I. Introduction

*Development progeria* is the phenomenon where a poor country, with a per capita income, say, of less than $5th, displays the industrial share dynamics of a rich mature economy. The phenomenon is characterized by the progressive retreat of the shares in total value added of the Industry sectors, notably of Tradable Industry, such as Manufacturing, and the increasing share of the Service sector. Economies on the trajectory of economic catch-up with mature economies exhibit the opposite dynamics: the share of the industry and, especially, manufacturing sectors in total value added gains while that of the Service sector loses. Since high investment rate and rapid economic growth rate is generally associated with a rapidly gaining Industry and Manufacturing sectors, the longer term growth rate of development progeriacs is low, mimicking that of mature economies. Thus, a development progeriac’s prospect for catching-up with mature economies is limited, if not non-existent. Development progeria is the economic analogue of *progeria* (premature aging) in medical parlance caused by a genetic malfunction. Medically, a progeriac is usually a pre-teen child displaying the physical characteristics of a 60-year-old.

II. Is the Philippines a Development Progeriac?

To address this question, we first view the trajectory of industrial shares in the Philippines in the last 25 years (*Figure 1*):

*Figure 1: Shares in Total Value Added of Various Industrial Sectors: 1986-2009*
The share of Agriculture in total value added fell from about 25% to about 12% during the period. This is to be expected in the course of development. The share of Industry fell from about 35% to 30%, while that of Manufacturing fell from about 25% to 20%. By contrast, the share of the Services sector ballooned from about 40% to now about 57% today! Is there anything unusual about this long-term evolution in Philippine industrial share structure? The answer has to do with where the Philippines is in the development ladder.

We now juxtapose the Philippine development experience against those of selected countries: four countries (Indonesia, Thailand, Malaysia, and China) represent the increasingly successful catch-up economies; two, Germany and USA represent the mature (OECD) economies; South Korea represents the recent graduates of the catch-up academy. Figure 2 (originally from Fabella and Fabella, 2012) shows the per capita incomes of these countries in 1991 and 2002 representing the middle of two periods (1986-1996 and 1996-2009) we are interested in:

![Figure 2. Per Capita Income (US$), 1991 and 2002](image)

We see from Figure 2 that USA and Germany are clearly mature economies with per capita incomes in excess of US$10-thousand throughout the periods. South Korea crossed the threshold in the second half of the period; the rest of the countries had some ways to go although Malaysia is quickly closing the gap. To tease out the role of the development ladder, we turn to Figure 3.

Figure 3 (originally from Fabella and Fabella, 2012) presents the change in the percent share of the Manufacturing, Industry and Services sectors in the period 1986-1996 by countries. Starting with the mature economies Germany and USA, the Services sector share rose while the share of both Industry and Manufacturing for both periods fell. These are archetypes of late mature economy trajectory. South Korea, a new OECD economy, saw its Services sector and Manufacturing shares rise but still with a slight increase in Industry share. Indonesia and Thailand saw their Service sector shares falling in the face of rapidly rising Industry and Manufacturing shares in both periods. This is the archetypal catch-up trajectory that opens the door to economic maturity. Malaysia exhibited a rising Service sector share in this period but with rising Industry and Manufacturing shares. This means a rapid fall in the Agriculture’s share. China exhibited the same pattern.
The experience of these countries from 1996 to 2009 is given in the next figure. Figure 4 (Fabella and Fabella, 2012) gives the trajectories for the second period (1996-2009). Malaysia reverts somewhat but not fully to the archetypal catch-up trajectory with a falling Service sector share to go with a rising Industry but falling Manufactures share. Malaysia’s per capita income was by then approaching the OECD standard. China continues the pattern where both the Industry and Manufacturing sectors gain to go with a rising Service sector share at the expense of the agriculture sector. It is an economy firing on all cylinders. Indonesia, Thailand, Malaysia still have the Service sector falling behind with Industry forging ahead.
Finally, the Philippines. The trajectory exhibited by the Philippine industrial structure dynamics in the last quarter century mimics that of late mature economies: in both periods, Industry and Manufacturing shares declined while Services share rose just as they did in Germany and the USA. By the end of the second period, the Services sector share stood at the 55.4%, a feature common to OECD and mature economies. Premature economic aging accompanied its journey throughout the 25-year period. This also means that it’s prospect for convergence with mature economies is poor. (Source: Fabella and Fabella, 2010).

