Ensuring the Sustainability of Economic Growth: Avoiding the Mexican Experience

Congressional Planning and Budget Office

The Chinese military strategist Liu Ji (ca. 1300) warned against complacency: "Sages are very careful not to forget about danger when secure, not to forget chaos in times of order." The Romans said likewise: *Pacem vis, para bellum.* Mexico paid the price for ignoring such principles.

In the past few months, we have indulged ourselves in self-congratulation over the unexpected favorable performance of the country's economy. Respected economists like Noel De Dios and Raul Fabella, however, have warned of the basic and fundamental weakness in our economic structure which threatens to undermine, if not endanger, the sustainability of the much touted growth.

According to De Dios, the real appreciation of the peso has penalized export and import-substituting industries, prevented export diversification and deepening, and encouraged greater import dependence in consumption and production. As a result, the balance-of-trade deficit is expected to worsen.* Moreover, the share of manufactured exports with high domestic value-added and strong linkages to agriculture has stagnated or even declined, making us more dependent on fewer export lines like electronics. Finally, De Dios concludes that the simplest and most effective option is to accommodate capital flows through corresponding monetary expansion and contraction, consistent with the liberalized financial and foreign exchange regime. This, in turn, would entail getting out of the framework of the International Monetary Fund (IMF).

Fabella complements these views, citing some worrying indicators (Table 1). The decline in the growth of durable investment is worrisome since it indicates that investors are not building new factories fast enough or that manufacturers are not expanding their capacity as much as before. This decline is consistent with the increase in our unemployment rate.

Table 1

Worrying Indicators

	1993	1994
Growth in:		
Fixed capital formation (%)	10.9	10.0
Durable investment (%)	13.3	8.3
Trade deficit	$8.5 billion	
Trade deficit (% of GNP)	9.0	10.6
National savings (% of GNP)	19.1	19.0
Unemployment rate	8.6	9.7

*The National Economic Development Authority (NEDA) had earlier projected a $6 billion trade deficit for 1994. Latest estimates predict $8.5 billion.

Our savings rate, as has been repeated often enough, is much lower than that of our neighbors and is similar to that of Mexico.

"The decline in the growth of durable investment is worrisome since it indicates that investors are not building new factories fast enough or that manufacturers are not expanding their capacity as much as before."

Hideyoshi Sakai, in his article analyzing our monetary policy, identified the peso's appreciation as the main culprit that may cause the country's deindustrialization. This is reflected in the fact that our manufacturing sector has not grown as much as it normally should when sustained economic growth occurs. Sakai stresses that turning around the course of industrial repression in the Philippines is far more important than achieving GNP growth alone.

The Mexican Monetary Crisis

We can learn some lessons about the current Mexican debacle to protect the country from a potential crisis that may occur due to the remaining fundamental weaknesses in the economy. These weaknesses include our low domestic savings mobilization rate, high trade and current account deficits, and peso overvaluation – traits that we share with Mexico (Table 2).

According to *The Economist*, what went wrong was that Mexico's current account deficit proved unsustainable for two good reasons. First, part of the increase in deficit reflected higher consumption, and second, Mexico was overly dependent on hot money. This had the negative effect of exposing Mexico's economy to volatile investor behavior. As stressed by *The Economist*, "a large current account deficit financed by speculative capital leaves an economy exquisitely vulnerable to swings in investor confidence."

It will be good to highlight some Philippine similarities to Mexico:

1. Trade and current account deficits (7.6 percent of GDP) financed by short-term, speculative capital

2. Low savings to GNP ratio

3. Decreasing inflation rate

4. Decreasing interest rate (14.5 percent in 1994 from 21.1 percent in 1991)

5. Reduced fiscal deficit

6. Export growth of 17.3 percent in 1994

Table 2

Data on Mexico

Real GDP growth (%)	3.0	
Inflation (%)	6.9	(from 18.8 percent in 1991)
Export growth (%)	17.3	(58.3 billion)
Import growth (%)	19.3	(75.4 billion)
Savings (% of GDP)	16.9	
Current account balance (% of GDP)	7.6	(26.9 billion)
Trade balance (% of GDP)	4.9	(17.3 billion)

Our financial and economic managers have brushed aside worries about the Mexican crisis happening to the Philippines since, as mentioned above, we have been incurring deficits to finance, not consumption as was the case in Mexico, but capital investments.

However, Philippine data cited by De Dios do not seem to bear this out. Capital goods as a percentage of our imports have risen by only one percentage point, from 24 to only 25 percent, over the last five years, despite the large increases in trade deficits. Conversely, imports of consumer goods have risen from five percent of imports in 1986 to nine percent in 1994.

The claim that we have floated the peso while Mexico have not does not address the core issues of trade and current account deficits financed by speculative inflows and the low savings rate, as well as the country's high dependence on foreign capital.

