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Philippine Institute for Development Studies
Surian sa mga Pag-aaral Pangkaunlaran ng Pilipinas

Two Essays on Regional Economic Integration in East Asia

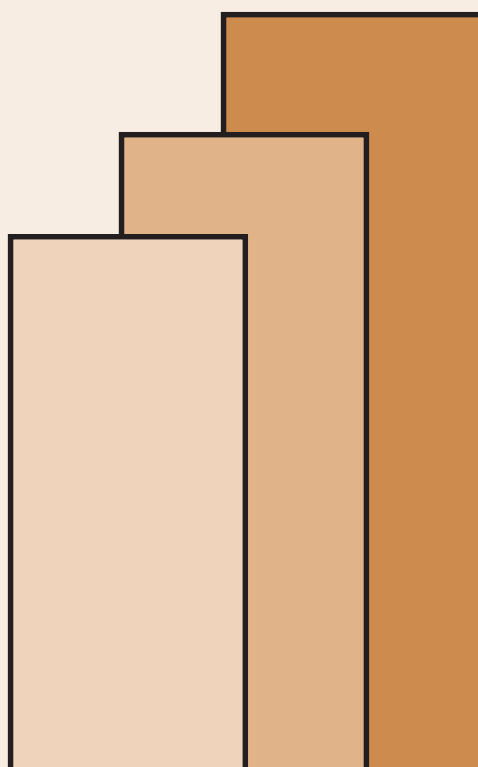
Josef T. Yap

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Two Essays on Regional Economic Integration in East Asia

Josef T. Yap

Abstract

Regional economic integration in East Asia has gained momentum in the aftermath of the 1997 financial crisis and the escalation of international terrorism. In the first essay, the integration process in Europe and East Asia is compared briefly. This is followed by a discussion on the expansion process by the European Union and how East Asia can learn from this. In particular, the concern is how to integrate the CMLV countries in a meaningful way. Proposals deal with the impact of freer movement of natural persons, the Japan-ASEAN comprehensive economic partnership agreements, and the viability of core labor standards.

The second essay is more straightforward. Criteria for successful exchange rate coordination are specified and the paper determines whether the Philippines has satisfied the criteria. The conclusion is that while monetary policy has been fairly stable, the weak fiscal position will prevent the Philippines from participating in regional exchange rate coordination.

Keywords: regional economic integration, regional monetary cooperation, accession countries, human development, fiscal bind

Essay 1: Integrating the Lower Income Countries in Europe and East Asia: Some Comparative Issues¹

Josef T. Yap

I. Introduction

The European Union is poised to increase its membership gradually over the next decade beginning with Slovenia and Cyprus in 2004. Apart from these two countries, the other candidates are Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Poland, Romania, and Slovakia. Together with Slovenia, the latter nine countries form what is called the CEEC-10 or the Central and East European countries.

A natural concern is the impact of the enlargement both on the present members or the EU-15 and the new entrants. Many studies have demonstrated convincingly that the benefits from enlargement in terms of further trade integration and migration are substantial and will largely outweigh the costs of accession at the EU aggregate level and the level of individual EU members. However, the integration process has to be

¹The author gratefully acknowledges the excellent research assistance provided by Ms. Jennifer C. De Castro. The usual disclaimer applies.

accompanied by policy measures that would ensure the positive outcome. A recent study identified four broad sets of policies:²

- Reforming EU-wide redistribution policies so as to make them more transparent as well as to encompass the new members.
- Allowing for a gradual dismantling of the remaining barriers to migration from the candidates of accession.
- Making the accession by the CEECs conditional on reforms to their systems of social welfare provision that will mitigate the undesirable distributional effects of enlargement.
- Implementing structural reforms at home that will allow domestic labor markets to absorb more effectively the shock associated with the entry of countries with much lower per capita income levels.

The primary purpose of this paper is not to delve into the details of the EU integration process. Rather it is to determine whether the evolution of the EU over the past fifty years and the issues it is currently facing can provide lessons for East Asia as the latter contends with various alternatives for closer regional economic integration and regional cooperation.

The paper is structured as follows. In the next section the more important issues that must be addressed are outlined. This would include deciding on the countries that should be involved in the East Asia integration process. Section III then looks at the options available to East Asia in its pursuit of regional economic integration with emphasis on the major lessons that can be learned from the European experience in incorporating the accession countries. The last section concludes.

II. Key Issues

When comparing the EU integration experience with East Asia, it would be useful to analyze the disparity in the level of development of the countries involved. As of 2001, the mean per capita GDP of the EU 15 measured in PPP dollars was 26,477 (Table 1 and Table 2 for a summary). In that year, the eleven accession countries had a mean per capita GDP of 11,444 or 43 percent of the EU-15 average.

Table 2. Average Per Capita GDP PPP\$ per Region 2001	
Region	Average GDP
EU-15	26,447
CEEC-10 plus Cyprus	11,444
Japan, Brunei, Korea, Singapore	20,528
China, Indo, Malaysia, Phil, Thailand	5,190
CMLV	1,644
Source: 2003 UNDP Human Development Report	

²Bertola, Boeri, et al. (2002). The paper also cites studies that demonstrate the net beneficial effect of enlargement.

Meanwhile, the 13 countries of East Asia can be classified into three distinct groups. Japan, Korea, Brunei and Singapore have the highest per capita GDP with an average of 20,528 which is close to the EU average. The middle-income countries consisting of China, Indonesia, Malaysia, the Philippines, and Thailand have a mean per capita GDP of 5,190, which is 25.3 percent of the average income of the four high-income countries. The so-called CMLV—Cambodia, Myanmar, Lao PDR, and Viet Nam—countries have an average per capita GDP of only 1,644, which is only 8 percent of the average of the high-income countries. Thus, there is more disparity in the level of development in East Asia compared to Europe.