Industrial Share of Labor

The industry value share dynamics in Development progeria is also echoed in the industrial labor share dynamics. Below is the change in employment share of Agriculture, Industry and Services in the period from 2000-2010. This time, the third sector is Agriculture since employment for manufacturing is unavailable in our data source.

Figure 5: Change in Employment Share of Industry Sectors: 2000-2010

Once again the Philippine labor share trajectory mimics those of mature economies USA and Germany where both Agriculture and Industry labor shares fell. China, Indonesia and Thailand all experienced the Industry employment share on the rise despite rapid rise in the Services share. Malaysia and South Korea, by this time bearing down on OECD income status, have started to mimic high income country labor share dynamics.

Progeriacs Elsewhere

Is the Philippines unique in exhibiting development progeria? Since the factors contributing to development progeria are not the Philippines monopoly, the answer should be no. Figure 6 below shows the Industrial share dynamics spanning the period 1990-2010 for select countries in Latin America.
Figure 7 shows that with the exception of Peru, the trajectories of Industrial shares from 1990 to 2010 for 5 countries (Argentina, Chile, Colombia, Costa Rica, Uruguay, and Venezuela) smacks of development progeria. It has been claimed that the Philippines is a Latin American economy in the wrong geography (East Asia). This is yet another evidence of that claim. There is also a claim that Chile is an East Asian economy that is in the wrong geography (Latin America). This claim is not born out by the industrial share trend in the period 1990-2010.

III. From Manufacturing to Tradables: Shifting Emphasis

The goods and services produced by the economy are classified into Traded goods or Non-Traded goods. Non-traded good and services are produced and consumed in the same country. The services rendered by government agencies such as the judiciary and legislature, the services of barbers and store clerks are non-tradable. Likewise, road and transport services are produced and consumed in situ. If politicians and lawyers are exportable, we would indeed be a rich country. Traded goods are produced in one country but consumed in many other countries. The Industry sector has a traded goods subsector largely Manufacturing and a non-traded subsector such as electric power generation and utilities largely associated with large fixed capital investment. The products of the traded goods sector called Tradable goods are further classified into Exportables or Importables. Exportables are sold not only domestically but also exported and earn foreign exchange for the country; Importables are produced and consumed at home where it has, however, to compete with imports from other countries. The Manufacturing sector is a proper subset of the Tradables sector which encompasses all mineral, agricultural products and now tradable services such as BPOs. Both rice and wire harness are tradable goods. The distinction between importables and exportables often blurs as former importables cross-over to exportables and vice-versa. Rice is perennially an importable in the Philippines but for a few years in the early seventies it was an exportable. An important emerging segment of Tradables is Tradable Services led by Business Process Outsourcing (BPO): services, such are retail backroom operations and audit, accountancy and legal services, now cross borders via fiber optics to instantly reach customers in other countries. Electric power supply is
not normally shipped from one country where it is produced to another country where it is
consumed. But Canada’s electric power is exported via transmission grids and consumed in the USA.

It is more fruitful to shift our analytical focus (and advocacy) from the Manufacturing sector to the
whole Traded goods sector which encompasses also the Agricultural and (extractive) Mining sectors.
All traded goods sectors are sensitive to exchange rate movement. The drawback is that while most
data sources carry the Industry and Manufacturing categories, they do not carry a separate Tradable
sector category.

