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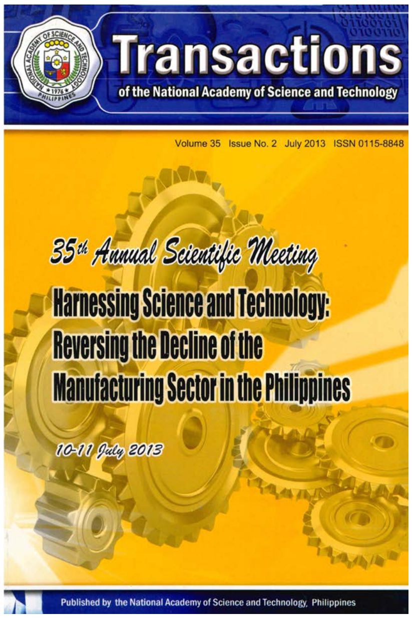

Development Progeria: The Face of the Philippine Disease

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DEVELOPMENT PROGERIA: THE FACE OF THE PHILIPPINE DISEASE

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Abstract

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 Tradable sectors, such as Manufacturing and Agriculture, and the increasing share of the Service sector. Economies on the successful economic catch-up trajectory exhibit the opposite dynamics: the share of the industry—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. We argue that the strong peso policy and market and other institutional failures have contributed to the emergence over the years of development progeria in the Philippines. We discuss ways to reverse the decline of Manufacturing.

Keywords: decline of manufacturing, services sector gain, development progeria, strong peso, market and institutional failures.

We argue that the twin headwinds of the China export tsunami and the OFW remittance, combined with what for a long time amounted to neglect by the monetary authorities to stem the injury, put a squeeze on the traded goods sector, namely, the Manufacturing and the Agricultural sectors. This battering inevitably left its mark on the industrial structure of the economy. What arose is what we call here *development progeria* (see also Fabella and Fabella 2012).

Development progeria is the economic analogue of 'premature aging' in the life sciences (a progeriac is usually a pre-teen child displaying the characteristics of a 60-year-old). A development progeriac displays the industrial structure dynamics and growth trajectory of a mature economy even while its per capita income remains very low, say, less than $5 thousand. The phenomenon is characterized by the progressive retreat of the shares of the industrial sectors, notably Manufacturing, and the increasing dominance of the service sector in a poor country typical of rich mature economies. Since rapid growth rate is generally associated with an advancing industrial sector, the overall growth rate of mature economies and development progeriacs alike is feeble. Thus, the development progeriac's prospect for a successful catch-up with mature economies is minuscule.

In contrast to the products of the traded goods sector, services—apart from those carried by fiber optics—do not cross borders: electricity is not normally shipped from one country where it is produced and consumed in another country. If that were so, our electricity prices would tract Malaysia's and would not be so high. Retail and distribution services are location-specific, although *amazon.com* makes one feel that that may soon end. Likewise, road and transport services have to be produced and consumed *in situ*. Unfortunately for us, politicians and lawyers are non-exportable or we would indeed be a rich country. Clearly, China's low-cost prowess cannot touch the Services sector except in lowering the cost of such inputs as steel plates and bathroom fixtures. The demand boost from OFW remittance—when trained to services purchases (say, a condo or fine dining)—wholly supports the domestic service producers. Telcos, megamalls, and banks thrive with growth in OFW remittance. When the peso appreciates, that portion of Services inputs that is imported (say, Italian marble or bathroom fixtures by real estate developers) becomes cheaper so boosts profit. When domestic input prices—such as wages—rise, services producers can always pass them on to domestic consumers, which neither exporters nor importers can do. Furthermore, the service sector is nearly always the breeding ground of asset price bubbles and busts which make the business landscape unstable for the tradable sector. The fate of the Services sector is the negative mirror image of the Manufacturing sector (Rodrik 2008) and the differential impact of market distortions and institutional weakness.

Is the Philippines a Development Progeriac?