The situation in East Asia becomes more complex because a formal regional trade agreement exists only among the members of ASEAN, which some analysts do not consider to be a viable area for this type of configuration. Several studies have pointed to the reasons why ASEAN member states were reluctant to proceed with regional economic integration (Chia, 2000). One, the wide differences in levels of economic development, industrial competence and commitment to free trade made it difficult to forge consensus on economic integration. Two, there has been limited complementarity among the economies, except perhaps between Brunei and Singapore, on the one hand, and the other ASEAN countries, on the other. However, Brunei and Singapore have small populations and cannot perform the role that Germany and France did in the EU. At present, a modest degree of complementarity exists between the middle-income Southeast Asian economies and the CMLV countries. And three, ASEAN was—and remains—too small to be economically crucial for individual member countries. Intra-ASEAN trade is still relatively small—23 percent of total exports in 2001 compared to 61 percent for the EU—and sources of investment are largely extra-ASEAN—91 percent in 2001.

In order to overcome these limitations, an obvious course of action is to expand the regional integration agreement to encompass Japan, Korea and China. Such an arrangement actually has been in existence although this has been fuelled by spontaneous market forces directly linked to the restructuring of the Japanese and other economies in the area. While this arrangement addresses the problem of lack of complementarity, it brings to fore the crucial differences between the European and East Asian integration experience. It has been observed that these differences are related to the depth of economic integration, the institutional density of regional arrangements, the content and negotiating devices of regional rules and the procedures for ensuring these rules are respected (Guerrieri and Falautano, 2000). In particular, the EU is considered to be a highly legalistic institution, and the political integration objective had facilitated the shift in political sovereignty to the supranational institutionalized way of implementing and enforcing integration (Langhammer 1997). The economic reality of increased interdependence came later for Europe while in East Asia the intensity of economic interaction was the basis for considering greater integration (Munakata 2002).

The more critical issue is whether the East Asian countries should adopt a more structured or institutionalized approach in their efforts toward greater regional economic integration.³ Such a scheme has historically been hampered by several

³ It is assumed that the benefits of regional economic integration in East Asia will outweigh any costs. Some studies have shown this empirically (e.g the World Bank publication, see Krumm and Kharas, 2003).

factors such as 'competition and antagonism between Japan and China, disgruntlement and suspicion among some about US regional leadership, and an absence of a kind of overwhelming geopolitical challenge that helped postwar Europe to cohere' (Munakata, 2001). On the other hand several so-called driving forces have heightened interest for closer political and economic relations (Munakata 2002, 2001):

- East Asian economies' growing concern about regionalism gaining momentum particularly in Europe and North America after the end of the Cold War.
- East Asian frustration with unilateral approaches by the US and 'market fundamentalism' symbolized by the Washington Consensus. East Asian countries felt the need for greater negotiation vis-à-vis pressure from the US and US-dominated institutions.
- The desire for East Asian economies to have an effective mechanism for cooperation based on geographic proximity, de facto integration and challenges of 'compressed development' through rapid industrialization and institutional transition to adapt to globalization. In particular, there is a proposal that East Asia must reduce its dependence on exports outside the region and base its economic growth more firmly on domestic or regional demand in order to stabilize the global as well as regional economy.

These centripetal forces have become more compelling in the aftermath of the 1997 financial crisis and the recent escalation of international terrorism.

The reasons for a more structured approach to regional economic integration and regional cooperation can be extended beyond the aforementioned political and economic considerations. Table 3 shows a similar wide disparity between the European countries and the countries of East Asia in terms of human development. The average of the United Nations Human Development Index—a summary statistic that covers economic, social, health, and environmental conditions—for selected regions is presented in Table 4. The disparity, particularly between the middle-to-low income countries of East Asia and the other countries, echoes the concern expressed in the 1999 UNDP Human Development Report that "when the market goes too far in dominating social and political outcomes, the opportunities and rewards of globalization spread unequally and inequitably--concentrating power and wealth in a select group of people, nations and corporations, and marginalizing others."⁴ At that time inequality had been rising within and between countries and as a result the income gap between the fifth of the world's people living in the richest countries and the fifth in the poorest rose to 74 to 1 in 1997, up from 60 to 1 in 1990 and 30 to 1 in 1960.

⁴ United Nations Development Programme (UNDP) Human Development Report 1999, pp. 2-3.

Table 4. Average Human Development Index per Region	
Region	Average HDI
EU-15	0.924
CEEC-10 plus Cyprus	0.835
Japan, Brunei, Korea, Singapore	0.892
China, Indo, Malaysia, Phil, Thailand	0.742
CMLV	0.579
Source: 2003 UNDP Human Development Report	

The challenge is to design development strategies that would counter the ‘unilateral approaches by the US and market fundamentalism.’ It can be argued that assuring convergence in human development or at least accelerating the convergence process requires more direct government intervention not only at the national level but the regional level as well. This follows mainly from the textbook theory of public goods that is the basis for providing free public school education and free or subsidized health care. Meanwhile, strategic intervention at the regional level can directly relate efforts to enhance human development with the process of regional economic integration. Developing economies need the capability—in terms of infrastructure, technology, and human resource development—to maintain a competitive business environment and economic and social stability in order to capitalize on the benefits of liberalization (Munakata 2002).

Viewed from another perspective, developing countries have to achieve a minimum threshold level of economic and social development to participate effectively in both the regional integration and globalization processes. For example, an agreement on core standards for labor conditions, education, health, and the environment could encourage foreign direct investment that is characterized as ‘movement of firms to markets’ rather than the traditional ‘movement to low-cost locations.’ In this context, the approach of the EU in incorporating the accession countries should be quite relevant to East Asia.

III. The Way Forward

Because of the renewed emphasis on the ‘driving forces,’ attempts toward closer economic ties have gained momentum in East Asia. At present, regional economic integration and regional cooperation in East Asia are following two general tracks. One, there has been a proliferation of bilateral free trade agreements, most of which are still at the negotiating stage: between Japan and Korea, between Japan and Singapore, between China and ASEAN, and between Japan and the other ASEAN countries. The dominance of these bilateral arrangements instead of a region-wide East Asian Free Trade Area reflects the pragmatic approach being taken by the countries of the region.

Meanwhile, the various countries have embarked on closer monetary and financial cooperation with the possibility of establishing a monetary union in the distant future. Regional cooperation in the monetary and financial spheres can be justified by three phenomena that were highlighted during the 1997 crisis (Montiel, 2003): (i) spillovers from exchange rate policies, which presents a reason for exchange rate coordination;

(ii) inadequate supplies of international liquidity; and (iii) common structural weaknesses in the financial sector and corporate governance, which can be addressed more effectively by cross-country cooperation in the reform process. The existing mechanisms to achieve greater cooperation and the various proposals to enhance these arrangements were analyzed extensively in a two-volume study published by the Asian Development Bank (2003).