IV. Genesis of Development Progeria

Development progeria is an outcome of a combination of circumstances and policy choices.
Countries with abundant endowment of valuable and easily extractible mineral resources tend to
become dependent for foreign exchange from exports of minerals contract a disease known as
“Dutch Disease”: when considerable inflow of foreign exchange coming either from extracted
minerals or from exogenous sources (the safe-haven seeking inflow into Switzerland) push the local
currency so high (say, the peso/dollar exchange rate to fall so low), the other tradable sectors are
unable to compete and thus wither away. The modern example is Australia whose endowments of
exportable minerals is so massive and has in the last ten years has generated export revenues been
so overwhelming that the Australian dollar has become so strong. The result is that local
manufacturing is disappearing. The most recent example is the announcement by Ford Australia that
it is closing all its factories in the country at the loss of 2,000 jobs. The subtext is that Ford Australia
will from hereon source its Ford vehicles offerings from Ford subsidiaries in other countries. The
Australian monetary authority could have but chose not to combat the appreciation. Thus policy
choices are relevant even in the presence of natural extractible abundance. The Swiss National Bank
in the face of massive foreign exchange inflow from the crisis-afflicted Euro zone, chose otherwise; it
fixed the Swiss franc/ Euro exchange rate and devalued the Swiss franc by 10%. (More on this
below). It has so far worked. It is our contention that development progeria in the Philippines cannot
be dissociated from the pursuit of the strong peso throughout our history and especially in the last
25 years.

A. The Strong Peso and Development Progeria

In lieu of a barrage of statistics on the strong peso in the last 25 years, I choose to relate two
historical policy episodes in the last 30 years that blindsided the Tradable Sector/Manufacturing in
the Philippines and implicate the strong peso in the contraction of DP.

In January 1994, the People’s Republic of China devalued its currency 40%. We did not need
atomic physics to glean that PRC’s move would devastate manufacturing and employment in the
Philippines and elsewhere. In the first quarter of that year, group of us (Noel de Dios, Benjamin
Diockno, Cayetano Paderanga, Toti Chikiamko and myself together with PHILEXPORT) called for
the deliberate weakening of the peso. The proposal was soundly rejected despite the surprising
support by the then Senate President Edgardo Angara at the first plenary session of the 1994
National Economic Summit. Instead, we were treated worse than lepers. One mouthpiece of the
then Central Bank governor labeled us the “jukebox economists”: singing any tune the
moneybags call. The implied moneybags, IMF and the World Bank, did not even know they were
calling our tune; they were, in fact, calling the CB’s mantra: “It’s the market!” They had a catatonic fixation for floating the exchange rate which, at that point of considerable dollar inflow due to the capital account liberalization, pointed to peso appreciation. The business community was firmly on the CB governor’s side. But even labor unions whose jobs we were trying to save called for our heads.

The then Central Bank governor responded to the proposal with the defiant “Over my dead body!” To the business complaint of high domestic interest rate on peso loans to support the overvalued peso, the Central Bank’s response was: “Borrow in dollars.” It was a counsel towards disaster. This they did with vengeance, especially the banks who borrowed low interest dollars and lend in high interest. After all, with appreciation you have a one way bet, the dollar borrowing get high interest rate in peso lending and a sure appreciation gain! The ‘Over my dead body’ boast was a perfect come-on for portfolio inflow which forced the peso upwards to P24/$. And this omen of impending debacles was called a success; the market has spoken! In other words, the Philippine economy got a cocaine fix disguised as medicine. We partied on cheap imports which starved our traded goods sectors. 1995 and 1996 saw the foreign exposure of the private sector balloon. Two years later, the Asian Financial Crisis, the bitter harvest of private over-borrowing and asset bubbles, wiped out the gains painstakingly won by the Ramos team in the preceding five years.

This neglect of simple economic common sense is a source of great sadness. Fellow traveler, Calixto “Toti” Chikiamco, summed up our collective despondency at the Summit’s rejection of our proposal: “We lost our balls!” Meaning, as a people we failed to address a crucial collective action challenge at a special juncture in our history. We let misguided central bankers and entrenched vested interest of the banking and business community short-change our future. Consider the counterfactual: had we moved the exchange rate as proposed, there would have been no excessive private foreign borrowing. The banks would have remained healthy and the Ramos growth inertia would have continued into the next decade. The Asian Financial Crisis would have spared our shores. One decade of successive 6% growth would have propelled the economy to the orbit of the Asian tigers. Instead, we decided to tango with portfolio and collapsed into a decade painful adjustment.