Moreover, our claims on political stability rest on very volatile perceptions. A crisis in Mindanao or the possible kidnapping of a prominent foreign businessman or diplomat can reverse perceptions of stability overnight in the same manner that the Chiapas rebellion and political assassinations did to Mexico.

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Citing the 'market determined' peso rate may also highlight to money market players the inability of the *Bangko Sentral ng Pilipinas* (BSP) to control the peso's overvaluation, which has, and will continue to, worsen our trade balance by diverting investments away from export-oriented industries and encouraging more imports.

Recommendations

Our over-all recommendations are visualized in Figure 1 below.

We should work hard at keeping the peso competitive. A target rate should be at least P26:$1 going up to P28:$1 and eventually to P30:$1, if we want to effect the long-term structural changes that will make our economy export-driven and to reduce our huge trade deficit problem.

We agree with the proposal of De Dios and other U.P. economists, *i.e.*, Alburo, Fabella, and Monsod, that monetary aggregates should be allowed to contract and expand with the view of accommodating forex inflows and outflows. The inflationary effects would be limited since these monetary contractions and expansions will be seen as temporary. We will also have to move out of the restrictive IMF framework of tight monetary ceilings.

To avoid or soften possible inflationary pressures from temporary expansions in money supply, the government should enact measures to declog food supply routes and continue to vigorously pursue the demonopolization and decartelization of the economy, as well as the removal of barriers-to-entry in food production and processing.

Final Comments

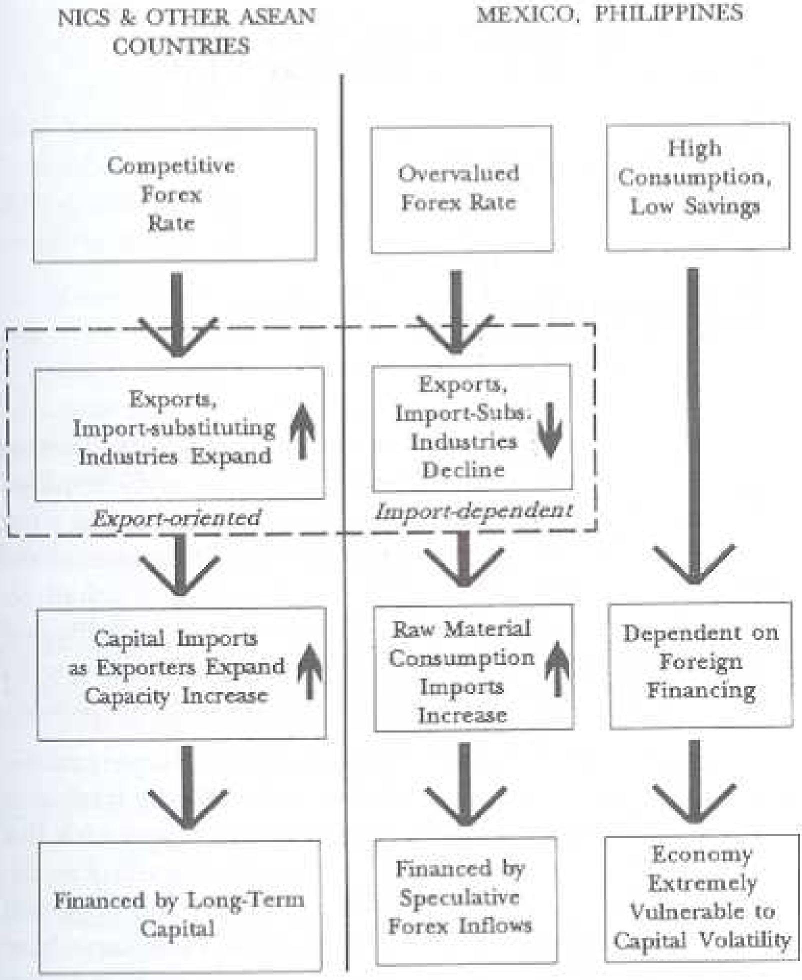
The ability to manage monetary policy competently, particularly as they affect exchange rates, has become extremely crucial to the sustainability of our economic growth. Unfortunately, our economic managers have thus far downplayed the problem.

It is also important that the investing community perceives the government to be undertaking, or at least prepared to undertake, the needed short-term and structural long-term measures to make the peso more competitive and thus, cure the persistent and growing trade deficits. We have to undertake strong and convincing measures to mobilize domestic savings in order to show the investing community our resolve to reduce our dependence on foreign capital.

These measures will signal to investors that we have taken the necessary steps to prevent , or at least face up to, unfavorable contingencies. This, in turn, will sustain investor confidence and avoid the Mexican experience.

Figure 1

Sustaining Philippine Economic Growth and Reducing Vulnerability



1. Competitive forex rate to encourage exports, limit imports and protect domestic manufacturers (Let money supply increase as speculative dollars enter)

2. Continue trade liberalization to strengthen domestic industries