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THE EFFECTS OF THE GLOBAL FINANCIAL CRISIS ON ASIA AND ON THE PHILIPPINES

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Thus far, the effects of the global financial crisis on Asia, including the Philippines, have not been as virulent as the effects in the US or in Europe. No banks or financial institutions have needed to be nationalised or recapitalised. The Asian economies are still growing, although many of them, including the Philippines, have started to exhibit signs of slower GDP growth. Countries in the region are experiencing slower export demand from large markets such as the US and Europe, a reduction in capital inflows and a withdrawal of credit lines from abroad necessary to finance investment, as well as a withdrawal of US investment from the region. The ratio of investment to GDP in Asia remains at levels below that prior to the Asian Financial Crisis. This situation is certainly going to be aggravated by the ongoing global financial crisis, with dire consequences for growth. In some countries like the Philippines, insufficient investment is a particularly acute problem and a major constraint to growth.

While the full effects of the global financial crisis on Asia are not expected until next year, some effects are already being felt by countries in the region. Whether unilateral or coordinated measures adopted in the US and in Europe will work to resolve the financial crisis, and whether China can continue to grow to counter the deflationary effects from the US and Europe on the region remain unresolved issues. So far, countries in Asia have responded unilaterally to the global financial crisis. They have not adopted a coordinated regional response – notwithstanding proposals of an US$80 billion regional standby credit facility and the expansion of the US$84 billion swap facility under ASEAN + 3.

The global financial crisis has increased the risk of financial contagion and recession in Asia. There is a growing lack of dollar liquidity in financial markets in Asia as capital retreats from countries in the region to safe havens abroad. As a result of the ongoing global financial crisis, there has been a significant increase in risk aversion against emerging market assets and bond spreads have widened. There has been a flight of capital to safe havens elsewhere. Both of these have drastically reduced the values of assets held by banks in Asia, although by how much exactly is unknown. Credit has become tighter and economic growth in many economies is beginning to slow down.

Since the beginning of October, monetary authorities in China, Hong Kong, India, Korea, South Korea, and Taiwan have been easing monetary policy. They have reduced policy interest rates and/or reserve requirements, and generally adopted measures to increase liquidity in financial markets, such as expanding the types of eligible collateral for repurchase agreements with the central bank. In some of these countries, policy rates were reduced by over 100 basis points in only a 3-week period (Liu, 2008, p1). Singapore has eased monetary policy by shifting to zero appreciation in the Singapore dollar NEER on 10 October from a policy of gradual appreciation since 2004. As of October 2008, monetary authorities in the Philippines and Thailand have maintained their policy rates, but there are indications that the authorities are also prepared to end the monetary tightening stance they adopted earlier in the year to quell inflation generated by high oil and food prices in the world market. Some countries have also extended sovereign guarantees on the external debts of banks and/or inter-bank liabilities for a limited time period to increase confidence in the financial system. Many countries in the region have also announced that fiscal policy would be more expansionary to cushion the impact of the global financial crisis on economic growth.

In the case of the Philippines, the US dollar, already a relatively scarce commodity under normal conditions, has become even more so. The current very large demand for dollars is due to several reasons. First, there has been a flight to safe havens due to increased risk aversion attached to holding Philippine sovereign bonds and emerging market bonds, in general, following the collapse of Lehman Brothers. Both Philippine sovereign bond spreads and credit default swap spreads widened as of the end of September, the latter to 283.1 basis points from 265 basis points in June. When the risk of holding these sovereign bonds rises and they are sold off, their

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values drastically decline. Since Philippine banks are required by law to maintain a 100 percent reserve cover against foreign currency deposits, they need to hold a dollar worth of liquid assets as reserves for every dollar of deposits held in their foreign currency deposit units. The latter typically hold dollar-denominated Philippine government bonds as reserve cover. The drastically-reduced value of these dollar-denominated sovereign bonds means that banks have suddenly found themselves with insufficient reserve cover for their dollar deposits. This has led them to scramble to buy dollars in the spot foreign exchange market called the Philippine dealing system and/or sell these dollar-denominated bonds even at huge losses in order to acquire dollars to help meet deficiencies in their foreign exchange cover. The sell-off of these bonds further reduces their value, raises interest rates and steepens the yield curve.