This was not the first time the Central Bank figured in the abortion of nascent breakout in the post-EDSA era. Ten years before that (1984-5), the sledgehammer was the “interest rate cure” administered by the CBP through the JOBO Bills that shrank the economy to fit the overvalued peso. In the late 70’s and early 80s, the regime of dictator Marcos soaked up on readily accessible low-interest re-cycled petro-dollars to prop up the regime and mount ambitious major industrial projects. A poisonous admixture of blatant cronyism, behest loans, bad policy choices and external circumstances sent the grand gamble crashing from which we took decades to recover.

The era of the 70s was a high inflation era for the global economy in the wake of two oil crises (1972 and 1979). Paul Volcker who became FED Chairman in the early 80s led the charge to extirpate inflation and inflationary expectation at any cost. His punishingly high interest rate (the Federal funds rate reached 20%) causing a deep recession in the USA unmatched since the Great Depression and raising US unemployment to unprecedented 13%. But it forced inflation to retreat from 13.1% 1981 to 3% in 1983. The “low and stable inflation” orthodoxy was birthed then. This was the cradle of subsequent adherence to the monetary policy known as “inflation targeting.” But the unintended
result of the Volcker scorched-earth campaign was a steep global interest rate hike that drove many highly-indebted countries into debt default and debt depression which is echoed today by the Eurozone sovereign debt crisis.

It also changed Philippine history forever. The foreign debt-laden Marcos regime tottered under the weight of debt-service payments. To stem the depreciation of the peso, the Marcos-appointed central bank governor Jose “Jobo” Fernandez used a Volcker type interest rate-cure to shrink the economy to fit the massively overvalued peso. The economic firestorm scorched the investment landscape and the unrest that followed swept away not only Marcos but also a brighter post-Marcos future for the Philippine economy. It promptly also acted as a poison pill for the incoming Cory presidency: not only was the debt overhang massive, the government financial institutions bankrupt and needing humungous bailout, the economic dislocation gave comfort to military adventurism who sent foreign investors scurrying. Had the depreciation been allowed as a painful but necessary cure, the domestic traded goods sector at least would have had some breathing space. As it was, the toxic brew of military restiveness and the strong peso born of the interest rate cure effectively aborted the Cory Aquino recovery.

The strong peso environment of the last 25 years was punitive of Tradables and specifically of Manufacturing. The overall retreat was logical and understandable.

V. Learning from the Canny Swiss

The problem we are facing now, have faced in the last few years and for the next few is the appreciation of the peso. The peso depreciation in the middle of June 2013 occasioned by the signals from FED Chairman Ben Bernanke of the gradual phase out of QE in the US and the consequent pullout of portfolio flow is temporary. The effect of this current weakening of the peso on global competitiveness is limited since other currencies like the Indian rupiah and the Indonesian rupee are weakening as well. There are, however, nuggets of learning we can extract from this gyration: (i) It affords us a glimpse of how much higher the enlarged portfolio flow in last two years pushed the peso. We would have stayed in the vicinity of P43/$ without the portfolio flow which serves little purpose anyway aside from stoking asset bubbles and worsening income inequality. The ideal response is for the BSP to exploit the global turmoil to raise the exchange rate floor from P41/$ to P43/$ and operate from there since the extra strength of the peso at P41/$ level seemed to have been only a portfolio flow effect. (ii) It tells us how asset price bubbles (as in the PSEi) are intimately related to transitory portfolio flows. (iv) The current turmoil means that the BSP is given relief from open market purchase of dollars. The BSP is rightly refraining from selling dollars to force the peso back to P42/$ or higher in the name of volatility reduction, which would be a real blunder. When the smoke from current QE phase out-related clears, the pressure on the peso to strengthen will resume. Flexibility and the courage to use conjunctural events to one’s advantage is a very important trait but one that requires a worldview not slavishly tethered to the market fundamentalist orthodoxy. This was plenty exhibited by the Swiss Monetary Authorities in mid-2011.
The primary lesson here is not the specific policy action taken by the Swiss monetary authorities. It is the moral courage to go against the herd when one's interest calls for it. The herd response to the inflow and rapid rise of the Swiss franc would have been: "Let the market take its course! Global money swells is unstoppable and will sweep away any and all the ramparts you erect." Well, they did not. The Swiss franc stands at SF1.23/Euro and most commentators now think the Swiss move was pretty clever.