To address this question, we juxtapose the Philippine experience against those of four countries (Indonesia, Thailand, Malaysia, and China), which represent the increasingly successful catch-up economies; Germany and USA represent the mature (OECD) economies; and South Korea represents the recent graduate of the catch-up academy. Figure 1 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.

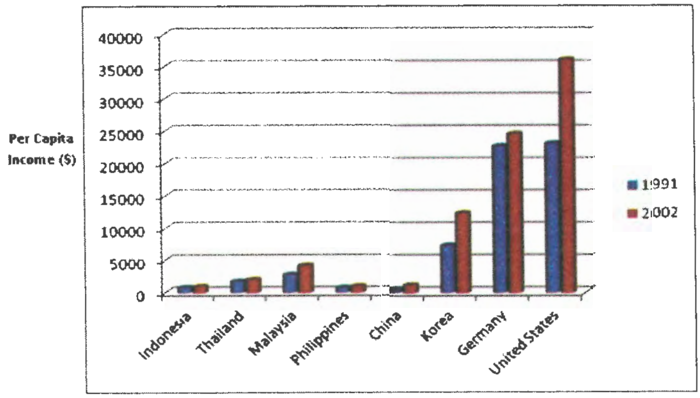

Figure 1. Per Capita Income (US$), 1991 and 2002.

We see that USA and Germany are clearly mature economies with per capita incomes in excess of US$ ten 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.

Figure 2 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. Malaysia exhibited a rising Service sector share in this period but with rising Industry and Manufacturing shares. China exhibited the same pattern.

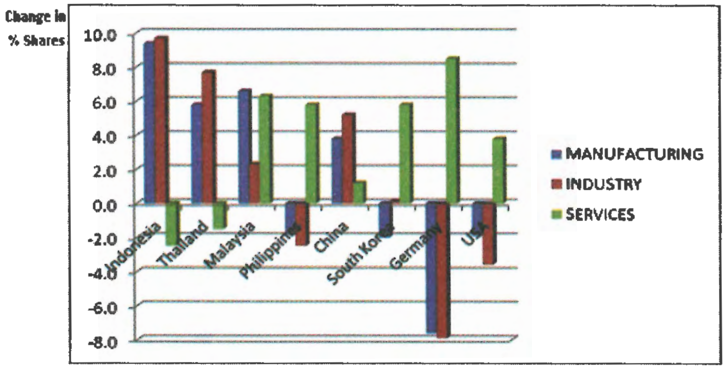

Figure 2. Change in % Industry Shares 1986 to 1996.

Figure 3 gives the trajectories for the second period (1996-2009).

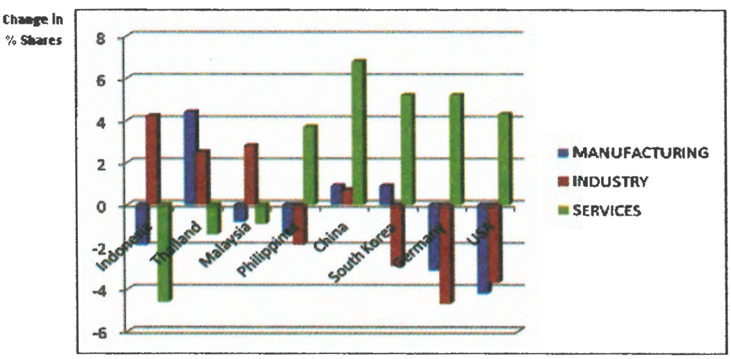

Figure 3. Change in % Industry Shares 1996 to 2009.

Malaysia reverts somewhat to the archetypal catch-up trajectory with a falling Service sector share to go with a rising Industry but falling Manufactures share. China continues the pattern where both the Industry and

Manufacturing sectors gain to go with a rising Service sector share. It is an economy firing on all cylinders.

Finally, the Philippines. The trajectory exhibited by the Philippine industrial structure in the last quarter century mimics that of late mature economies: in both periods, Industry and Manufacturing shares declined while Services share rose. 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 its prospect for convergence with mature economies is poor (Fabella and Fabella 2012).