Second, the global financial crisis has also led to a greater degree of uncertainty in the Philippine financial market that has made banks reluctant to lend. The viability of banks and the health of their balance sheets given much reduced asset values, the level of exposure of local banks and other domestic financial institutions (such as the government pension system) to structured products of problematic financial institutions abroad and other foreign assets etc., are not known precisely by the public nor by banks themselves. Much reduced bank asset values increases counterparty risk, which is difficult to assess correctly given the ongoing financial turmoil. Banks have become reluctant to lend even to each other. Bank depositors' confidence tends to waver, forcing the Philippine Deposit Insurance Corporation to propose that Congress raise the amount of deposit insurance to P1 million (about US$20,000) from the current level of P250,000 per depositor. In light of the blanket guarantee on deposits adopted by other Asian countries, however, it is unclear whether a measure such as this will be effective in maintaining the public's confidence in the banking system and preventing capital flight even to other countries in the region. In addition to domestic financial institutions, some abroad, especially those that have been adversely affected by the ongoing global financial crisis, have also began to liquidate their assets in emerging markets like the Philippines in order to raise needed funds. The stock market has been experiencing record losses. Based on data from the Philippine central bank, there was a reversal of some US$503.99 million of net portfolio inflows in local stocks, bonds and bank products between January and September 26 of this year. In contrast, the country had experienced net inflows of US$3.4 billion in the same period last year.

The very large demand for dollars and capital flight to safe havens has made the peso, which appreciated by 19 per cent and was the region's best performing currency in 2007, depreciate by 12.3 per cent by 30 September 2008 since the start of the year. It is now among the region's worst performing currencies in 2008 (along with the Indian rupee and the South Korean won). In turn, the depreciation of the peso raises the cost of servicing the country's external debt. The government, for example, spent a little over US$3 billion (P 161.69B of its P535B debt service) to settle its obligations in foreign currency in the period between January to September this year, an amount larger than that in the same period last year. While the share of interest payments has declined from a high of 30 per cent of government's total expenditures 8 years ago to 23.3 per cent in 2007, it is unlikely that a further reduction to the target of 21.9 per cent for 2008 will be met in the face of higher interest rates as global and domestic credit markets tighten (Remo, 2008, B3). Even as the government's deficit rises with the depreciation of the peso, the only expenditure that clearly increases is debt service while spending necessary to stimulate the economy may not. The central bank has incurred a sizable reduction its holdings of foreign reserves, as it sold dollars in the spot market for foreign exchange in an effort to prevent a very rapid and large depreciation of the peso.

The central bank's stock of foreign reserves declined by US$870 million in September alone. The central bank has made available about US$10 billion from foreign currency swaps, an amount equivalent to about 25 per cent of its total stock of foreign reserves, to increase the supply of dollars in the spot market or to service some of its liabilities (Dumlao, November, 2008, pB1). It has also essentially suspended the mark-to-market rule until 31 March 2009 so that bank losses on foreign assets will temporarily not be booked by banks and they will therefore not need to source additional dollars for foreign exchange cover in the meantime. There have been some suggestions for the government to issue Treasury warrants to convert dollar-denominated sovereign bonds into peso-denominated sovereign debt. This is intended to restore confidence in the face of falling asset values of sovereign dollar-denominated debt and reduce the pressure on the peso to depreciate. In any case, it is unwise for the government to continue its proclivity to borrow abroad rather than domestically given the current global financial crisis.

As was the experience during the Asian Financial Crisis of 1997, a financial crisis tends to spill over to the real economy. Although US data are only now beginning to confirm a recession there, the effects of the financial crisis there that began in August 2007 have begun to be felt in the real sector here. Data from the Philippine central bank show that real GDP grew more slowly at 4.6 per cent in Q2 2008 compared with 8.3 per cent in the same period last year. There has been spending compression as household spending and capital formation slowed down, while government consumption declined. The latter declined by 5.1 per cent in Q2 2008 after expanding by 11.9 per cent in the same quarter last year. Energy sales and electricity consumption fell in Q2 2008.

