnutrition rate especially among children, and a decrease in the contraceptive prevalence rate in the rural areas of the country (Reyes et al. 1999).

Table II presents a selected set of social indicators that describe the effects of the crisis in the Philippines. In a number of these indicators the series for the period prior to and after the crisis is not complete for reasons earlier pointed out. Nevertheless they provide a benchmark of the pattern of social effects that the crisis may have generated.

Apart from the immediate response to the crisis in terms of policies (described in the previous section), the government also responded in terms of its operations, programs, and projects that in turn had social consequences. Often described as the fiscal impacts of the crisis, these are generally more than that. The weight of the impacts is found in the changes in government provision of basic physical, economic, and social infrastructure that condition the environment for the whole economy. After all, the immediate responses in terms of interest rate increases, exchange rate adjustments, and banking regulations also have fiscal effects.

In the Philippines the contraction of the economy resulting from the crisis altered the government's revenue program as tax revenues fell consequently altering its expenditure program as well. How the latter evolved in the crisis aftermath also had impacts especially on the social sectors of the country. Various levels of government have also been affected which in turn had social effects. These are among the impacts arising from the responses to the crisis.

The government had a budget surplus in 1997 of 0.1 per cent of GNP which was not changed as the crisis started in July of that year. But the decline in the revenue generation led to a downward scaling of expenditures in early 1998. This was accomplished through the issuance of an Administrative Order imposing a 25 per cent reserve on total maintenance and operating appropriations of all national government agencies and a 10 per cent reserve on the share of revenues going to local governments.[11] This effectively was a cut in government program budgets by 25 per cent in addition to the *real* cuts because of the ensuing inflation that the crisis had triggered. Given the nuances of government fiscal processes (delays in funds flows, budget modifications, etc.) the actual expenditure reduction may have been more. For example, estimates of the actual expenditure obligations for economic services were only 30 per cent of their programmed levels for the 1998 budget. This affected such services as water resources development, power/energy, and transportation and communications. In social services, housing/community and social welfare/ employment were similarly affected (Reyes et al. 1999).

In order to protect basic social services and provide safety nets for those affected by the crisis, the government gave exemptions to the mandatory reserves to major agencies engaged in their delivery. This exemption was promulgated in July 1998. But this was not immediately carried out and in fact the slowdown of the cash flows, and postponement of contracts for supplies meant that program cutbacks remained in effect. Thus in health, actual obligations for drugs and medicines amounted to only 42.7 per cent of appropriation by the end of 1998. In education, expenditure obligations for textbooks, desks, chairs, and instructional materials amounted to only 37.7 per cent of appropriation for the same time period (Reyes et al. 1999).

Local governments also provide essential services such as water, health and sanitation, and education especially in areas beyond the reach of national agencies. The 10 per cent reserve imposition on their share of national revenues resulted in actual cutbacks that were higher. This came mainly from three sources. First the decline in national revenues meant a corresponding decline in revenue allotted to local governments. Second the crisis also resulted in reduction in local revenue sources mostly from real property tax collections. Third overall finances of local governments meant programmed levels had to be cut. Thus they imposed mandatory reserves that approximated national impositions.

These illustrative but actual magnitudes *cannot* be seen in the aggregate figures of government operational responses to the crisis. Table III defines some measures of overall government operations. Based simply on the budgetary appropriations the per capita national government expenditures in real terms actually fell only slightly in 1999 compared to 1998. And if one looks at the growth rate of national government expenditures this remained positive throughout the period of the crisis. This lends credence to the assertion that the government had acted positively to the

[11] Administrative Order 372 issued in February 1998.

TABLE III

SELECTED FISCAL INDICATORS: PHILIPPINES, 1996–99

	1996	1997	1998	1999
Government surplus/(deficit) (% of GNP)	0.4	0.1	–1.8	n.a.
Per capita national government expenditure (1985 pesos)	2,517.50	2,733.00	2,736.50	2,700.20
Growth rate of national government expenditure (%)	4.8	17.9	12.6	9.7

Source: Reyes et al. (1999).

impacts of the crisis through the provision of adequate protection of the affected groups. But as the closer examination of the actual program operations reveal, the responses even magnified the impacts though it must be admitted that budgetary corrections were undertaken. Unfortunately the move toward *discriminatory* responses in the form of protecting basic social services came too late and the impacts became worse.