While there are many fathers to development progeria, especially the secular retreat of Manufacturing, the punitive and myopic policy response embodied in the monetary and exchange rate policy has to take much of the blame. There is not much we can do about China's muscled export machine; OFW remittance will continue to exert pressure for peso appreciation even while it continues to butter our bread in the foreseeable future; our power, regulatory and labor cost disadvantages will, even with the best effort, mend only slowly. Nevertheless, these drawbacks can be partly redressed by a balanced exchange rate policy.

For so long and up to the late nineties, our exchange rate policy was perverse: it punished domestic production of tradables and rewarded importing from abroad. It never emerged, despite rhetoric, from the import substitution dogma held by the technocracy then that imported inputs must be subsidized by an overvalued peso to support assembly activities and that the peso depreciation will only humor the loathed sugar lobby and enrich the disdained sugar barons. An over-valued peso was viewed as a vote against the rustification of the economy.

Had Taiwan followed this advice (Taiwan's exports then were almost 100% rice and sugar and all governed by rigid quotas), Taiwan would still be keeping the Philippines company in the development wilderness. The strong peso worldview was also a recipe for periodic BOP crises and the so-called boom-bust trajectory! Both Taiwan and Japan abandoned this bankrupt dogma in the 1950s on the way to becoming export and manufacturing behemoths.

Greece, Spain, Italy, and Portugal are the current European witnesses to those perils of massive appreciation. The latter countries (derisively called PIGS) effectively experienced a massive currency appreciation with the shift to the Euro. The result is now clear to all: the death of its tradables and an orgy of foreign borrowing that fueled a humungous real estate bubble. The European sovereign debt crisis is the unintended 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 the Argentine peso at one US dollar. Argentina wallowed on borrowed affluence and for a while was the icon of growth with price stability. Until, that is, the bill came due. 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. Therefore, they must instead devalue all their assets, primarily their labor assets. The ritual spawned a neologism "fiscal devaluation"! The forced retreat of asset prices reaps the harvest of social unrest. The Philippines, by contrast, has monetary independence but for so long has chosen to deploy it in a sado-masochistic sacrifice on the altar of the strong peso.

The People's Republic of China is, by contrast, the Asian witness to the wisdom of the East Asian exceptionalism that began in the 1950s. PRC in the last decade is the current embodiment of the East Asian Model before the orgiastic capital account liberalization of the 1990s. PRC has staunchly resisted the mounting global pressure to revalue the yuan at a pace dictated by Western countries. The Chinese authorities view the yuan undervaluation (estimated to be about 25%) as the ticket out of poverty of the still over a hundred million Chinese below the poverty line. Premature appreciation is viewed correctly as the unconscionable embrace of the Japanese-style *Bubble Economy* and an invitation to a similar decade-long economic stagnation. This is learning lessons from the past and wielding monetary independence responsibly.

Poor and struggling economies like the Philippines should make the yuan undervaluation an excuse to imitate the strategy (imitation being the sincerest form of flattery). We should be astride the elephant's back rather than chafing under the elephant's hooves. We cannot hope to reproduce the China Miracle but the modest goal of escaping the development progeria of this country would be easier. There is evidence that this is a necessary step is mounting.

A spate of research results in the last decade has come out that confirm the positive undervaluation-growth nexus. 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. Undervaluation raises the profitability and, consequently, the share in GDP of tradables. This has direct bearing on the breakout from development progeria. The novel reason for government intervention in the exchange market 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 tradables than should be. Undervaluation helps level the playing field. Bhalla (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 (2012) also presented evidence that undervaluation boosts growth and does so via faster capital accumulation and investment (Smithian argument of expanding markets). Korinek and Servén (2010) shows that undervaluation boosts growth and productivity via technical change and learning by doing in tradables (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) revisit Rodrik 2008 paper and confirm even with proper corrections that Rodrik was on the money: overvaluation is bad and undervaluation is good for growth. Complementary to these results is one by Prasad, Rajan and Subramanian (2007) that overvaluation caused by foreign exchange inflows tend to hurt manufacturing (the Dutch Disease effect).

