

Perspective

by Steve Hanke



Will the Philippine boom continue?



AN ECONOMIST IS “SOMEONE WHO SEES SOMETHING happen and wonders whether it would work in theory,” as Ronald Reagan used to say. The old quip contains a lot of truth. Indeed, economists’ obsessive pursuit of theory has led them into a cul-de-sac, detached from reality.

What’s absent from today’s economic discourse is the concept of consumer and investor confidence in a nation’s government and economy. This wasn’t always the case. As the Cambridge don John Maynard Keynes put it: “The state of confidence, as they term it, is a matter to which practical men pay the closest and most

anxious attention.” Another Cambridge economist of his era, Frederick Lavington, identified confidence as a key component of the business cycle. His 1922 book, *The Trade Cycle*, described the “tendency for confidence to pass into errors of optimism or pessimism,” which triggers booms and busts.

By ignoring the confidence factor, economic theory can lead to wildly incorrect conclusions and misguided policies. Just consider naïve Keynesian fiscal theory—the type presented in textbooks and embraced by most policymakers and the general public. According to Keynesian theory, an expansionary fiscal policy

Ease of Doing Business in the Philippines (178 countries ranked)

EASE OF...	2008 RANK	2007 RANK	CHANGE IN RANK
Doing Business	133
Starting a Business	144	135	-9
Dealing with Licenses	77	75	-2
Employing Workers	122	122	0
Registering Property	86	81	-5
Getting Credit	97	94	-3
Protecting Investors	141	141	0
Paying Taxes	126	129	3
Trading Across Borders	57	52	-5
Enforcing Contracts	113	113	0
Closing a Business	147	147	0

Source: World Bank, *Ease of Doing Business 2008*

(an increase in government spending and/or a decrease in taxes) stimulates the economy, at least for a year or two after the fiscal stimulus. To put the brakes on the economy, Keynesians counsel a fiscal contraction.

A positive fiscal multiplier is the keystone for Keynesian fiscal theory because it is through the multiplier that changes in the budget balance are transmitted to the economy. With a positive multiplier, there is a positive relationship between changes in the fiscal balance and economic growth: larger deficits stimulate growth and smaller ones slow things down.

So much for theory. What about the real world? Suppose a country has a very large budget deficit. As a result, market participants might be worried that a further loosening of fiscal conditions would result in more inflation, higher risk premiums and much higher interest rates. In such a situation, the fiscal multipliers may be negative. Fiscal expansion would then dampen economic activity and a fiscal contraction would increase economic activity. These results would be just the opposite of those predicted by naïve Keynesian fiscal theory.

The possibility of a negative fiscal multiplier rests on the central role played by confidence and expectations about the course of future policy. If, for example, a country with a very large budget deficit and high level of debt makes a credible commitment to significantly reduce the deficit, a confidence shock will ensue and the

economy will boom, as inflation expectations, risk premiums and long-term interest rates decline.

There have been many cases in which negative fiscal multipliers have been observed. The Irish stabilization of 1987-89 is notable. The fiscal deficits that preceded the Irish fiscal squeeze were clearly unsustainable, and risk premiums and interest rates were extremely high. A confidence shock accompanied a tightening of fiscal policy, and with negative multipliers in play, the Irish economy took off. Building on this first burst of confidence and growth, Ireland introduced a host of free-market reforms and has become the so-called Irish Tiger. To accommodate its high growth, Ireland, a traditional exporter of labor, has become a labor importer.

Margaret Thatcher also made a dash for confidence and growth via a fiscal squeeze. To restart the economy in 1981, Thatcher instituted a fierce attack on the British deficit, coupled with an expansionary monetary policy. Her moves were immediately condemned by 364 distinguished economists. In a letter to *The Times*, they wrote a knee-jerk Keynesian response: "Present policies will deepen the depression, erode the industrial base of our economy and threaten its social and political stability." Thatcher was quickly vindicated. No sooner had the 364 affixed their signatures than the economy boomed. People had confidence in Britain again, and Thatcher was able to introduce a long series of deep free-market reforms.

This brings us to the Philippines. President Arroyo came to power in 2001. She had inherited a fiscal mess, the type that is accompanied by negative multipliers. Fiscal consolidation quickly became the order of the day, with the consolidated budget deficit falling from 5.3% of GDP in 2002 to a projected 1% this year. As in the Irish and British cases, a confidence shock and a boom have resulted from Arroyo's fiscal squeeze.

Will the Philippine boom continue? Not without further deep economic reform. At a fundamental level, the Philippine economy is dysfunctional and doesn't produce enough jobs. That explains why it dumps (exports) such a huge portion of its surplus labor force. According to the Commission on Filipinos Overseas, over eight million Filipinos are working in foreign countries. That amounts to 21% of the Philippine labor force, and in 2006 they sent home \$24.7 billion, 56% of Philippine exports.

As further evidence of the long reform road ahead for President Arroyo, consider the results of the World Bank's most recent Ease of Doing Business 2008 (see table). Of the 178 countries included, the Philippines has very poor rankings. Even more troubling is the fact that its rankings have not improved during the past year. If anything, they have deteriorated.

If President Arroyo fails to capitalize on her positive fiscal confidence shock with a credible set of structural reforms, the Philippines will continue to be one of the world's biggest labor dumpers and its economy will remain vulnerable. GA

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