And the Chinese

The People’s Republic of China is by contrast the Asian witness to the still valid wisdom of the East Asian model that began in the 1950s and became discredited in the late 1990s due to the Asian Financial Crisis. PRC in the last decade is the current embodiment of the East Asian Model before the wrong-headed opener-than-thou contest for financial and capital account liberalization of the 1990s. Since its fateful devaluation in 1994, PRC wracked up massive trade surpluses against partner countries and has been castigated as a currency manipulator. Despite the massive pressure, China has staunchly resisted the stiff revaluation of the Yuan favored by Western countries. The Chinese authorities view the yuan undervaluation (estimated to be about 25%) as the ticket out of poverty of the still hundreds of millions of Chinese below the poverty line. Premature appreciation is viewed correctly as the unconscionable abandonment of the still hundreds of millions under the poverty line and the embrace of the Japanese-style Bubble Economy -- an invitation to a similar decade-long

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Box 1
Learning from the Canny Swiss

The protracting Euro zone crisis sent Euro zone asset holders to safer havens of which the closest and the most accessible is Switzerland. The massive capital inflows sent the Swiss franc on a precipitous climb towards parity with the Euro. The result was predictable: the massive squeeze on the Swiss traded goods sector threatening bankruptcies. Tourist destinations hosted fewer and fewer visitors who found bargains in alternative locations in Austria and France. Swiss shoppers flocked to German border towns to do their periodic shopping. This was threatening to massively overhaul the composition of Swiss output in favor of its non-traded sectors. The usual response of setting the interest rate to zero did not stem the deluge. The Swiss National Bank’s (SNB) response in 06 September 2011 to what it labeled “massive overvaluation” was decisive and unequivocal: after 30 years of floating, it pegged the Swiss franc to the Euro and promptly devalued it by 10% setting the rate at SF120/euro. This was very instructive, apart from being a big surprise. The old consensus considers this move unwarranted since the trigger is, as the excuse goes, “one-off and temporary.” It is assumed in that case that bridge financing to weather the turbulence can always be found. Furthermore, if it proves permanent the entities in question can always move up the value chain! The reality is that one-offs can kill, otherwise, healthy firms and, once dead, return to normality will not bring them back to life. The peg-and-devalue response is precisely the proper lifeline to extend to Swiss Tradables. To hold the Swiss Franc at €1.20, the Swiss authorities just signaled the world it will print paper SFs in the quantity needed. In other words, it asserted its monetary sovereignty, something which the Euro zone PIGS cannot do, however helpful that would be! This episode shows that the Swiss monetary authorities paid attention to output composition and disregarded such neoclassical niceties as perfect capital markets that can provide any bridge financing required. It then drew from a richer (non-neoclassical but pragmatic) toolbox to respond.
economic stagnation. Social unrest in China is a prospect not to be belittled in China, This is wielding monetary independence responsibly.

VI. The Weak Peso and Economic Performance

The secular retreat of the traded goods sectors especially Manufacturing, has many fathers. China’s muscled export machine sowing desolation to manufacturing everywhere clearly stands out. The OFW remittance which largely underpinned the BOP surplus since 2002 is another; our power, regulatory and labor cost disadvantages will, even with the best effort, mend only slowly. But these drawbacks can be partly redressed now by a more balanced exchange rate policy. Just leaving the value of the peso to the whims of the spasmodic world financial markets is imprudent. Rodrik (2008) argues that the exchange rate should be used as a leveler for the Tradable goods sector.

A spate of research results in the last decade have come out to confirm the positive undervaluation-growth nexus. The previous orthodoxy pointed to overvaluation of the domestic currency as bad for growth (Prasad, Rajan and Subramanian; 2007). It was at best ambiguous on the question of undervaluation. Rodrik (2008) opened new ground when he and others reported that undervaluation of the currency (using a corrected RER index is used) is good for growth but that this strongly positive relation applies only to poor countries (< $6,000 per capita income); it vanishes with rich countries in the samples. Bhalla S (2007) evidenced the claim that undervaluation promotes growth in the case of India and China. Levy-Yeyati and Stuzzenegger (2007) and Gluzman, Levy-Yeyati and Stuzzenegger (2007) also presented evidence that undervaluation boosts growth and does so via faster capital accumulation and investment (Smithian argument of expanding markets). Korinek and Serven (2010) shows that undervaluation boosts growth and productivity via technical change and learning by doing in Tradeables (a Schumpeterian argument). Hadad and Pancaro (2010) reaffirms Rodrik that undervaluation promotes growth significantly for poor countries (most especially < $2,500 per capita income). Undervaluation that works must be stable and accompanied by macro-economic stability. Berg and Miao (2010) revisited Rodrik 2008 paper and confirms even with further corrections that Rodrik was on the whole the money: overvaluation is bad and undervaluation is good for growth.