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? As observed, Rodrik (2008) breaks new ground by claiming that bad institutions tend to 'tax' tradables more than non-tradables. 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

(Korinek and Servén 2010) than non-tradables and may exhibit more scale economies due to the Baumol Effect (barber shops will never exhibit economies of scale). Undervaluation levels the field for tradables and non-tradables. I prefer the position that 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 be fully appropriated by forex earners at market equilibrium. Thus, a market failure. Undervaluation is a government intervention that remedies this market failure.

However, the switch towards greater exchange rate benignity to tradables remains a collective action challenge. As observed above, the Service sector now constitutes over half of Philippine value added. Overvaluation favors the non-traded goods sector. That huge economic interest led by the banking sector will normally resist it. All the political decision makers whose pay and allowances are in pesos and who like going to Las Vegas for boxing matches will be averted to the move. Fortunately—times, they are changing.

The OFW sector, which contributes upwards of $20-billion to the country's dollar earnings, has become more vocal about the exchange rate. The BPO sector, which adds upwards of $10-billion and promises more under more favorable circumstances are making their presence felt. The BPO, since mid-2011, is hurting because of the massive depreciation (about 25% by August 2012) of the Indian Rupee. However, the greater promise may be in the BSP itself.

A Reason for Hope: A New BSP

Things have begun to change in the BSP in the second half of the last decade. 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 ($76.3-billion plus). This too is a new development in the Philippine economic landscape—the bulging GIR and the BSP seemingly becoming more sensitive to the plight of our forex earners: OFWs and families, merchandise and agricultural export industries, the BPO, and tourism. Since the BSP officially pursues an inflation targeting monetary policy, it must keep inflation within the target band from 3% to 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 Php1.75-trillion of banking sector resources are lodged at risk-free 4.5% interest in lieu of printing paper money. 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 (Php43-45) in the next five years letting the GIR, if need be, rise to $100-billion in the next three years, it will be acting responsibly, breathing more life into our manufacturing and traded goods sector and spurring activity in the investment space. Currently the BSP is asking the central government for capital infusion of Php30-billion to cover its losses. If the losses are incurred to sterilize the inflows to keep the peso from overvaluing, the capital infusion is a good use of the money. If we let the exchange rate slide, we will have to pay that and more as amortization for foreign borrowing to finance the resulting BOP deficit.

The path to undervaluation is no longer 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 does PRC today. Defending the peso from appreciating 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 for that purpose we deploy dollars which we cannot print and can quickly run out of. If the peso-dollar exchange rate is kept at Php42 for ten years 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 slowly dismantles development progeria. I dread to contemplate the failure scenario: seeing yet another batch of Asian neighbors (Vietnam, Kampuchea and Myanmar) whizzing past the Philippines.

It has been our consistent position that both the PRC onslaught and the Dutch Disease pressure from OFW remittance on the traded goods sector could—and should—be countered by a more balanced monetary and exchange rate policy. By "more balanced" is meant more weight given to the composition of output, our catch-up aspiration and incipient asset bubbles. If it is true that the Chinese RMB is artificially undervalued and nobody seriously doubts that, then the appropriate response from a struggling economy like the Philippines is, let me reiterate, not to join the developed countries in the chorus of critics but instead to jump into China's bandwagon by fighting, if not reversing, appreciation. As we know from the theory of the second best, when one player plays hooky with the rules, abidance by others by the rules is no longer Pareto efficient. As for the rest of the world, we can brandish the eminently logical arguments that China offers to defend its RMB policy (see, e.g., Kroeber 2011). It will also serve to level the currency playing field serving as a defensive retaliation to PRC for exporting its unemployment to the Philippines. Moreover, why not, with a little more mettle we can use a measure of exchange rate aggression as a small but effective weapon to avenge the attempted Scarborough Shoals highjack.