The financial, economic, and social impacts of the crisis have been interactive. At one level the financial and economic sectors have been directly hit as depreciating exchange rates and rising prices and interest rates take their toll. At another level the secondary impacts have taken place as economic conditions translate into deteriorating social conditions. In between these two levels the government has taken on policy adjustments aimed at addressing the immediate impacts. Yet in the process of these adjustments further impacts have been experienced not from the crisis per se but from the way the crisis has been managed. To the extent that the adjustments are inappropriate the impacts may be explosive.

V. CONSEQUENCES OF RESPONSES AND STRATEGY

In the context of the Asian crisis, the Philippines has not really been in the center of its onslaught. The country's active participation in short-term capital movements pervasive in Thailand came in late, and as bubbles began bursting in that country, the seeds of a potential Philippine crisis were just germinating. That it has been classified as among the five most affected Asian countries comes from the fact that it suffered from the contagion of the crisis.

The impacts on the country are obvious, and parallel those in the other affected countries though with less severity as has been shown in the previous sections. Growth nosedived from respectable achievement in 1997 to technical recession in 1998. All the other social conditions deteriorated.

The government's initial, immediate, and subsequent responses to the crisis have been described earlier. In terms of their intentions the approaches may have been appropriate. The larger question however is whether from a more comprehensive context they were appropriate.

The floating of the exchange rate after several days of active defense following Thailand's depreciation of the baht was more a default response (due primarily to lack of adequate foreign exchange reserves) than a deliberate policy strategy. In fact in the few days before the first depreciation on July 11, 1997 the country's central bank had lost more than a billion U.S. dollars trying to peg the exchange rate while making pronouncements of a stable rate.[12]

The central bank also raised interest rates (through a variety of instruments) to exert influence on the exchange rate without direct foreign exchange reserves cost to it. This was of course a standard prescription that the country had used in the past through the auspices of the IMF. Yet the country had announced its exit from IMF arrangements even though it borrowed a small amount during the crisis. Besides, with a depreciation of more than 50 per cent as the crisis wore on, interest rates to match exchange rates would have been devastating. The pronouncement to this policy indicated its use as a supplement to stabilization not to buck peso depreciation.

The central bank had also issued, belatedly, banking measures and controls to reduce "less-than-arm's-length" transactions among related establishments and among directors and owners, one of the supposed causes of the crisis. But presumably the elimination of the pegged exchange rate removed the implicit social guarantee to private transactions.

Both the discrete exchange rate change and the rise in interest rates had effects on the government itself aside from their effects on private markets. Import contraction because of the exchange rate sharply reduced customs collections and the overall revenue of government. Import contraction also contracted the economy reducing the tax revenue base. In addition the rise in interest rates closed many establishments, reducing employment, and further revenue collection.

The national government however had a projected budgetary surplus in 1997 (see Table III) which it did not alter to allow for these changes in the economy arising from the crisis. It was only in the next year when the crisis effects had deepened that the national government took policy measures. But instead of being anti-recessionary, the measures as described in the previous section further exacerbated the adverse impacts of the crisis. Indeed the uniform expenditure cuts were directed at programs meant to provide safety nets to those affected by the crisis. While the policy preserved government employment (the item for personnel services was maintained) the critical services they were hired for were severely curtailed. The size of government overhead essentially remained the same but the size of services fell by as much as 30 per cent.

12 See for example the daily issues (before July 11, 1997) of the *Business World* which reported the continuous assurances from the central bank governor that the (pre-crisis) exchange rate would continue to prevail.

Consequently the social impacts (both direct and indirect) from the crisis were magnified and larger than they would otherwise have been. Poverty incidence rose, unemployment reached record highs, educational enrollment suffered, and essential government services rationed.