This section deals primarily with the regional response to the need to integrate the lower income countries in a meaningful way. One approach stems from an observation by Langhammer (1997) that even if ASEAN has very little to learn from Europe's highly institutionalized way of implementing and enforcing integration, it still could draw a lesson on how the EU handled the issue of widening membership to encompass lesser developed neighboring countries through its social chapters and social cohesion fund. This is related to the need to reform EU-wide redistribution policies to accommodate the accession countries. ASEAN has actually implemented a cost-sharing scheme to accommodate CMLV countries. It also proposed to set up a cost-sharing fund and establish the ASEAN foundation, a vehicle for receiving private sector contributions. In addition, the transition period for these countries to comply with the requirements of the ASEAN Free Trade Area (AFTA) was extended.

There is a strong likelihood that ASEAN will be financially constrained to help the CMLV countries in a significant way. This should not pose a major constraint since the CMLV countries benefit a great deal from the usual assistance from bilateral and multilateral institutions. Apart from these traditional sources, the comprehensive economic partnership agreements espoused by Japan deserve closer scrutiny (Yamazawa and Hiratsuka, 2003). For example, in the case of the Japan-Singapore Economic Partnership Agreement, the two countries agreed to cooperate in financial services, information and communication technology and human resource development. The implication is a more direct channel of addressing social concerns, at the same time promoting greater regional integration.

Another avenue to enhance human development directly is to focus on relevant provisions in the General Agreement on Trade in Services (GATS) particularly those related to the movement of natural persons. This can result in the freer flow of skilled labor and professionals among ASEAN member states, likely benefiting the CMLV countries in terms of increased access to health services. Proposals in this area at the regional level are presented in the box.

Regional agreements based on GATS can also deal with the thorny problem of migrant workers, particularly those without legal status. Promoting workers' protection and the improvement of working conditions are avenues for empowering the migrant workers and a means of reaping the benefits of market access and liberalization in trade services (Tullao and Cortez, 2003). However, the situation in ASEAN differs markedly from the European case where it is acknowledged that current measures that limit mobility within the EU should be phased out (Bertola, Boeri, et al. 2002). One option is to adopt ASEAN-wide migration policies that would

include not only enforcement of border controls, but also on-site controls of illegal employment of migrants.⁵

Related to the issue of labor mobility is the adoption of core standards for labor conditions. This would include weighing the need for specifying a minimum level of social welfare provision across countries of Southeast Asia. The benefit of setting these standards lies mainly in preventing a ‘race to the bottom’ where countries try to attract foreign investment by providing labor at a very low cost. Deciding on these matters at the regional level has the advantage of reducing the perception that these standards are a covert means of protectionism by developed countries. A publication by the Asia-Europe Foundation that compares labor relations in Europe and Asia could provide a useful starting point for the debate (Koh and van der Linden, 2000).

BOX. Proposals at the regional level to deal with the movement of natural persons.*

1. Establish bilateral or regional Mutual Recognition Agreements (MRAs)

Since the practice of professions has domestic regulatory implications, there is a need to evaluate the capability of the service provider to render the service in order to safeguard public interest and the welfare of the consumers. If a certification process is done for domestic service providers, it should also be done for foreign-service providers as part of the regulatory function of governments. Once an MRA agreement is established it will be easier for professionals to move within the coverage of the MRA. Initially, it can start with less contentious items with significant common grounds like the accreditation of higher educational institutions. Then it can proceed with the process of establishing equivalence of education levels, degrees, and quality of graduates. The final process is the recognition of licenses and professional certifications and experience. Although domestic regulation is an inherent component of state responsibility, the private sector can have a significant role in the formation of MRAs. The establishment of an MRA can be initiated by various professional associations and other concerned organizations in the private sector as a way of assisting the government in domestic regulation under a freer movement of natural persons.

At the regional level, improvements in market access on the movement of natural persons can proceed through the establishment of MRAs on specific professions and occupations. Since MRAs are very difficult, lengthy and tedious to undertake at the multilateral level, a bilateral or regional MRA may be more practicable and feasible that can contribute positively to the liberalization of the movement of natural persons at least at the regional level.

At the ASEAN, the ASEAN Framework for Trade in Services (AFAS) provides member countries to enter into bilateral or regional mutual recognition agreements. The intention in the recognition of education, experience, and other forms of certifications from the other member states is for the licensing and certification of service providers in the host member states.

⁵ This is similar to the proposal of Bertola, Boeri, et al. for the case of accession countries during the transition phase.

2. Review the immigration policies in the region

The ASEAN has lifted the visa requirement for its citizens for easy movement across the region. This facility is also done for business purposes under the APEC business visa. What can facilitate further the movement of natural persons is it's de-linking from the mode of commercial presence. For example, the issuance of a visa for temporary employment to render a specific service in a host country for a specified period can boost the movement of natural persons in the region.

3. Hasten the implementation of liberalization schemes in services

The ASEAN Framework Agreement in Services (AFAS) was established with the objective of forming a free trade area in services in the ASEAN. This objective can be attained through the improvement of the efficiency and competitiveness, diversification of production capacity and supply, and the distribution of services within and outside ASEAN. Since movement of natural persons is part of the mode of supply in the regional liberalization framework in services, the immediate implementation of AFAS can accelerate the movement of natural persons in the region. There is a need to substantially eliminate restrictions to trade in services and liberalize trade in services by expanding the depth and scope of liberalization beyond those undertaken under the GATS. The aim of the new liberalization guidelines is to have free flow of all services by 2020 while fast tracking selected sectors by 2010.

*Lifted from Tullao and Cortez (2003)

IV. Concluding Remarks

Regional economic integration in East Asia can benefit from a more coherent political vision among the countries involved. While this may take some time, recent developments—particularly the unilateral actions by the US in several fronts—have made this task more imperative. But even if East Asian leaders continue to take a pragmatic stand vis-à-vis political issues, this should not prevent them from adopting a more institutionalized approach in matters related to social concerns.