Except during election years, fiscal policy in the Philippines has not been as expansionary relative to that in neighbouring countries, relative to the government's own targets for the year, and relative to the previous year. Given the widespread level of poverty and now, the need to cushion the adverse effects of the global financial crisis on economic growth, and therefore, on poverty, there is a need for government to spend more, particularly on infrastructure such as roads and irrigation, health, education, and larger cash transfers to the poor. Yet, data from the Department of Finance show that while cumulative expenditures for the first semester of 2008 grew by 6.7 per cent to P588 billion compared with the same period in 2007, this amount was P14.1 billion lower than the program for Q1-Q2 2008. Furthermore, the deficit of the National Government for the first semester of 2008 stood at P18 billion, less than half the P41 billion deficit for the same period last year. This was also lower than the programmed deficit for Q1-Q2 by P23 billion.

Part of the reason for anaemic government spending is that the government has always been fiscally-challenged by persistent deficits and a low tax to GDP ratio of about 12 per cent. Despite an improvement in the fiscal position with the imposition of the expanded VAT Law in 2006, tax revenues have been plagued by poor collection and poor tax administration. Some academics also conjecture that appropriated amounts are deliberately not spent today so that they may be reallocated to election-related spending in 2010.

Merchandise exports fell by 11.1 per cent in Q1 2008 led by the general slowdown in the electronics industry and the decline in garments exports. Electronics exports account for 60 percent of total Philippine exports. They contracted by 2.8 per cent year-on-year in August 2008 to US$2.53 billion. Exports to the US declined by 14.9 percent in August 2008 from a year ago and amounted to US$652.77 million compared with US$766.7 million in the same month last year. Merchandise imports in Q1 2008 fell by 7.4 per cent due to the decline in the importation of raw materials for electronics manufactures. This caused total imports to fall by 6.6 per cent. While the Philippines' BOP is still in surplus, largely due to the enormous amounts of remittances from overseas workers (US$14 billion in 2007), this kind of import compression will neither promote nor sustain growth. The target for overseas workers' remittances for 2008 of over US$15 billion may not be met as many of them may be laid off as a result of the global financial crisis and recession abroad. While remittances typically surge in the last quarter of the year in the face of the Christmas season, thus far, they have not prevented the peso from depreciating as it has.

Policymakers have generally tried to project an image that they are in control of the situation and have largely downplayed the gravity of the effects of the global financial crisis on the Philippine economy. They emphasise that there is no crisis in the economy at the moment and the idea that while the country has to be prepared, the expectation is that the effects on the economy will not be as severe as elsewhere. They characterise as 'unwarranted' the recent depreciation of the peso by the economy's 'good fundamentals' citing for example, the surplus in the BOP, strong overseas worker remittances, and the low level of NPLs in the banking system as a result of measures put in place after the Asian Financial Crisis (Dumlao, October 27 2008, p B1). They have also sought to assure the public that there is an adequate supply of dollars in the financial system, attributing apparent shortages to a 'distribution problem (Philippine Daily Inquirer, 30 October 2008, p1).

The print media have largely relied on press briefings of officials to report on the measures being contemplated or undertaken by government. In this respect, they have been able to effectively communicate the position of government and the steps being taken to address specific problems. However, there does not appear to be a broader perspective of the problem, with only 'sectoral' reporting on monetary policy from the central bank and fiscal policy from the Department of Finance. Outside of the newspapers, however, there is hardly any news or commentary on how external shocks are affecting or likely to affect the domestic economy in the media. There is no careful analysis of the crisis and measures adopted.

Academics, on the other hand, are beginning to question whether government has correctly described the nature of the ongoing crisis and how it will affect the Philippine economy as well as the likely effectiveness of proposed measures to be adopted. However, the views of academic economists on the economy are not usually sought by policymakers or by the media. In part, this has to do with the historical mistrust between policymakers and academics as well as the relatively basic understanding of complex economic issues by media and the public at large.

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