This chronology, incomplete though it may be, summarizes the important policy responses to the Asian crisis and their consequences on the Philippine economy and social conditions. Each instrument or policy response may have been appropriate for a narrow objective. But looking at the crisis from a larger perspective it seems that these responses were piece-meal approaches to what was essentially a general equilibrium disturbance caused by an external shock.

The policy responses, individually appropriate, lacked synchronization, sequencing, and, more importantly, coordination. Moreover these were drawn up without the benefit of a strategic framework to view the crisis, anticipate its likely impacts and their paths, and design the policies in ways that they would be mutually reinforcing and lead to mitigating their consequences. The financial polices appear to have been drawn up independent of their interdependence with fiscal policies.[13] Budgetary policies ignored the need for discrimination and targeting in reprogramming resources. In addition with greater policy coordination each of the policy responses could have been tied to other policies, e.g., exchange rate adjustment and fiscal expansion.

VI. CONCLUSION

The five affected Asian countries are expected to recover from the crisis earlier than anticipated and in some cases faster than projected with the Philippines marginally ahead (ADB 1999). This is not surprising given the fact that the country was not in the center of the path of the crisis. In the medium-run however the Philippine recovery path is expected to be no higher than the other countries.

Before the crisis the Philippines was trailing behind most of the other affected countries in economic and social terms with a few exceptions. Thus even if the Philippines was not as severely affected as the others, it was in some sense made worse off. It could not "afford" the harsh impact of the crisis. The imperative was to come out of it a more efficient and resilient economy capable of growing at rates close to the country's maximum potential.

In the course of its adjustment to the crisis the country adopted policies and measures to ease its adverse effects. These were traced in the previous sections. More than a year after the crisis many of its initial effects had ebbed, e.g., exchange rates stabilized and in fact appreciated (confirming its original overshooting), inter-

[13] The central bank apparently instituted policy responses without adequate consultation and coordination with other economic policy-making bodies.

est rates subsided, and trade resumed its past vigor.[14] Moreover the government introduced many measures to increase transparency, institute prudential regulations along international standards, reduce corruption, and other administrative regulations affecting the banking and financial sectors which were supposed to have abetted the crisis in the region. A more flexible exchange rate management is also apparent in the manner in which the central bank has operated in the exchange markets. In short, a more robust banking and financial sector should avoid similar crisis in the future.

When one looks beyond the economic and financial repercussions and into the social impacts of the crisis, which has seldom been done, its adverse effects appear more pronounced. This is particularly true for the Philippines since its social conditions have been poor relative to its ASEAN neighbors and to a number of developing countries to begin with.[15] Whether it is health, nutrition, education, income distribution, poverty incidence, or a composite human development index, the Philippines had a significant handicap even before the start of the crisis.

Through the financial and economic impacts, the social consequences took their toll in worsening indicators. While the transmission of the crisis to the Philippines was immediate, its effects were not immediately large. Indeed the country managed to achieve a positive growth in the first six months of the crisis. It was only in 1998 that the crisis really had its adverse impacts. When these numbers are considered they imply serious long-term consequences. The sharp drop in education enrollment (elementary and secondary levels) means a long-term reduction in human capital formation needed for the country's sustained growth. Increased poverty incidence will mean further deterioration of living conditions essential for productive life.

The national government's response to the contagion in the country did not help alleviate the impacts of the crisis either. In fact this paper argues that it actually exacerbated it by curtailing essential government services to those that have been adversely affected by the economic and financial turmoil. And when corrections were initiated to allow for maintaining these services, government bureaucratic delays resulted in their failure. Thus the social effects of the crisis came from the indirect effects from the external shock and the direct effects from government responses.

The country's recovery from the crisis in a short period of time is important. As trade is reinvigorated, banks recapitalize, and firms rejuvenate, it will not be long before the country begins to take on a medium-term trajectory. But the damage to the social sector and its potential long-term injury to the economy as a whole will remain.

14 The Philippines did not have severe trade credit shortages as the other affected countries in resuming export and import transactions.

15 The Philippines is classified in the medium human development rank of the UNDP Human Development Index (77 of the 174 countries classified).