Undervaluation is a state intervention in the market for foreign exchange. A state intervention must be anchored on a market failure: What market failures anchor undervaluation? Undervaluation we know raises the profitability and consequently the share in GDP of tradables. The novel reason for government intervention in the exchange market proposed by Rodrik (2008) is that market distortions and institutional weaknesses which abound in poorer countries harm Tradables more than Non-Tradables thus lead to less investment going to Tradeables than should be. Undervaluation helps level the playing field. As observed, This deserves elaboration and reiteration. Tradables tend to be more complex and round-about, needs the cooperation of many agents and thus more contract-intensive. Tradables move across borders and are subject to physical hijack and predation in weak states. Tradables also produce more positive externalities, technological spillovers and learning-by-doing (Serven and Korinek, 2010) than non-tradables and may exhibit more scale economies due to the Baumol Effect (barber shops will never exhibit economies of scale) (Gala, 2007). Undervaluation levels the field for tradables and non-tradables.
I would add the position taken by Caves (1984): A healthy forex reserve is a public good and a source of positive externality. In the Philippines, it is without doubt that the credit upgrade of the country is anchored in part on a healthy GIR. Addition to the forex reserve lowers the cost of borrowing for the country (with credit rating upgrade) and its firms and decreases perceived instability for all. This positive externality cannot fully appropriated by forex earners at market equilibrium. Thus a market failure. Undervaluation is a government intervention that remedies this market failure.

The PIGS and Argentina: Overvaluation and Disaster

By contrast, the current tragedy being played out in the PIGS (Portugal, Italy, Greece and Spain) is an eloquent witness to the ravages of overvaluation. The latter countries (derisively called PIGS) effectively experienced a massive currency overvaluation with the shift to the Euro. The Euro is not overvalued indeed may even be undervalued relative to Germany but it clearly is overvalued with respect the PIGS. The result is now clear: the demise of its export capacity combined with an orgy of foreign borrowing that fueled a humungous Service sector bubble. The still ongoing Euro sovereign debt crisis is the unwanted child of massive overvaluation.

It is a re-run wrought large of the Argentine crisis in early 2000 when Argentina pegged by law the value of one Argentine peso to one US dollar. With the retreat of inflation, Argentina suddenly wallowed on debt-financed affluence and for a while was the global template of growth with price stability. Until, that is, the bill for service of the massive foreign borrowing came due. Fortunately for Argentina, it still retained monetary independence. Argentina recovered only after it reversed the mistake with a massive devaluation. By contrast, the PIGS cannot devalue its currency to reverse the process as they gave up monetary independence in 2000 with the monetary union. And so they must instead devalue all their assets primarily their labor assets. The imperative spawned a neologism, “fiscal devaluation”! The forced retreat of asset prices and wages now reaps the harvest of social unrest. The Philippines has monetary independence but for so long has chosen to deploy it to marginalize its tradable sector.

VII. A Collective Action Challenge

The switch away from the strong peso remains a collective action challenge. As observed above, the Service sector now constitutes over half (57%) of Philippine value added. The strong peso still favors the non-traded goods sector and the banking sector that serves it. Add to that the massive importing sectors such as the automotive. That huge economic interest did not and will not take it lying down. All the political decision makers whose pay and allowances are in pesos and who fancy going to Las Vegas for boxing matches will be averse to a weaker peso. Fortunately, the times they are achanging.