This paper generally argues that East Asian economies, particularly the ASEAN member states, can learn from the process that the EU has adopted when it expanded its membership, especially in the case of the CEEC-10. The overall outlook in the EU is best summarized by G. Schiavone (2001):

“The fact is that respect for human rights and fundamental freedoms should not be viewed as an objective to be pursued per se on a region-wide level but rather as a key component of any advanced cooperation and integration experience rooted in regional model of society. The ultimate success of any regional integration arrangement would ultimately be guaranteed by the full observance of human rights.”

The term ‘human rights’ can be substituted with ‘human development’ and this statement will be fully relevant to East Asia, especially in the case of the CMLV countries.

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Table 1. Per Capita GDP PPP\$, 2001

EU 15		CEEC and Cyprus		East Asia 13	
Austria	26,730	Bulgaria	6,890	Myanmar	1027
Belgium	25,520	Czech Republi	14,720	Brunei	19,210
Denmark	29,000	Estonia	10,170	Cambodia	1,860
Finland	24,430	Hungary	12,340	Lao PDR	1,620
France	23,990	Latvia	7,730	Indonesia	2,940
Germany	25,350	Lithuania	8,470	Malaysia	8,750
Greece	17,440	Poland	9,450	Philippines	3,840
Ireland	32,410	Romania	5,830	Singapore	22,680
Italy	24,670	Slovak Republ	11,960	Thailand	6,400
Luxembourg	53,780	Slovenia	17,130	Viet Nam	2,070
Netherlands	27,190	Cyprus	21,190	China	4,020
Portugal	18,150			Japan	25,130
Spain	20,150			Korea	15,090
Sweden	24,180				
UK	24,160				
MEAN	26,477		11,444		

Source: 2003 UNDP Human Development Report

Table 3. Human Development Index

EU 15		CEEC and Cyprus		East Asia 13	
Austria	0.929	Bulgaria	0.795	Myanmar	0.549
Belgium	0.937	Czech Republi	0.861	Brunei	0.872
Denmark	0.930	Estonia	0.833	Cambodia	0.556
Finland	0.930	Hungary	0.837	Lao PDR	0.525
France	0.925	Latvia	0.811	Indonesia	0.682
Germany	0.921	Lithuania	0.824	Malaysia	0.790
Greece	0.892	Poland	0.841	Philippines	0.751
Ireland	0.930	Romania	0.773	Singapore	0.884
Italy	0.916	Slovak Republ	0.836	Thailand	0.768
Luxembourg	0.930	Slovenia	0.881	Viet Nam	0.688
Netherlands	0.938	Cyprus	0.891	China	0.721
Portugal	0.896			Japan	0.932
Spain	0.918			Korea	0.879
Sweden	0.941				
UK	0.930				
MEAN	0.924		0.835		

Source: 2003 UNDP Human Development Report

Essay 2: Overcoming the Fiscal Bind: Is the Philippines Ready for Regional Exchange Rate Coordination?⁶

Josef T. Yap

Introduction

Interest in regional monetary and financial cooperation and integration increased in the aftermath of the 1997 East Asian financial crisis. Regional financial and monetary cooperation can be justified by three phenomena that were highlighted during the 1997 debacle (Montiel, 2003): (i) spillovers from exchange rate policies, which presents a reason for exchange rate coordination; (ii) inadequate supplies of international liquidity; and (iii) common structural weaknesses in the financial sector and corporate governance, which can be addressed more effectively by cross-country cooperation in the reform process. The European experience is also cited as factor that has heightened interest in greater financial and monetary cooperation.

The costs and benefits of exchange rate coordination have been discussed extensively elsewhere.⁷ In this paper, we examine the major prerequisites of effective exchange rate coordination at the regional level and then proceed to determine whether the Philippines has satisfied the criteria. The focus will be on fiscal prudence. However, it must be emphasized that the goal of fiscal sustainability is a key element of macroeconomic stability and overall economic development. In the latter context, regional exchange rate coordination is only peripheral.

Exchange rate coordination is one aspect of general macroeconomic policy coordination and the relationship between the two is asymmetric. Countries can benefit from coordinating macroeconomic policy, e.g. monetary policy among G8 countries, even if they do not coordinate their exchange rates. On the other hand, exchange rate coordination requires coordination in other macroeconomic policies, particularly monetary and fiscal policies. A typical list of preconditions for a successful regional basket peg regime reads as follows (Ito and Park, 2003):

- Ability to manage (independent) monetary policy prudently when countering external and internal shocks, without nominal anchor (possibly with inflation targeting).
- Fiscal policy prudence.
- Credibility in macroeconomic management.

These conditions guarantee that there will no persistent source of exchange rate fluctuations from domestic macroeconomic stability. The criteria generally apply to any regional exchange rate coordination scheme.

⁶ Paper prepared for the Workshop on Exchange Rate Cooperation in East Asia, Tokyo, 8 March 2004. The author is grateful to the Ministry of Finance of Japan for the invitation and financial support to join the workshop; Dr. Mario B. Lamberte, president of PIDS, for helpful suggestions; and to Ms. Merle G. Galvan for excellent research assistance. The usual disclaimer applies.

⁷ A number of studies are cited and integrated in the ADB (2003) publication.

A brief evaluation of the current state of monetary policy in the Philippines will be given in the next section. This will be followed by a discussion on the nature and evolution of the fiscal bind in the Philippines, which is the focus of the paper. The penultimate section then deals with policies to overcome the fiscal bind. The last section concludes.

Monetary Policy in the Philippines⁸

The Bangko Sentral ng Pilipinas (BSP, the Philippine Central Bank) formally shifted to an inflation targeting regime in January 2002. Prior to this, monetary policy decisions relied for the most part on information on monetary aggregates. These served as operating targets under the monetary targeting framework employed then by BSP.

Several developments led to the decision to adopt inflation targeting. First, countries that adopted this framework have shown better performance in terms of lower and more stable inflation rates. Second, financial liberalization has limited the efficacy of monetary aggregates both as a lever of monetary policy and as an indicator of the monetary stance. Lastly, the more flexible exchange rate regime that followed the 1997 East Asian financial crisis is more conducive to an inflation targeting framework.