REFERENCES

Alburo, Florian. 1998. “The Asian Financial Crisis and Policy Response in the Philippines,” *Philippine Review of Business and Economics*, 35, no. 1: 62–86.

———. 1999. “Foreign Direct Investment in the Philippines amidst Crisis and a New Global Economic Environment.” Paper for the Philippine Exporters’ Confederation, Trade and Investment Policy Analysis and Advocacy Support Project (TAPS).

Asian Development Bank (ADB). 1998. *Key Indicators of Developing Asian and Pacific Countries 1998*. Manila: Asian Development Bank.

———. 1999. *Asian Development Outlook 1999*. New York: Oxford University Press.

Columbia Business School. 1998. *Challenges and Opportunities of the Southeast Asia Crisis*. New York: Columbia University Business School.

De Dios, Emmanuel; Benjamin Diokno; Raul Fabella; Felipe Medalla; and Solita Collas-Monsod. 1997. “Catching Up: The Role of the Exchange Rate.” Presentation before the House Committee on Economic Affairs, Philippine Congrress.

Glick, Reuven. 1998. “Thoughts on the Origins of the Asia Crisis: Impulses and Propagation Mechanisms,” Pacific Basin Working Paper Series, PB98-07. San Francisco: Federal Reserve Bank of San Francisco.

Glick, Reuven, and Andrew K. Rose. 1998. “How Do Currency Crises Spread?” FRBSF Economic Letter, no. 98-25, August 28. San Francisco: Federal Reserve Bank of San Francisco.

Gochoco-Bautista, Ma. Socorro; Soo-Nam Oh; and S. Ghon Rhee. 1999. “In the Eye of the Asian Financial Maelstrom: Banking Sector Reforms in the Asia-Pacific Region.” Manila: Asian Development Bank.

Ichimura, Shinichi; William E. James; and Eric D. Ramstetter. 1998. “On the Financial Crisis in East Asian Economies.” ICSEAD Working Paper Series, no. (A) 98-14. Kitakyushu: International Centre for the Study of East Asian Development.

Krugman, Paul. 1998. “What Happened to Asia.” The Official Paul Krugman Web Page, http://web.mit.edu/krugman/www/.

McKinnon, Ronald, and Huw Pill. 1998. “International Overborrowing: A Decomposition of Credit and Currency Risk.” *World Development* 26, no. 7: 1267–82.

Medalla, Erlinda M. et al. 1995. *Philippine Trade and Industrial Policies: Catching Up with the Tigers*. Vol. 1. Manila: Philippine Institute for Development Studies.

Montes, Manuel F. 1998. *The Currency Crisis in Southeast Asia*. Singapore: Institute of Southeast Asian Studies.

Moreno, Ramon. 1998. “What Caused East Asia’s Financial Crisis?” FRBSF Economic Letter, no. 98-24, August 7. San Francisco: Federal Reserve Bank of San Francisco.

Moreno, Ramon; Gloria Pasadilla; and Eli Remolona. 1998. “Asia’s Financial Crisis: Lessons and Policy Responses,” Pacific Basin Working Paper Series, PB98-02. San Francisco: Federal Reserve Bank of San Francisco.

Nomura Asia Pacific Research Group. 1999. “Asia’s Bubble Crisis: No Instant Cure.” Hong Kong: Nomura Securities.

Paderanga, Cayetano, Jr. 1998. “Currency Crisis and Policy Response: The ASEAN and Philippine Case,” *Philippine Review of Business and Economics* 35, no. 2: 248–78.

Reyes, Celia M.; Generoso G. de Guzman; Rosario G. Manasan; and Aniceto C. Orbeta. 1999. “Social Impact of the Regional Financial Crisis in the Philippines.” Paper presented to the Finalization Conference Assessing the Social Impact of the Financial Crisis in Selected Asian Developing Economies, June 17–18, at Asian Development Bank, Manila.

United Nations Development Program (UNDP). 1998. *Human Development Report 1998*. New York: Oxford University Press.

United Nations Conference on Trade and Development (UNCTAD). 1998. *World Investment Report*. Geneva: United Nations.