A Reason for Hope I: A New BSP

In the second half of the last decade, green shoots of change are rearing their heads. There appears to be a subtle shift in BSP mindset. To keep the appreciation from going out of hand, the BSP now under Governor Tetangco has become a determined net buyer of dollars which has resulted in the BSP’s GIR now approaching unprecedented levels ($84b +). This too is a new development in the Philippine economic landscape: the bulging GIR and the BSP acting as if it is now more sensitive to
the plight of our forex earners: OFWs and families, merchandise and agricultural export industries, the BPO, Tourism. The public rhetoric of the BSP remains the same and in keeping with the dominant monetary and exchange rate policy of “inflation targeting”: to remain neutral but reduce ER volatility. But its actions suggest that it has gingerly embraced its responsibility for the composition of output and thus the weaker peso thesis.

Since the BSP officially pursues an inflation targeting monetary policy, it must keep inflation within the target band 3-5% in 2011. To keep inflation from breaching target levels and to have the ammunition to buy dollars, the BSP effectively borrows pesos from the public through the Special Deposit Account (SDA) where P1.75 tr of banking sector resources are lodged at risk-free x% interest in lieu of printing paper money. Printing paper pesos is deemed inflationary. The problem is that in the process of sterilization the BSP incurs a negative carry (loss or deficit) since the return to dollar assets it acquires (largely US treasuries) is close to zero. Nonetheless, if the BSP manages to keep the exchange rate within the current band (P43-45) in the next five years letting the GIR, if need be, rise to $100b in the next 5 years, it will be acting responsibly. It will breath life into our manufacturing and traded goods sector and spur activity in the investment space. Currently the BSP is asking the central government for capital infusion of to cover its losses. The BSP losses however in 2012 alone has already reached P75b. There is no question that the fiscal sector can make good these losses and still maintain its own integrity. The BSP must consider a different path.

A Reason for Hope II

Because of the pressure from OFW remittance, the path to undervaluation no longer treads the traditional one of a massive devaluation and a determined effort to fight back inflation. When the pressure on the peso is towards appreciation, undervaluation can be attained by simply fighting off appreciation long enough by determined sterilization as PRC has done for the last 20 years. Pushing against appreciation involves only printing enough paper pesos (risking some inflation if need be) which is our prerogative as a monetarily sovereign economy. It is an altogether different animal from defending the peso from depreciating since our ammunition for the purpose is dollars which we cannot print and can quickly run out of. If the peso-dollar exchange rate is kept at P42 or above through the next decade, we shall have given our dollar-earning industries a needed space to grow. That is not too much to ask to save our BPO and Tourism industries even as it duly honors the sacrifice of our OFWs. And we shall have begun the slow process of dismantling development progeria.

For this, there is no need to renounce inflation targeting; there is a need to smoothen its sharp edges. Our quarrel with the BSP, thankfully, is no longer with the policy direction (non-appreciating peso) but with policy instrument (to use or not to use QE-like printing of peso).

A Reason for Hope III: Political Economy

The political arena on which the exchange rate issue is fought has changed. The OFW sector is becoming more assertive of its rights, more aware of its muscle and is finding more and more political champions of its interests. The retail and real estate sectors now know that their own vitality depends on the vibrancy of the BPO- and remittance-based demand. The banking sector which is deeply exposed to the retail and real estate sectors know this connection well. Some
business conglomerates such as the Ayala group now directly own dollar-earning business interests. They have become more receptive to the weak peso advocacy. Even Philippine Chamber of Commerce and Industry (PCCI), long an opponent of the weak peso, has now seen the protective effect of the policy. The BPO industry widely recognized as the sunshine industry and for some time indifferent to the cause has become a staunch opponent of the peso appreciation. We have gone a long way from 1994! The collective action challenge is thereby made easier. It remains hard.

Scarborough Shoals: A Geopolitical Aside

We reacted with outrage to PRC’s territorial adventurism in the South China Sea. Militarily, we do not stand a chance. But unrecognized by many, the PRC’s undervalued yuan coupled with our pursuit of a strong peso has already resulted in the virtual economic occupation of the country. A little exchange rate aggression will serve to slow this takeover. It will serve as a defensive retaliation for PRC’s exporting its unemployment to the Philippines. We can and should use some exchange rate aggression ourselves as a small but effective weapon to avenge the attempted Scarborough Shoals highjack. That will put real fangs to the otherwise toothless outrage over the takeover.
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