Under inflation targeting, the BSP becomes more forward looking in its approach to monetary policy. Monetary decisions are based on the BSP's policy reaction function: the BSP would set its policy rates (specifically its overnight borrowing and lending rates) based on the assessment of future inflation and output growth, relative to the desired path of these variables. Operationally, inflation targeting entails a careful review and analysis of past and current trends in indicator variables along with the forecasts of inflation.

Based on the assessment shown in Box 1, the BSP seems to have achieved the requirements for a successful inflation targeting regime. This would imply that the Philippine economy has met the first criterion for its involvement in regional exchange rate coordination.

Another important indicator of a more conducive environment for inflation targeting is the degree of exchange rate pass-through (ERPT) in the Philippine economy. Inflation targeting is a monogamous monetary framework in the sense that it does not admit other nominal anchor, such as exchange-rate target or money-growth rate target, other than the inflation-forecast target. However, exchange rate fluctuations can have a large effect on inflation rate with a lag much shorter than those of monetary aggregates. Thus, although the BSP may have espoused inflation targeting as its framework, it may be tempted to target an exchange rate, without necessarily being explicit about it, to achieve its low inflation target. What is at issue here is the extent of the ERPT to domestic prices, because a higher ERPT would require the BSP to pay greater attention to exchange rate movements to stabilize domestic prices.

⁸ This section draws heavily from Lamberte (2002).

Box 1. Hurdling the Requirements for Inflation Targeting	
Requirements for the Adoption of Inflation Targeting	Is it in place in the Philippines?
Central Bank independence	Yes, the law provides fiscal and administrative independence to the BSP as the central monetary authority.
Central Bank commitment	Yes, the law mandates that the central bank should be primarily concerned with maintaining price stability.
Good forecasting ability	Inflation forecasting models are continuously being improved; these will be supplemented by judgment and discretion given available economic and financial indicators.
Transparency	In addition to existing reports and publications, the BSP will also publish an Inflation Report and the minutes of relevant Monetary Board discussions on monetary policy (with a lag).
Accountability	The BSP will stand firmly behind the inflation target and will explain to the public and higher authorities should there be any deviations.
Sound financial system	The financial system is constantly developing partly in view of the measures implemented by supervisory authorities to strengthen it.
Source: www.bsp.gov.ph/resources/other_docs/inflation_targeting.htm	

Recent studies on ERPT have shed new light on this issue. Taylor (2000) was the first to point out that the recent decline in ERPT in most industrialized countries could be attributed to their low inflation environment. ***In other words, ERPT may be endogenous to a country's performance in stabilizing domestic prices.*** Taylor went on to develop a microeconomic model based on staggered price setting and monopolistic competition to explain the relationship between inflation and exchange rate pass-through. Firms set prices for several periods in advance and adjust them if they perceive that cost increases brought about by certain factors, such as exchange rate depreciation or other factors, are persistent. Countries with higher inflation rates tend to have higher persistence of cost changes, which can then lead to higher ERPT. Conversely, countries with lower inflation rates tend to have lower persistence of cost changes, and hence, lower ERPT. It therefore implies that a country with a credible low inflation policy tends to experience low ERPT.

Choudhri and Hakura (2001) extended Taylor's paper by developing an open macroeconomic model based on imperfect competition and price inertia. The latter arises from staggered price adjustment. Their model rests on the assumption that the monetary authorities follow a monetary rule that targets a low inflation rate and responds strongly to deviations from the target. Thus, they argue that:

“The dependence of CPI pass-through on the inflationary environment arises essentially because the pass-through reflects the expected effect of monetary shocks on current and future costs. A low inflation regime lowers the pass-through by weakening the expected future effect of the shocks (via its reaction to price deviations from the target

path). Low inflation economies could also be subject to less variable monetary shocks. The lower the variability of monetary shocks would decrease the information content of the exchange rates in predicting monetary shocks and this effect suggests another reason for the pass-through to be smaller under a low inflation regime.”

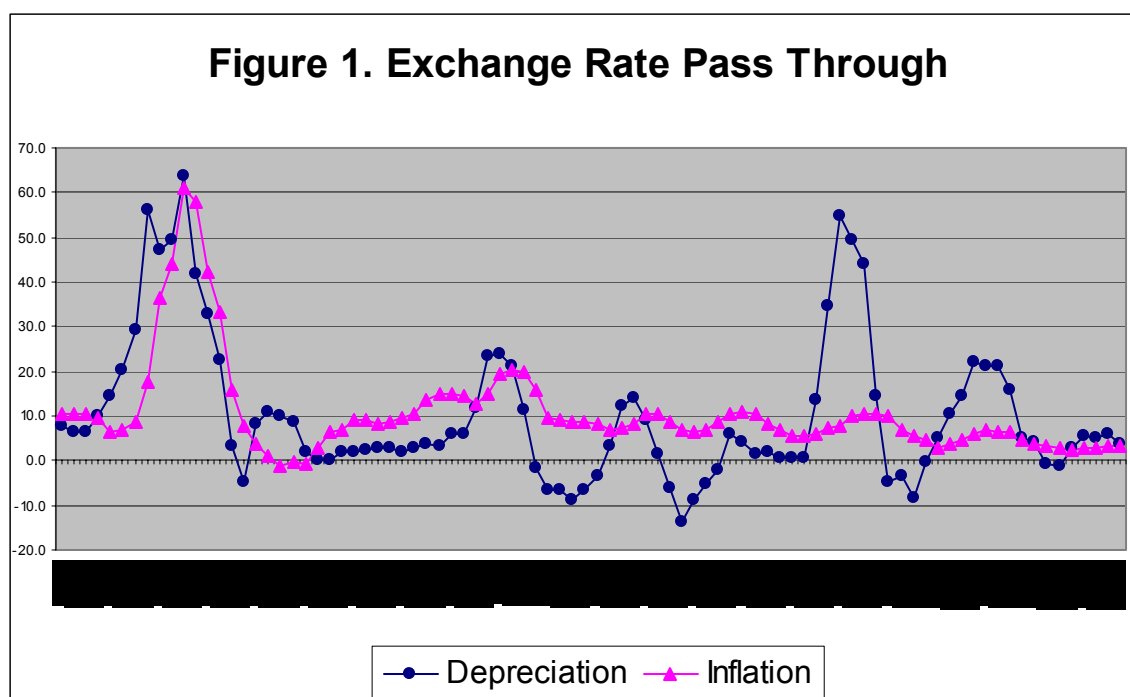
The pricing power of international firms increases in high inflation regimes, causing the ERPT to become larger. Conversely, their pricing power declines in low inflation regimes, causing ERPT to be small.