Development Entrepreneurship

As documented in Faustino and Fabella (2011) and by Fabella (2011), collective action challenges can many times be hurdled by determined development entrepreneurs—those brokers of collective action who tip the scales in favor of public interest. This genre is motivated less by immediate personal gain than by legacy considerations. These can be persons in the private or public employ or whole organizations that make it their mission to identify and remedy a market or government failure. The task is arduous and often thankless. Most important is that development entrepreneurs know the lay of the land as they must negotiate a political minefield. In the case of the exchange rate collective challenge, the new leadership of BSP seems acting the part.

Summary

In this paper, we employed the concept "development progeria" first proposed by Fabella and Fabella (2012) to put in perspective the sad plight of the Manufacturing sector in particular and of the Tradables sector in general in the Philippines. We showed that in the last quarter century, the Services sector share in total value added rose rapidly while those of the Industry and in particular the Manufacturing sectors retreated. While this is a normal feature of high-income mature economies, it is an anomaly for income-poor countries struggling to catch-up. We call less developed economies displaying such feature development progeriacs. We showed that indeed less developed economies in a sustained rapid growth trajectory (convergent trajectory) display the opposite feature: the Services sector share retreats in the face of gains in the shares of the Industry and the Manufacturing sectors. We showed that the trajectory of the employment shares of the Industrial sectors mimics that of the value added shares: Industry and Manufacturing shares fall while that of the Services sector advance.

We then enquired into the wherewithal of development progeria in the Philippines. We argued that policy option rather than fate is at the root of development progeria. Our contention is that, while there are other factors notably weak institutions and governance, the Philippines' pursuit of a strong peso was contributive to the retreat of Tradables in general and Manufacturing in particular. We revisit two policy episodes in our history in the last quarter century both related to the Philippine central bank. The first was the effort to support the appreciating peso in mid-1990s leading to the encouragement to local business and banks to source their financing requirements from abroad which resulted in heavy dollar exposures and currency mis-matches. It created bubbles in the stock and real estate, which made for artificial prosperity. The Asian Financial Crisis exposed the unsustainable and dangerous nature of the strong peso strategy which in turn effectively aborted the promising Ramos recovery. The second was the attempt to snatch the strong peso from needed depreciation in the mid-1980s that involved the use of the infamous *Jobo Bills* which administered the "interest rate cure." This effectively shrank the real economy in order to fit the massively mis-aligned Philippine peso. What was a disaster for the economy was however a boon for Philippine banks which bought the Jobo bills. The interest rate cure and the strong peso effectively aborted the prospect for the Aquino recovery. In this environment, given other entrenched institutional drawbacks, there was no room for new investments in Tradables and Manufacturing.

We then reviewed the evidence on the relation between weak currencies in stimulating growth. There is now strong evidence that weak currencies (undervalued currencies) make for higher growth. The reason advanced by Rodrik (2008) is that weak currencies compensate for many institutional failures which tend to negatively affect Tradables more than they do Non-Tradables. This levels the playing field for investment in Tradables. Another market failure that undervalued currencies remedy is the public good character of forex reserve: everybody benefits (e.g., the state can borrow at a lower interest rate) with a healthy forex reserve, but which mostly private forex earners cannot appropriate.

Finally, we confront the question of shifting from a strong peso stance to a weak peso stance. In the last 25 years, advocates of the weak peso policy have repeatedly been rebuffed. However, at times they are changing. The new BSP is now less tethered to the interest of the banking sector, more receptive to ideas anathema to the old monetary orthodoxy (exemplified by the SNB's since 2011) and in general more flexible. The Philippines since 2002 has now become a lender to the world rather than being perennially a beggar to the world chained to IMF conditionalities. The Philippines can now say "No" not only to credit offers but also to the worldviews imbedded in them. There is now a greater awareness among the business community of the dangers of the strong peso, the vitality of the Services sector (banking, real estate and retail) now more than ever being tied to the well-being of Tradables (say, the BPO industry demand for office space) and OFW households (demand for low cost housing). There is now a greater awareness of the protective effect of the weak peso especially in deterring smuggling.

Development progeria is not in the genes, unlike its physical counterpart. It can be reversed with the right policies. However, even with the ideal set of policies it will heal only slowly. The fruits will be harvested by our children. Our reward is that we started the healing process. Let us get busy today.

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