Figure 1 shows the behavior of inflation and the rate of change of the exchange rate over the past twenty years. The graph suggests that the degree of ERPT has declined. Lamberte (2002) tested this formally following a model applied by Choudhri and Hakura. His empirical results clearly show a significant decline in ERPT between 1980 and 2001. The substantial drop in the ERPT during the BSP period leads to two important conclusions. First, the hypothesis that ERPT depends on the inflation regime has been found in the case of the Philippines. Second, the low inflation rate regime would make it easier for the BSP to implement its inflation targeting framework.

It should be noted that inflation targeting is compatible with exchange rate coordination, which includes a common basket band system. This was clearly explained by Ogawa, et al. (2003), thus:

“An interesting question here is whether inflation targeting and a managed exchange rate regime could be compatible. Most of the time, they will be compatible. Consider a situation where an economy, which has achieved internal and external equilibria, is hit by an exogenous shock of currency appreciation and pushed to the ceiling of the tolerance range (assuming a basket band system). Appreciation is undesirable since it will make exporters lose their competitiveness and the trade balance will become a deficit. At the same time, currency appreciation will lower the inflation rate from two channels: dampened demand from a slump in tradable sectors, and lower price of imports. The basket band consideration will call for a lower interest rate to encourage capital outflows, and inflation targeting will call for lower interest rate to combat deflationary pressure. In this case, therefore there is no conflict between the basket band and inflation targeting. Similarly, a depreciation shock can be countered by tight monetary policy, both from the basket band and inflation targeting considerations.”

Ogawa, et al. then proceed to consider the case of a domestic inflation shock caused by an increase in aggregate demand and an adverse supply shock. Their conclusion is that the goal of inflation targeting and that of a basket band system will not point to conflicting directions of monetary policy, most of the time. East Asian economies with an inflation targeting strategy can safely adopt the basket band system.



The Fiscal Bind in the Philippines

The nature of the fiscal bind in the Philippines is not difficult to portray. Data in Table 1 show that since 2000, among the countries hardest hit by the 1997 crisis, the Philippines has a national government deficit that is second only to Malaysia in terms of its ratio to GDP. However, in the last three years (2001-2003) Malaysia has outperformed the Philippines in three categories that are directly affected by the fiscal deficit: investment-to-GDP ratio; growth of public consumption in real terms; and growth of the construction sector in real terms (Table 2). This is an indication that, unlike in the Malaysian case, the deficit incurred in the Philippines in the past three years or so has not been channeled to pump-priming activities.

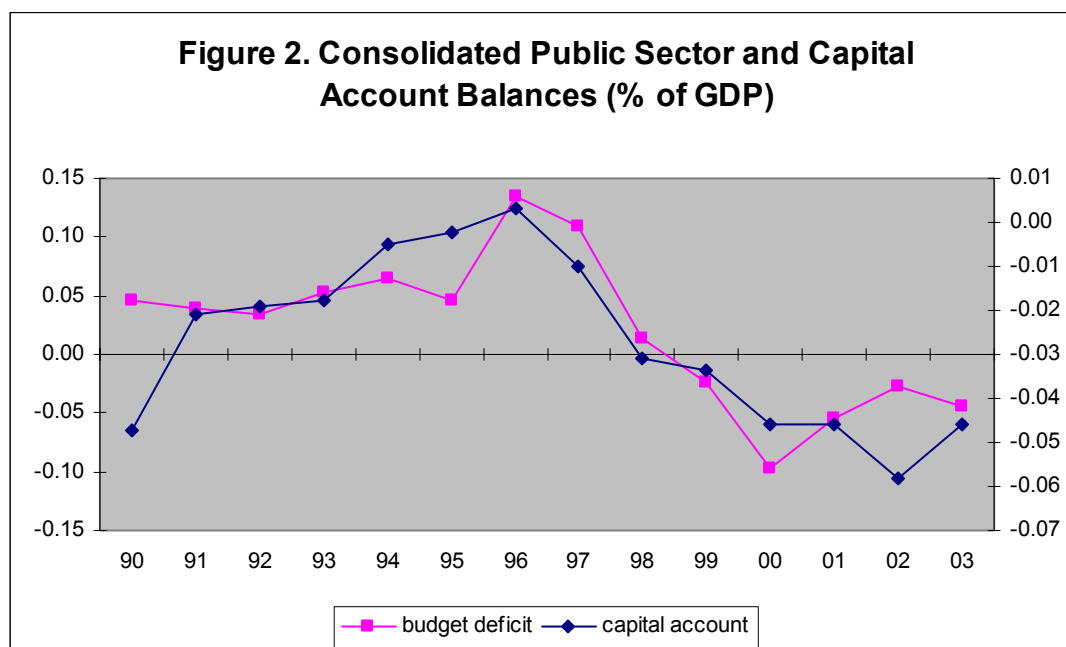
Table 1. Fiscal Balance as Percentage of GDP					
	Indonesia	Malaysia	Korea	Philippines	Thailand
2002	-1.8	-5.6	3.8	-5.2	-1.4
2001	-3.8	-5.5	1.3	-4.0	-2.4
2000	-1.2	-5.7	1.2	-4.1	-2.2
1999	-1.1	-3.1	-2.7	-3.7	-3.3
1998	-2.9	-1.8	-4.2	-1.9	-2.8
1997	-0.7	2.3	-1.5	0.1	-1.5
1996	1.2	0.7	0.3	0.3	0.9

Note: A negative number denotes a deficit.
Source: Asia Recovery Information Center

Table 2. Selected Key Indicators for Malaysia and the Philippines						
	Investment/GDP		Public Consumption (Real growth rate)		Construction (Real growth rate)	
	Mal	Phil	Mal	Phil	Mal	Phil
2003	21.8	18.7	7.9	-2.8	2.0	-5.9
2002	23.6	19.3	12.2	2.4	2.3	-3.3
2001	23.9	20.6	17.0	-5.3	2.1	-5.0

Source: Asia Recovery Information Center

Figure 2 shows that the fiscal balance—specifically that of the consolidated public sector—is directly related to movements in the capital account. This implies that developments in the fiscal sector have a direct impact on exchange rate movements. A higher fiscal deficit can lead to an outflow of capital—particularly that which is short-term in nature—which in turn puts upward pressure on the exchange rate (local currency per US dollar).



Another indicator of the fiscal problems in the Philippines is the ratio of total external debt to GDP. The data in Table 3 show that only Indonesia has a higher ratio and that its problem is a direct consequence of the 1997 crisis. The Philippines has struggled with this problem even before 1997. These numbers however should be interpreted with caution since not all external debt accrues to the public sector.

The picture even becomes worse when the coverage is extended to non-financial public sector debt. A publication by UBS Investment Research estimates non-financial public sector debt of the Philippines in 2002 to be 109 percent of GDP, compared to 78 percent for Indonesia, slightly above 60 percent for Malaysia, approximately 55 percent for Thailand, and only 40 percent for Korea.⁹ The IMF

⁹ UBS Investment Research, Asian Economic Perspectives. "The Next Asian Crisis." 30 October 2003. Non-financial public sector includes liabilities of the central government, of sub-national governments and non-financial public sector enterprises.

estimates that public debt of emerging markets averaged about 70 percent of GDP in 2002. A high level of public debt raises the risk of a fiscal crisis, discourages private investment, adds to interest rates via a risk premium and the crowding-out phenomenon, and constrains the flexibility of fiscal policy (IMF 2003).

Table 3. Total External Debt as Percentage of GDP					
	Indonesia	Malaysia	Korea	Philippines	Thailand
2002	75.7	51.4	27.4	69.2	46.9
2001	92.7	51.9	27.8	72.7	58.5
2000	93.9	47.0	28.5	69.7	65.0
1999	105.2	53.9	33.7	68.6	77.6
1998	157.1	61.9	46.3	73.1	93.1
1997	60.5	48.5	33.2	55.0	69.4
1996	48.2	38.5	31.3	50.5	59.8
Source: Asia Recovery Information Center					

An important issue is whether the stock of public debt is sustainable. A given debt level is considered to be sustainable if it implies that the government's budget constraint (in present value terms) is satisfied without an unrealistically large future correction in the primary balance. This definition takes into account both economic and political considerations.

One commonly used approach is to view fiscal policy as sustainable if it delivers a ratio of public debt to GDP that is stable, and then to calculate the primary budget that would achieve that—known as the 'debt stabilizing primary balance' (IMF, 2003). If the actual primary balance is less than the debt stabilizing balance, current fiscal policy implies an increasing ratio of public debt to GDP, and is therefore viewed as unsustainable. An application of this approach was developed by Anand and van Wiggergen (1989) and Catsambas and Pigato (1988) with their methodology being applied by Manasan (2002) for the Philippines.

In their application, the consistency between debt service, the fiscal deficit, and target output growth can be assessed based on a fiscal constraint derived from basic macroeconomic relations. The various macroeconomic aggregates must satisfy the following condition:

$$\frac{g-t}{y} + (r-q)\beta + (r^* + \hat{e} - q)\phi = (q + \pi - \theta)\mu + \dot{\beta} + \dot{\phi}$$

The equation relates the fiscal deficit to other macroeconomic variables. In this specification, policy makers can calculate a deficit-GDP ratio $\frac{g-t}{y}$ which is

consistent with a target growth rate q , the change in the ratio of real value of domestic debt to GDP $\dot{\beta}$, and the change in the foreign debt to GDP ratio $\dot{\phi}$. Other parameters of interest are the real interest rate r , inflation rate π , change in real exchange rate \hat{e} , the rate of change in income velocity of base money, θ , and the ratio of money supply to output μ .

Manasan computed a sustainable primary deficit for the period 1995-2003 and compared it with the actual primary deficit and projected primary deficit for 2002 and 2003. The actual primary deficit exceeded the sustainable primary deficit during the interval 2000-2003, indicating that there is need for fiscal adjustment in the Philippines. Otherwise, the present level of debt will eventually lead either to a sharp economic downturn or a fiscal crisis, or both.

The Evolution of the Fiscal Bind

The previous analysis begs the question as to what caused the recent deterioration in the fiscal balance of the Philippine government and the overall unsustainable level of public sector debt. In terms of components, the widening of the fiscal deficit is largely due to a drop in revenue effort. As a share of GDP, total expenditures fluctuated between 18 and 20 percent during the period 1992-2003. However, total revenues are presently only 14 percent of GDP after having peaked at 20 percent in 1994. That the fall in revenues is the main source of the widening deficit is consistent with the earlier observation that recent fiscal deficits were not a source of an economic stimulus.

Data in Table 4 shows that the Philippines has the lowest revenue-GDP ratio and lowest tax effort when compared to its neighbors. And while the other countries have recently reversed the downward trend in the tax effort—that is likely the result of the 1997 crisis—the same is not true for the Philippines. Manasan (2002) performed some calculations to explain the decline in tax effort (Table 5).

The decline in tax effort can be attributed to three general factors: 1) Change in economic structure, i.e. economic activity is greater in lightly taxed sectors like agriculture or there is a change in composition of imports; 2) Change in tax policy, the main examples being trade liberalization and the shift from an *ad valorem* to specific tax system for assessing excise taxes; and 3) Increased tax evasion. The latter was calculated as a residual. These factors affect both the amount of internal revenue and external revenue, the latter being associated with tariff collections.

Table 4. Revenue and Tax Effort in Selected ASEAN Countries, 1996-2002
(Percent of GDP)

	1996	1997	1998	1999	2000	2001	2002
Total Revenue							
Indonesia	16.5	17.9	16.4	18.6	16.2	20.7	18.6
Malaysia	23.0	23.3	20.0	19.5	18.1	23.8	23.1
Thailand	18.5	17.9	15.5	15.4	15.2	15.1	16.1
Philippines	18.6	19.0	17.3	15.9	15.2	15.3	14.1
Taxes							
Indonesia	10.8	11.3	10.7	10.3	9.2	12.8	13.1
Malaysia	18.6	19.0	16.0	15.1	13.8	18.4	18.5
Thailand	17.0	16.0	13.5	13.5	13.6	13.6	14.5
Philippines	16.9	17.0	15.6	14.5	13.7	13.3	12.3

Source: Asian Development Bank (ADB) - Key Indicators 2003 (www.adb.org/statistics)

Table 5. Explaining the Decline in Tax Effort in the Philippines

	1998			1999			2000			2001		
	ES	TP	IE	ES	TP	IE	ES	TP	IE	ES	TP	IE
Internal Revenue	0.3	-0.3	-0.3	-0.2	-0.5	-0.8	-0.8	-0.8	-0.4	-0.2	-1.1	-1.1
External Revenue	-0.3	-0.4	-0.3	-0.5	-0.5	0.0	0.0	-1.0	0.0	-0.1	-1.3	0.1
Total			-1.4			-2.5			-3.1			-3.6

Notes: ES – Economic Structure; TP – Tax Policy; IE – Increased Evasion

All numbers are change in tax effort relative to 1997, expressed as a ratio of GDP. The total is for all categories for both internal and external sources of revenue. For example, in 2000 the reduction in taxes compared to 1997 was equivalent to 3.1 percent of GDP. The number 3.1 can be distributed as follows: 0.8 percent due to a change in economic structure that led to a fall in internal revenue; 0.8 percent due to a change in tax policy that led to a fall in internal revenue; 1.0 percent due to a change in tax policy that led to a fall in customs collections or external revenue, etc. The numbers may not add up exactly due to rounding off.

Source: Manasan (2002)

The data in Table 5 indicate that the effects of tax policy were felt more greatly in the latter part of the time period. For example, the fall in tax revenue in 2001, which is equivalent to 3.6 percent of GDP, can be attributed mainly to changes in tax policy since 1997— about 67 percent of the total, calculated as 2.4 divided by 3.6. Approximately 31 percent is due to policy changes affecting domestic taxes and 36 percent due to policies affecting trade taxes.

One obvious policy measure that could have mitigated the fall in tax effort was the indexation of specific taxes to inflation in order to preserve the advantage of the *ad valorem* system. However, due to political considerations, this facet was not included in the final version of the Comprehensive Tax Reform Package approved in 1997.

While total government expenditures have been fairly constant as a percentage of GDP, the large allocation to debt service has drained the economy of investible funds. Between 1986 and 2002 the Philippine government has shelled out an equivalent of \$74.7 billion for debt service. The interest and principal payments for both domestic and external obligations were on average equivalent to 7.4 percent of GDP.¹⁰ With a lower debt service burden, the fiscal deficit and level of outstanding debt would have definitely been smaller.

The source of the high level of non-financial public sector debt has not been fully ascertained. One reason of course is the chronic fiscal deficits but it cannot account for the entire debt stock. Meanwhile, many pundits blame the corruption during the Marcos administration for the accumulation of government liabilities without the commensurate economic development. However, the entire 1986-2002 is after the Marcos administration and the growth of public debt accelerated during this time.

Overcoming the Fiscal Bind

Given the current fiscal constraints, the Philippines is not in a position to participate effectively in a regional exchange rate coordination scheme.¹¹ Public debt is very high, a large proportion of contingent liabilities is likely to materialize into actual losses, tax effort is progressively declining, and the current fiscal balance is not sustainable. Based on past experience, this the unhealthy fiscal situation will likely contribute to exchange rate volatility.

Several legislative bills pending in the Philippine Congress will definitely go a long way in improving the tax effort. One is the indexation of specific tax rates to inflation, a proposal that stemmed from the observation that the fall in excise taxes was the main cause of the structural decline in the tax effort. However, the present version of the bill excludes fuel taxes from consideration, thereby leaving out a substantial amount of potential revenue. The bill that carries most weight is the proposal to overhaul the Bureau of Internal Revenue and creating the Internal Revenue Management Authority (IRMA), lately recast to a National Authority for Tax Administration. This measure aims to restructure the incentive system in tax collection efforts in order to favor government.

Another course of action is to revisit proposals for the rationalization of fiscal incentives. These proposals call for a shorter list of activities that would qualify for investment incentives and the adoption of an operative budget for tax expenditures pertaining to fiscal incentives. The far greater challenge remains to strengthen tax

¹⁰ The situation is analogous to running the 100 meter dash with a 50 kilogram weight strapped to one leg.

¹¹ So, too, for that matter are most other East Asian economies. The IMF set a rule-of-thumb critical threshold level for non-financial public sector debt of 50 percent of GDP. Indonesia, Malaysia and Thailand have breached this threshold.

administration by plugging all the leakages caused by tax evasion. One area has been the value added tax where firms tend to underdeclare sales or overdeclare claims for input value added tax. Meanwhile, the BIR has adopted measures to strengthen its computerization process in order to improve its access to required information. This would reduce reliance on the discretion of BIR examiners.

The government should carefully manage its liabilities. For instance, it should not agree to projects—including Build-Operate-Transfer schemes—where the terms are grossly disadvantageous. The recent implementation of the Procurement Law will help reduce graft and corruption related to government transactions. A more aggressive posture on debt restructuring should also help. One course of action is to invoke the Odious Debt Doctrine, where odious debts are defined as “those contracted against the interest of the population of a state, without its consent and with full awareness of the creditor.” The government could seek legal remedies in the international arena to relieve the excessive debt burden of the Philippines.

Concluding Remarks

The Philippines has made substantial progress in achieving macroeconomic stability over the past twenty years. However, it has come full circle in its fiscal position. The fiscal bind came to the attention of policy makers during the administration of President Aquino (1986-1992). Despite efforts to resolve the problem, it has reappeared and in certain aspects the problem has become worse.

The situation clearly prevents the Philippine from effectively participating in any regional exchange rate coordination scheme. Nevertheless, it may prove useful to enter into an agreement for regional exchange rate coordination within a given time horizon. It has been noted that some criteria for successful regional economic integration may be endogenous in nature, i.e. they arise after the countries have agreed to cooperate more closely.

While this may not be necessarily the case for fiscal prudence, an agreement towards exchange rate coordination should grant domestic policy makers more leverage in the design and implementation of specific fiscal measures. A case in point is the legislative bills that are pending in the Philippine Congress. Intransigent legislators may be forced to change their views if they realize that what is at stake is the international reputation of the Philippines.

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